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ESG Briefing Series

Regulating EU and non-EU ESG rating providers: Ready for the new EU rules?

26 February 2024

With the Regulation on ESG rating activities (the **ESG Rating Provider Regulation**), the EU is the first jurisdiction in the world to move to regulate the nascent ESG rating market to facilitate progress towards achieving the net-zero objectives by 2050 while leveraging private finance into activities in line with the objectives of the Green Deal. It aims to address the perceived lack of completeness, standardisation, methodological clarity, and integrity concerning ESG metrics and scores, as highlighted by studies demonstrating the significant inconsistency in evaluation methods and divergence in results.¹ However, it is important to note, that the envisaged regulation primarily focuses on transparency and conflict of interest rules for ESG rating providers, not on the substance and methodology of the ratings themselves.

As the last missing piece of its Action Plan on Sustainable Finance, the European Commission published its initial proposal in June 2023 (the **Initial Proposal**).² While the scope of application and several regulations were highly debated by the co-legislators (European Parliament and Council) until the end, a compromise was reached on a final version of this Regulation on 5 February 2024 (the **Draft Proposal**).³ This is a rather fast adoption in EU policymaking, showing the strong political will that the three EU institutions had to regulate ESG ratings.

In this briefing, we summarize the most important aspects of the Draft Proposal, including background (below [A.]), relevance (below [B.]), scope (below [C.]), authorisation (below [D.]), third-country regimes (below [E.]), transition rules (below [F.]), key requirements for ESG rating providers (below [G.]), in particular the separation requirement (below [H.]), supervision by ESMA (below [I.]) rights of (investors of) rated items and stakeholders (below [J.]) as well as ESG in credit ratings (below [K.]).

¹ Berg/Kölbel/Pavlova/Rigobon, ESG Confusion and Stock Returns: Tackling the Problem of Noise, MIT, June 23, 2023.

² Proposal for a Regulation of the European Regulation and the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities, COM/2023/314 final, 13 June 2023.

³ Proposal for a Regulation of the European Regulation and the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities, and amending Regulation (EU) 2019/2088 - Confirmation of the final compromise text with a view to agreement, 2023/0177(COD), 9 February 2024.



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A. Background

The ESG Rating Provider Regulation is one of many measures to translate the Commissions "Financing Sustainable Growth" action plan of March 2018⁴, aiming to redirect capital flows towards sustainable investments, into concrete legal requirements and has remained the last missing piece until February 2024. It also ties in with international efforts aiming to address the issues of the lack of widely accepted market standards for assessing companies' sustainability performance, in particular the report by the International Organisation of Securities Commissions (**IOSCO**) from November 2021.⁵ However, the ESG Rating Provider Regulation will neither regulate ESG ratings, nor the methodologies used. Instead, it addresses the ESG rating providers themselves.

In terms of content, the ESG Rating Provider Regulation is largely inspired by the existing regulatory regimes of the CRA-Regulation⁶ and the Benchmark-Regulation⁷. In particular, ESMA is also given a preeminent supervisory role for regulating ESG rating providers in the EU, in line with the role it has for supervising Credit Rating Agencies and Benchmark Administrators. Thus, for those who are familiar with these regulations, it offers surprises only where deviations from these blueprints were made in order to achieve political goals and/or compromises.

It is also worth noting that with this Regulation, the European Commission proposed a pioneering global initiative that introduces significant operational requirements, aiming to ensure comparability and reliability of ESG ratings used within the EU. It underscores the importance of transparency in the methodologies utilised by ESG rating providers, while acknowledging stakeholders' concerns that the emphasis on ESG ratings from large ESG rating providers may adversely affect the appeal of ESG ratings from smaller ESG rating providers.⁸ While most in the industry welcome the certainty that this new regime provides, many also underscored the risk of moving too quickly, hindering this market and discouraging the development of EU ESG rating providers. The Commission said that its proposal intended to find the right balance between all these elements – a question that will have to be reassessed once the new Regulation's effects can be measured in a few years.

B. Relevance of ESG Ratings

The general purpose of ratings is to simplify complex information into easily understandable and accessible results. This is particularly important for the complex and uncertain ESG risks and factors, as an individual review of each company would be almost impossible – not only for

retail investors, but also for larger institutional investors and credit institutions.

Typically scored on a scale or points basis, ESG Ratings usually are comparative assessments relative to a peer group rather than absolute values. However, considerable variations exist in the resources and methodologies used. In addition, it is important to differentiate between ESG scores, that rely on quantitative analysis only, and ESG ratings, that blend quantitative models with qualitative insights, often with accompanying analyst reports, thus encompassing an element of analytical judgment or opinion. Still, both will be considered ESG ratings under the broad definition of the Draft Proposal as set out further below in [C.I.]

Unlike traditional credit ratings, which are well-established references on the market, ESG ratings have gained prominence only more recently, owing to their rapidly increasing significance acknowledged by EU legislators, as well as various stakeholders and interest groups. ESG ratings have become indispensable for asset managers and their investment strategies, investors and their investment decisions, due diligence processes in mergers and acquisitions, and also for the affected companies themselves, especially when they influence their refinancing costs.

C. Scope

The Draft Proposal applies to **ESG ratings** (below [I.]) issued by **ESG rating providers operating in the Union** (below [II.]), if none of the highly **debated exemptions** (below [III.]) apply.

I. ESG ratings

ESG rating is defined as:

- an opinion, a score or a combination of both,
- regarding a rated item's profile or characteristics with regard to environmental, social and human rights, or governance factors or exposure to risks or the impact on environmental, social and human rights, or governance factors,
- that are based on both an established methodology and a defined ranking system of rating categories,
- irrespective of whether such ESG rating is explicitly labelled as 'ESG rating', 'ESG opinion' or 'ESG score'.⁹

Due to this broad definition, ratings on single E, S, or G factors as well as sub-components of ESG ratings (e.g.,

⁴ Action Plan: Financing Sustainable Growth, COM(2018) 97 final, 8. March 2018.

⁵ IOSCO, Report on Environmental, Social and Governance (ESG) Ratings and Data Products Providers, 2021.

⁶ Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies

⁷ Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the

performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014.

⁸ Action Plan: Financing Sustainable Growth, COM(2018) 97 final, 8. March 2018 (3.1, Action 6).

⁹ Art 3(1) Draft Proposal.

indicators or input data) can be considered ESG ratings in their own rights, thus also triggering all respective regulatory requirements.

II. ESG rating providers operating in the Union

ESG rating providers are defined as legal persons whose occupation includes (i) the issuance and (ii) the publication or distribution, of ESG Ratings on a professional basis.¹⁰

ESG rating providers are considered to be **operating in the Union** in the following cases:¹¹

- **EU ESG rating providers**, when they issue and publish their ESG ratings on their website or through other means or when they issue and distribute their ESG ratings by subscription or other contractual relationships to certain undertakings¹² in the Union; and
- **Non-EU ESG rating providers**, when they issue and distribute their ratings by subscription or other contractual relationships to these undertakings.

According to this wording, which deviates from the Initial Proposal, the sole issuance and the sole publication or distribution are not sufficient. Instead, a combination of these activities is required, emphasising that providers of ESG ratings are only subject to the EU Rating Regulation where they release their ESG rating into public space. In addition, for EU ESG rating providers established in the Union, issuance and any kind of publication is sufficient, while Non-EU ESG rating providers established outside the Union are only within the scope of the regulation, when they issue and distribute ESG ratings.

III. Debated Exemptions

However, some activities are excluded from the scope, which became the subject of lengthy discussions in the legislative process, such as the provision of private ESG ratings, credit ratings, benchmarks as well as ESG ratings issued by NGOs, EU public authorities and regulated financial undertakings if certain requirements are met.¹³ The most debated exemptions are outlined in more detail below. They concern the provision ESG data (below [1.]) and in-house ratings (below [2.])

1. ESG Data

Lack of data is a frequently referenced problem in the context of ESG regulation. Even if the situation is likely to improve with the gradual application of CSRD¹⁴ reporting in the EU, the provision of raw ESG data is still of great importance. This was already emphasised in the IOSCO report, which referred to both, ESG rating providers and data product providers.¹⁵ While the differentiation between ESG ratings and ESG data is not always straightforward, as the selection and processing of data can also contain elements of subjective judgement, the publication or distribution of data on environmental, social and human rights, and governance factors is excluded from the scope of the Draft Proposal.¹⁶

This particularly concerns ESG information on entities or financial products, relying on proprietary or established methodology (e.g., data sets on emissions and data on controversies that do not contain a rating element).¹⁷ However, the Commission shall present a report on the main findings of an evaluation of this Regulation to the European Parliament and the Council 4 years after entry into force of the Regulation (2028), that shall in particular assess “whether the scope of this Regulation is appropriate to achieve its objectives, including whether providers of data products on environmental, social and human rights, and governance factors should be included in the scope of this Regulation.”¹⁸

2. In-house ratings

The exception for in-house ratings is especially relevant for large asset managers, that are often using or developing their own ESG ratings as a supplement, which is why they argued, that the wholesale adoption of third party ESG ratings and their methodologies might not align with their investment strategies and philosophies.¹⁹ While small or medium-sized asset managers may have limited capabilities and resources available for analysing external ESG ratings or developing in-house ESG ratings and no standing contracts with several ESG ratings or data products providers to gather different perspectives of entities’ ESG profiles for their internal processes, the exemption in the Draft Proposal covers any ESG ratings issued by regulated financial undertakings²⁰ that are used exclusively for internal purposes or for providing in-house or intra group financial services or products issued by:²¹

- **EU-regulated financial undertakings** if (i) the ratings are incorporated in a product or a service, where such products or services are

¹⁰ Art. 3(4) Draft Proposal

¹¹ Art. 2(1) Draft Proposal.

¹² Undertakings that fall under the scope of Directive 2013/34/EU, to undertakings that fall under the scope of Directive 2004/109/EC or to Union institutions, bodies, offices and agencies or Member State public authorities.

¹³ Art. 2(2) Draft Proposal.

¹⁴ Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting.

¹⁵ IOSCO, Report on Environmental, Social and Governance (ESG) Ratings and Data Products Providers, 2021, p. 10 et seq.

¹⁶ Art. 2(2), lit. c Draft Proposal.

¹⁷ Rec. 15h Draft Proposal.; ESMA, Guidelines on the Scope of the CRA Regulation, Rec. 13 for credit ratings.

¹⁸ Art. 49 Draft Proposal.

¹⁹ IOSCO, Report on Environmental, Social and Governance (ESG) Ratings and Data Products Providers, 2021, p. 27.

²⁰ Cf. the extensive list in Art. 3(5) Draft Proposal.

²¹ Art. 2(2) lit. b Draft Proposal.

already regulated under Union law;²² and (ii) are disclosed to a third party;

- **Non-EU-regulated financial undertakings which are not authorised or recognised** if (i) the ESG rating is distributed at the own exclusive initiative of the user established in the Union without any prior contact, solicitation, promotion, advertisement or any other initiative by the ESG rating provider, or by any third party on behalf of the provider; and (ii) there is no substitute for the ratings offered by any ESG rating provider authorised under this Regulation.

3. Authorisation Requirement

ESG rating providers established within the Union will be required to obtain authorisation before commencing their operations.²³ This involves an application for authorisation to the European Securities and Markets Authority (**ESMA**), with the content of the application specified in Annex I to the ESG Rating Regulation and technical regulatory standards to be developed by ESMA within 9 months after its entry into force.²⁴ Upon receipt of the application, ESMA is required to review its completeness within 25 working days and inform the applicant of the outcome within this timeframe.²⁵ Subsequently, within an additional period of 90 days following this notification, which may be extended to 120 days under certain conditions,²⁶ ESMA must render a substantive decision on the application for authorisation.²⁷

Small and medium-sized ESG rating providers may commence their activities without prior authorisation, provided they notify ESMA and are subsequently registered.²⁸

To provide the public with easy, centralised access to relevant information, information on authorised ESG ratings and providers will have to be made available on the European Single Access Point (**ESAP**),²⁹ a centralized digital platform that facilitates streamlined access to financial and non-financial company information across European Union Member States that will be implemented until 10 July 2027.³⁰

D. Third-country Regimes

The regulation applies to all providers of ESG ratings, regardless of whether they are based in the EU or not. Non-EU ESG rating providers may operate in the EU on the basis of equivalence (below I.), endorsement (below II.) or recognition (below III.). The Commission shall evaluate

the adequacy of these regimes within 3 years from the date of entry into force of this Regulation.³¹

I. Equivalence

First, Non-EU ESG rating providers will get market access to the Union, if they are established in a third country, for whom the Commission has adopted an equivalence decision and ESMA has concluded an effective cooperation agreement with its competent authorities.³²

Equivalence is particularly indicated if the legal framework and supervisory practice of a third country ensure compliance with the IOSCO recommendations.³³

The relevance of the equivalence regime should, however, be limited, as there are currently rarely any countries with regulatory regimes for ESG rating providers.

II. Endorsement

Second, ESG ratings from Non-EU ESG rating providers may be issued and distributed in the EU, where an EU ESG rating provider of the same group has endorsed its ESG ratings, provided that several requirements are met:³⁴

- The EU ESG rating provider applied to ESMA for **authorisation** of such endorsement and fulfils a number of indicators of **minimum substance**;
- The endorsement of the ESG rating does **not impair the quality of the assessment** of the rated entity or the arrangement of on-site reviews or inspections, where provided for in the ESG rating methodology used by the ESG rating provider;
- The EU ESG rating provider has verified and is able to demonstrate on an ongoing basis to ESMA that the issuance and distribution of endorsed ESG ratings fulfils **requirements which are at least as stringent** as the requirements of the EU Rating Regulation;
- The EU ESG rating provider has the **necessary expertise to effectively monitor** the ESG ratings of the Non-EU ESG rating provider, to manage any associated risks;
- There is an **objective reason** why the ESG ratings have to be endorsed for their use in the Union (e.g., the specificities of the ESG ratings, the need for proximity of the production of the ESG ratings to the issuer or to specific economic reality, a particular industry, centres of excellence for sub-components of ESG factors, the availability of specific skills required for the

²² Including under Regulation (EU) 2019/2088, Directive 2013/36/EU, Directive 2014/65/EU, Directive 2009/138/EU, Directive 2009/65/EC, Directive 2011/61/EC, Directive 2016/2341/EU, Regulation 883/2014, Regulation (EU) 2020/1503, Regulation (EU) 2023/1114, Regulation 2016/1011/EU.

²³ Art. 5(1) Draft Proposal.

²⁴ Art. 5(2) Draft Proposal.

²⁵ Art. 6(1),(2) Draft Proposal.

²⁶ Art. 6(4) Draft Proposal.

²⁷ Art. 6(3) Draft Proposal.

²⁸ Art. 4a(1) Draft Proposal.

²⁹ Art. 13(1) Draft Proposal.

³⁰ Art. 1(1) Regulation (EU) 2023/2859 of the European Parliament and of the Council of 13 December 2023 establishing a European single access point providing centralised access to publicly available information of relevance to financial services, capital markets and sustainability.

³¹ Art. 49(2) Draft Proposal.

³² Art. 9 (1) Draft Proposal.

³³ Rec. 9 Draft Proposal.

³⁴ Art. 10(1) Draft Proposal.

production of the ESG ratings, the material availability of input data and the development of ESG ratings through the collaboration of global teams). While in the context of the Benchmark Regulation, additional reasons like habit, unavailability of EU-based alternatives, client demand or market power are considered objective as well, pure considerations of cost savings are unlikely to suffice.

Within 45 working days of receipt of the complete application for endorsement, but no later than 85 working days of receipt of the initial application, ESMA shall examine the application, decide either to authorise the endorsement or to refuse it and inform the applicant within 5 working days of its decision.³⁵

However, as a separate application and authorisation is required for each ESG rating to be adopted, a considerable effort is still required for the intra-group adoption of ESG ratings from third countries.

III. Recognition

The recognition regime is generally aiming to benefit smaller ESG rating providers.³⁶ It allows Non-EU ESG rating providers to operate in the Union, if:

- The Commission has **not yet adopted or repealed an equivalence decision**;³⁷
- The Non-EU ESG rating providers (consolidated) **annual net turnover** of all its activities is **below EUR 12 million** for the latest three consecutive years;³⁸
- The Non-EU ESG rating provider applied to ESMA for **authorisation** of such recognition;³⁹
- The Non-EU ESG rating providers has a legal representative, i.e., a legal person located in the Union and expressly appointed by that ESG rating provider to act on its behalf, demonstrating and being accountable to ESMA that the ESG rating provider meets the obligations laid down in this Regulation on an ongoing basis.⁴⁰

E. Transition Rules

In order to avoid cliff-edges for those currently offering ESG ratings and to ensure continuity, ESG rating providers may continue offering and distributing ESG ratings in the EU while awaiting ESMA's authorisation or third country regime decision, if they were providing their services at the time the ESG Rating Provider Regulation came into force, and inform ESMA within 19 months from its entry into force whether they wish to continue offering their services. In addition, they need to apply for authorisation or the

respective third-country regime within 4 months of the Regulation coming into force.⁴¹

Small ESG rating providers benefit from a prolonged period of 22-month from the ESG Rating Provider Regulation entering into force to apply for authorisation.⁴²

F. Key Requirements

Following the approach of the CRA-Regulation and Benchmark-Regulation, the EU Rating Provider Regulation does not interfere with the substance of ESG ratings, or the methodologies used. Instead, it outlines organisational requirements (below [I.]), regulations to prevent conflicts of interest (below [II.]), and disclosure requirements (below [III.]).

I. Organisational Requirements:

To ensure the quality of ESG ratings, the regulation establishes open, principles-based organisational requirements that are typical of EU financial market regulation.⁴³

Notably, other than in the Initial Draft inspired by the CRA Regulation,⁴⁴ ESG ratings only have to be **capable of justification and transparent**, not capable of validation.⁴⁵ This accounts for the fact that ESG ratings are not designed to forecast the exact timing or manner in which ESG factors and risk will manifest. Instead, ESG risks can swiftly emerge and become material in an unpredictable manner, rendering any attempt to mandate validation unsuitable.

Surprisingly, ESG rating providers shall not disclose information about their intellectual capital, intellectual property, know-how or the results of innovation that would qualify as **trade secrets**,⁴⁶ although such a provision is not necessary to protect the objectives of the proposed regulation. This is unusual, as companies are generally, free to choose whether or not they disclose details of their trade secrets within the boundaries of antitrust law.

These requirements are complemented by requirements for record-keeping⁴⁷ and regarding outsourcing.⁴⁸

II. Conflicts of Interest

Conflicts of interest among ESG rating providers are a central focus of the ESG Rating Provider Regulation. They can stem from various causes but are often exacerbated by the fact that ESG ratings (similarly to credit ratings) are typically paid for by the entity commissioning the rating. To prevent this:

³⁵ Art. 10(3) Draft Proposal.

³⁶ Rec. 17 Draft Proposal.

³⁷ Art. 11(1) Draft Proposal.

³⁸ Art. 11(1) Draft Proposal.

³⁹ Art. 11(2) Draft Proposal.

⁴⁰ Art. 11(3) Draft Proposal.

⁴¹ Art. 48 (1) Draft Proposal.

⁴² Art. 48(2) Draft Proposal.

⁴³ Art. 14 Draft Proposal.

⁴⁴ Art. 8(3) CRAR.

⁴⁵ Art. 14(7) Draft Proposal, in line with IOSCO, Report on Environmental, Social and Governance (ESG) Ratings and Data Products Providers, 2021, p. 50, 52, Rec. 2, 7.

⁴⁶ Art. 4(12) Draft Proposal.

⁴⁷ Art. 17 Draft Proposal.

⁴⁸ Art. 19 Draft Proposal.

- Measures shall be taken to ensure that conflicts of interest do not arise in decision-making processes, both within the institution itself and among institutions within the same group;
- Employees directly involved in the assessment process of a rated item are prohibited from engaging in certain activities;
- Requirements for identifying risks of conflicts of interest within an ESG rating provider (e.g., through ownership structures, controlling interests, activities of the provider or affiliates). In such cases, ESMA may require the provider to implement measures to mitigate these risks;
- Notably, the mechanism of an independent oversight function, as in the Benchmark Regulation,⁴⁹ but not in the CRA-Regulation, was deleted in the Draft Proposal. This would have been an unpopular regulation for ESG rating providers, as the implementation of an oversight function that can influence the ratings business in a meaningful way without interfering with the competences of the management bodies of ESG rating providers and the tasks of the internal oversight function could have proved difficult given the large number of potential rating users with conflicting interests.

This is flanked by rules aimed at avoiding conflicts of interest between the rated items and the analysts, employees, and other individuals involved in issuing ESG ratings (e.g., through role separation and a cooling-off period of six months after issuing a rating, during which individuals may not hold key positions in the senior management of a rated company).⁵⁰

Once again, small ESG rating providers can benefit from a lighter regime, applying only basic requirements, such as certain organisational and transparency requirements, while being particularly exempted from the remaining requirement. In addition, ESMA's instruments towards small ESG rating providers are limited to information requests and periodic penalty payments.⁵¹

III. Disclosure Requirements

To enhance the transparency of ESG ratings, the Draft Proposal introduces extensive disclosure requirements.⁵² They include the provision of a comprehensive overview of the rating methods and data processes used, including naming data sources such as sustainability disclosures under the CSRD in a clear and transparent manner and identified in a separate section of the ESG rating provider's website. Further details on disclosure obligations will be outlined in technical regulatory standards (*RTS*) to be developed by ESMA. The obligation to disclose methodologies, rather than regulating the preparation of

the methodologies themselves, is well-known, e.g., from the SFDR website disclosure.⁵³

In order to increase transparency, ESG ratings are required to have a certain level of granularity:⁵⁴

- **Separate E, S and G ratings** shall be provided rather than a single ESG metric that aggregates E, S and G factors; and
- ESG rating providers shall provide the **disclosures**⁵⁵ separately for each factor.

Single ESG ratings that aggregate E, S and G factors may only be provided, if they include the information on the weighting of the three overarching ESG factors categories (e.g., 33% Environment, 33% Social, 33% Governance), and an explanation of the weighting method, including weight per individual E, S and G factors.⁵⁶ This requirement was introduced by the European Parliament into the legislative process. Indeed, the French Socialist lead MEP Aurore Lalucq was particularly keen to ensure that "rating providers should also refrain from aggregating the E, S and G scores, as this could obscure poor performance on any of these individual metrics" and lead to situations where company with poor social practices, but stellar environmental performances get a very good ESG rating.

G. Separation Requirements

One of the most debated rules in the Draft Proposal is the requirement to separate the provision of ESG ratings from certain other activities, that aims to prevent conflicts of interest.⁵⁷

However, the prohibition was softened in the Draft Proposal. If certain requirements, depending on the activity, are met, ESG rating providers may:

- Provide **investment services** and activities of **credit institutions, and (re-)insurance** if they put in place specific measures,⁵⁸
- Develop **benchmarks**, provided that they put in place specific measures, and obtain an additional authorisation by ESMA.⁵⁹

For **consulting** activities to investors or undertakings, the **issuance and distribution of credit ratings, statutory auditing** on financial statements and **assurance engagements** on sustainability reporting, however, no exceptions apply. This could force some ESG rating providers to shift business units into separate entities if they want to continue providing these activities.

This is flanked by the requirement, that employees who are directly involved in the assessment process of a rated item may not provide consulting activities, the issuance and distribution of credit ratings and statutory auditing on financial statements and assurance engagements on sustainability reporting.⁶⁰

⁴⁹ Art. 4(3) BMR.

⁵⁰ Art. 16(2),(8) Draft Proposal.

⁵¹ Art. 4a(a) Draft Proposal.

⁵² Art. 21 Draft Proposal.

⁵³ See Art. 10(1)(b) SFDR.

⁵⁴ Art. 21(1a) Draft Proposal.

⁵⁵ Referred to in Artt. 21 et seq. Draft Proposal.

⁵⁶ Art. 21(1b) in conjunction with Annex III(1) lit. f Draft Proposal.

⁵⁷ Art. 15(1) Draft Proposal.

⁵⁸ Including those referred to in Artt. 23 and 24; Art. 15(1a) Draft Proposal.

⁵⁹ Art. 15(1b) Draft Proposal.

⁶⁰ Art. 15(1c) Draft Proposal.

Small ESG rating providers are exempted from the separation requirement.⁶¹

ESMA is mandated to develop RTS to specify the measures to ensure the avoidance of conflict of interest and autonomy only 9 months after the date of entry into force of the ESG Rating Regulation.⁶²

H. Supervision by ESMA

Unlike the supervision of administrators of (EU-critical) benchmarks,⁶³ where responsibilities are divided between ESMA and national supervisory authorities, the oversight of ESG rating providers mirrors that of (credit) rating agencies.⁶⁴ Thus, as already supported by ESMA in its 2022 Call for Evidence on ESG ratings,⁶⁵ the Draft Proposal assigns ESMA direct authority of and supervision over ESG rating providers.

ESMA will have the power to grant or deny authorisation based on regulatory criteria⁶⁶ and will subsequently oversee these providers through inspections, information requests,⁶⁷ and imposing fines for non-compliance (up to 10% of the total annual turnover of the ESG rating provider),⁶⁸ as well as periodic penalty payments to ensure compliance with the Regulation.⁶⁹

I. Rights of rated items and stakeholders

Given the common "subscriber-pay" model, there is generally no specific incentive for ESG ratings providers to engage meaningfully with companies. For instance, in 2021, a majority of respondents noted a lack of interaction between companies and ESG ratings or data product providers before the publication of final reports.⁷⁰ This lack of interaction limits companies' ability to verify the accuracy of the final report's content, preventing them from addressing factually incorrect or insufficient information in a timely manner. This is particularly problematic when investors receive the final report before companies do, potentially exposing companies to reputational risks and leading to uninformed investment decisions based on erroneous or limited information.

The ESG Rating Provider Regulation responds to this issue with transparency (below [I.]) as well as complaint (below [II.]) and concern mechanisms (below [III.]):⁷¹

I. Transparency

ESG rating providers are, upon request, required to provide more transparency to subscribers of ESG ratings and (investors of) rated items than to the general public.⁷² This aims to ensure greater reliability of the ESG ratings,

by giving the (issuers of) rated items the possibility to particularly verify the data used by the ESG rating provider and highlight any factual errors that could potentially impact the quality of future ratings. However, this stipulation is to be understood as a pure fact checking tool, not as a means to influence the rating methodologies or rating outcome in any manner. In addition, ESG rating providers that have a contractual relationship with the (issuer of the) rated item are required to notify it during its working hours and at least two full working days before the first issuance of the ESG rating. This notification requirement, however, only applies before the first issuance of the rating (and not to any following updates).⁷³

II. Complaints from (investors of) rated items

Due to the relative novelty of ESG ratings and the existing divergence in their results, along with their significant impact on rated companies, ESG ratings bear considerable potential for conflicts between the ESG rating providers and the (investors of) rated items or other stakeholders.

Following the blueprint of the Benchmark Regulation,⁷⁴ the ESG Rating Provider Regulation counters this by requiring ESG rating providers to implement complaint handling mechanisms (i.e., procedures for receiving, investigating, and retaining records of complaints from users of ESG ratings and (issuers of) rated items).⁷⁵ These may concern (a) sources of data used for a specific ESG rating, factual errors, and mistakes; (b) application of the rating methodology for a specific ESG rating; and (c) whether a specific ESG rating is representative of the rated item or issuer of the rated item⁷⁶ and must be published with clear information on the ESG rating providers website.

While a specific complaints handling process may address ESG ratings' shortcomings, the requirement to engage in complaints regarding their complex and proprietary ratings determination process is a considerably stricter regulation for ESG rating providers compared to that of credit rating agencies, although the ESG Rating Provider Regulation is essentially to be understood as a proportionate, lighter touch regime.

III. Reasoned concerns of stakeholders

ESG rating providers shall have in place procedures for receiving reasoned concerns from stakeholders, providing their names and position. ESG rating providers (except smaller ESG rating providers) shall endeavour to reply to the reasoned concerns within 30 working days.⁷⁷

⁶¹ Art. 4a(a) Draft Proposal.

⁶² Art. 15(1d) Draft Proposal.

⁶³ Art. 37 BMR.

⁶⁴ Art. 21 CRAR.

⁶⁵ ESMA, Call For Evidence on market characteristics for ESG Rating Providers in the EU, ESMA22-328-603, 3 February 2022 p. 4.

⁶⁶ Art. 7 et seq. Draft Proposal.

⁶⁷ Artt. 30-32 Draft Proposal.

⁶⁸ Art. 34 Draft Proposal.

⁶⁹ Art. 35 Draft Proposal.

⁷⁰ IOSCO, Report on Environmental, Social and Governance (ESG) Ratings and Data Products Providers, 2021, p. 30.

⁷¹ IOSCO, Report on Environmental, Social and Governance (ESG) Ratings and Data Products Providers, 2021, p. 30.

⁷² Art. 22, Annex III No. 2 Draft Proposal.

⁷³ Art. 14(11a), Rec. 12 Draft Proposal.

⁷⁴ Art. 9 Draft Proposal.

⁷⁵ Art. 18 Draft Proposal.

⁷⁶ Art. 18 (2a) Draft Proposal.

⁷⁷ Art. 18a Draft Proposal.

However, the Draft Proposal provides no further information on the question when a concern is to be considered reasonable.

J. ESG in Credit ratings

While the comparably new ESG ratings specialise in assessing the "sustainability" of companies, the well-established credit ratings assess the default risk of a company, which can be influenced by ESG factors and risks through various transmission channels.⁷⁸

The established credit rating agencies are already attempting to incorporate ESG risk factors into their credit models to the extent that they believe they impact the creditworthiness of borrowers, especially regarding climate risk. However, further legislative clarification is not to be expected in this context, since neither the competent authorities nor any other public authorities of a Member State shall interfere with the content of credit ratings or methodologies⁷⁹ and ESMA has opposed a proposal of the European Commission to amend the CRAR to explicitly require rating agencies to incorporate ESG factors into their ratings.⁸⁰

The European Banking Authority (**EBA**) expects that ongoing efforts to integrate ESG aspects into rating creation will lead to efficient risk differentiation within the existing framework over time,⁸¹ although the specific methods to include ESG risks and factors currently vary significantly among rating agencies, methodologies, and asset classes. If ESG factors have significantly contributed to a rating or rating outlook change, as presented and disclosed by rating agencies, ESMA expects the agencies to publish further information on this in accompanying press releases or reports.⁸²

K. Outlook

The ESG Rating Provider Regulation shall apply from 18 months after its entry into force, which we expect to be between Summer and Autumn of 2024.

It was one of the final missing pieces for the European Commission to deliver on its sustainable finance commitments outlined in its Action Plan, thus closing the current set of deliverables envisaged.

⁷⁸ Cf. EBA, Discussion paper on the role of environmental risk in the prudential framework, EBA/DP/2022/02, 2 August 2022 p. 17 et seqq.





⁷⁹ Art. 23 CRAR.

⁸⁰ ESMA Technical Advice to the European Commission on Sustainability Considerations in the credit rating market, ESMA 33-9-321, 18 July 2019.

⁸¹ EBA, Discussion paper on the role of environmental risk in the prudential framework, EBA/DP/2022/02, 2 August 2022 p. 30 et seq.

⁸² ESMA Technical Advice to the European Commission on Sustainability Considerations in the credit rating market, ESMA 33-9-321, 18 July 2019 p. 32.

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