Dear Commissioner, Dear Mairead,

In light of the upcoming Renewed Sustainable Finance Strategy (RSFS), I would like to take this opportunity to share ESMA’s views on one of the key challenges that we see in the area of sustainable finance which we consider requiring further attention. Specifically, I would like to address the unregulated and unsupervised nature of the market for “ESG” ratings and ESG assessment tools and the need to match the growth in demand for these products with appropriate regulatory requirements to ensure their quality and reliability.

This issue is linked with the more pervasive one of data quality in the area of sustainable finance in relation to which ESMA strongly supports the Commissions’ efforts to improve the quality of reported information through various initiatives, most notably the review of the Non-Financial Reporting Directive (NFRD), the Regulation on Sustainability-Related Disclosures (SFRD) in the financial services sector, and the disclosure requirements under the Taxonomy Regulation.

In many ways, the increased relevance of ESG ratings has arisen as a result of positive developments in other areas of legislative attention, particularly the requirement for market participants to take more systematically ESG factors into account in their investment decisions and risk management processes. However, we consider that increasing demand for assessments that provide insights on an entity’s ESG profile should go hand in hand with safeguards that ensure the information referred to is robust and that the assessments are reliable so to prevent the risk of green-washing.

Importantly, global sustainable investing has gained very significant traction in recent years, with estimates putting the total value of assets following sustainable investing strategies at
EUR 37 trillion in 2019\(^1\), including more than EUR 2.5 trillion in institutional assets tracking ESG ratings and assessments\(^2\).

**Main issues and scope**

ESMA has already taken the opportunity to highlight some of these issues in its response to the Commission’s consultation on the Renewed Sustainable Finance Strategy. In this response, we raised specific points in relation to ESG ratings, such as the lack of a legally binding definition and comparability among providers of ESG ratings or legal requirements to ensure transparency of underlying methodologies of such ratings. In addition, we highlighted concerns around protection against conflicts of interest that may arise in the business models of these providers. As a result, the risks of capital misallocation, product mis-selling and greenwashing are high while, at present, there are no appropriate legal tools to address these issues.

The existing literature on the topic shows that these issues are not trivial. Compared with credit ratings, ESG ratings display very low levels of correlation across providers, leading to issues down the investment value chain\(^3\). ESMA’s forthcoming analysis shows indeed that this is problematic in the context of ESG benchmark construction, with the choice of ESG rating provider significantly impacting the constituents of those indices. Considering current growth trends in Europe in sustainable investing and passive investment products such as ETFs, measures aiming to reduce the risk of capital misallocation will become crucial to facilitate the transition to a more sustainable financial system. Similarly, the fact that companies in highly polluting industries can obtain high environmental scores from some ESG rating providers\(^4\) can lead to investor confusion and highlights the need for greater transparency and the development of standardised definitions.

In this context, we believe it would now be useful to provide you with more detail on how these issues could be addressed through a legislative proposal. However, before going further, allow me to say that we fully appreciate the difficulties that preparing such a legislative proposal would present. The market for ESG ratings and assessments is complex and still developing. The industry is going through a simultaneous process of innovation on the products side and consolidation on the providers side. For instance, in line with the absence of a regulatory definition of ESG ratings, estimating the number of firms in the market for ESG ratings is challenging. Regardless of its actual size, the industry has experienced significant

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\(^{1}\) JP Morgan 2020

\(^{2}\) The Economist “Climate change has made ESG a force in investing”, 5 December 2019


\(^{4}\) Boffo, R., C. Marshall and R. Patalano (2020), “ESG Investing: Environmental Pillar Scoring and Reporting”, OECD Paris: www.oecd.org/finance/esg-investing-environmental-pillar-scoring-and-reporting.pdf For example, a broad definition that covers the full spectrum of possible ESG assessments would be appropriate if it were narrowed to those that are issued using a defined ranking system of rating categories: ESG rating means an opinion regarding an entity, issuer, or debt security’s impact on or exposure to ESG factors, alignment with international climatic agreements or sustainability characteristics issued using a defined ranking system of rating categories.
consolidation in recent years. This has often consisted of large companies buying their way into the market.

As such, any actions in this area need to be carefully calibrated to capture the broad spectrum of existing product offerings, while at the same time ensuring that future innovations do not fall out of scope. Likewise, any regulatory action needs to be proportionate to accommodate both large multi-national providers which may be subject to existing regulatory frameworks, as well as those smaller entities that have no such experience of regulatory compliance but have a valuable role to play in the further development of this industry.

Given this context, allow me to provide some thoughts from our side on what possible actions could be taken to address these issues in an effective and proportionate manner.

**Potential future legal framework**

First, a common legal definition should be developed for an ESG rating that captures the broad spectrum of assessment tools that are currently available in the market. This would ensure that all existing products that aim to provide an assessment of the ESG profile of an issuer or a security, regardless of the specific measurement objective, are subject to the same basic level of investor protection safeguards. At the same time, a broad approach to defining these products would future-proof this regulatory framework regarding subsequent innovations and prevent possible re-structuring opportunities to circumvent requirements. It would therefore minimise the possibility of obsolescence for the framework should the market move in a specific direction. As already mentioned in our response to the RSFS consultation, in setting up any definitions in this area it will be important to ensure consistency with definitions across other areas of EU capital markets and sustainable finance legislation, including the Taxonomy Regulation.

Second, any legal entity whose occupation includes the issuing of these ESG ratings and assessments should be required to be registered and supervised by a public authority. This would ensure that these gatekeepers of ESG ratings and assessments are subject to a common core of organisational, conflict of interest and transparency requirements.

Third, in addition to these core requirements there should be specific product requirements applicable to the ESG ratings and assessments provided by that entity. These should not necessarily be of the same level of prescriptiveness as those applicable to credit ratings. However, they should be sufficiently stringent to ensure that ESG ratings and assessments are based on up to date, reliable and transparent data sources, and developed according to robust methodologies that are transparent and open to challenge by investors.

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Finally, any regulatory framework in this area should ensure that larger more systemic entities are subject to a full suite of organisational and conflict of interest requirements that reflect their growing importance in sustainable finance. At the same time, it should be proportionate and adapted to the current market structure to ensure that smaller entities are eligible for certain exemptions from the most resource intensive elements, when this is appropriate (e.g. potential relief from supervisory fees and selected organisational elements). This will allow participation in the market both by well-resourced incumbents as well as the more dynamic start-ups that drive innovation.

We consider that the legal framework for ESG ratings and assessments described above would be suitable to address the risks of greenwashing, capital misallocation, conflicts of interest and product mis-selling that may arise in the future. To a large degree, these proposals have been inspired by the requirements of the CRA Regulation, as there are clear parallels between the processes of ESG and CRA rating providers and the objectives pursued by that Regulation. In addition to these elements, we would encourage further consideration be given to how any regulatory framework could accommodate ESG ratings and assessments elaborated outside the EU. On this point again we believe the CRA Regulation could be an informative starting point.

Registration and Supervision

As a final point, we note the high level of consolidation in the market for ESG ratings and ESG rating providers, which often belong to larger groups providing services such as green bond certifications and credit ratings. Given this market structure and the overlap with our existing mandate for CRAs, ESMA can see merits in being the authority entrusted with direct supervisory responsibilities for these actors. On a basic level, it would ensure economies of scale for supervisory resourcing and would have the benefit for the wider industry of avoiding different regulatory or supervisory mandates.

I hope that these considerations are useful for the European Commission when finalising the RSFS and deciding on the new legislative initiatives. We would be happy to provide further views on this topic, as needed.

Yours sincerely,

[signed]

Steven Maijoor