[Targeted Consultation on the Functioning of the ESG Ratings Market in the European Union and on the Consideration of ESG Factors in Credit Ratings]

ICI Response – Submitted 6 June 2022

SECTION I: Use of ESG ratings and dynamics of the market

3. Questions for all respondents

Do you consider that the market of ESG ratings will continue to grow?

- Yes
- No
- No opinion

If you responded 'yes' to the previous question, to what extent do you expect the following factors to be decisive, on a scale from 1 (not at all) to 10 (very much)?

- Growth in demand from investors in ratings of companies for their investment decisions
    - 6
- Growth in demand from companies in ratings including on rating future strategies
- Further standardisation of information disclosed by companies and other market participants
    - 10 (very much)
- Other
    - 5

If you responded 'other' to the previous question, please specify the other reasons you see for this market to continue to grow

- Further development and innovation of approaches and methodologies to assess sustainability characteristics

Comment:

ICI Global appreciates the opportunity to provide feedback on the European Commission's *Targeted Consultation on the Functioning of the ESG Ratings Market* ("the Consultation"). ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated investment funds. With total assets of $41.3 trillion, ICI's membership includes mutual funds, exchange-traded funds (ETFs), and UCITS and other funds offered to investors in Europe. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. In addition, ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds and their managers, who are users of ESG ratings and data products.

As noted in ESMA's *Call for Evidence on Market Characteristics for ESG Rating Providers in the EU* (February 2021), the role of ESG ratings and data providers in the financial market is growing and this reflects, on one side, a strong demand for ESG investment products and, on the other side, increased regulatory requirements on asset management and corporate disclosures. In the European Union, ICI members use the services of the ESG ratings and data providers for a variety of reasons. ESG data can help fund managers meet regulatory disclosure requirements, including under the Sustainable Finance Disclosure Regulation (SFDR). As global advisers to UCITS, mutual funds, ETFs and closed-end funds, our members may use third-party ESG ratings as one input among many that inform investment analyses.

The growth and evolution of the ESG ratings and data market will continue alongside the growth of sustainable investing, improvement and availability of data reported by companies, and the development of innovative sustainable investment strategies aimed at meeting the wide variety of investor preferences.

Ultimately, we believe that improvements to market practices of ESG ratings and data providers are needed. As a first step, these improvements can be addressed by principles-based industry standards, such as a code of conduct, to help drive convergence around best practices in the industry. Any intervention taken should allow for the continued growth and evolution of this space, and we caution against differentiating between ESG ratings and data products.

ICI agrees with the definition of ESG ratings provided, but we strongly encourage the Commission to clarify that the definition of ESG ratings includes only commercial ESG ratings intended for sale to third parties, and excludes ESG assessments that asset managers may develop internally for their own use.

SECTION II: Functioning of the ESG ratings market

Do you think the current level of correlation between ratings assessing the same sustainability aspects is adequate?

- Yes
- No
- No opinion

Please explain your answer:

One of the most significant recent global financial trends is the increasing investor interest in sustainable investing. The fund industry is responding to this increased interest by, among other things, creating new funds that explicitly tailor their investments to specific ESG criteria. Continued innovation in the fund industry reflects the increasing array of clients' sustainable investing objectives. In tandem, the ESG ratings market is developing and includes a diverse range of providers and products covering aggregated ESG assessments as well as analyses of individual E, S and G issues, using different approaches. This diversity of views, independent methodologies, innovation, and competition is beneficial to the markets and investors.

ESG ratings are opinions, just like the buy/hold/sell opinions that are commonplace among sell-side analysts. An ESG rating illustrates the subjective opinion of one rating provider. Similar to the financial outlook of sell-side analysts, ESG ratings on a particular sustainability aspect may vary dramatically depending on the underlying data and methodology used to formulate the opinion. This variation is healthy and necessary in the ESG space, given that there is no one-size-fits-all way to measure sustainability. Even using the example of one measurable sustainability aspect, such as carbon emissions, there are different ways to rate a company. For example, a rating focused on carbon emissions could reflect how the company compares to others within its sector, or alternatively how it compares to companies of a similar size across numerous sectors. The rating could be based on Scope 1 or Scope 2 carbon emissions, and may or may not take into account the use of any carbon credits or offsets.

Transparency to users of ESG ratings is key. While there may be good reasons for ratings to vary due to differences in focus, methodology, and sources of data, transparency about these features is crucial for asset managers to understand why providers may arrive at different ratings for the same companies. Asset managers must be able to understand the product's intended purpose, including its objective and methodology, in order to determine whether the ESG rating would meet the manager's specific needs. Moreover, ESG ratings providers should be willing and able to explain how they arrived at a particular company's rating so that the asset manager can understand why a company may have different ratings among different providers.

Additionally, consistency in applying the same methodology within an offered rating product is important. ESG ratings providers should be transparent about any written policies and procedures that ensure internal methodologies are applied consistently. ESG ratings and data providers should be able to balance the need to provide users with sufficient transparency with the need to protect intellectual property and proprietary information.

How much do you consider each of the following to be an issue, on a scale from 1 (no issue) to 10 (very significant issue)

- There is a lack of transparency on the methodology and objectives of the respective ratings
    - 6
- The providers do not communicate and disclose the relevant underlying information
    - 6
- The providers use very different methodologies
    - 1 (no issue)
- ESG ratings have different objectives (they assess different sustainability aspects)
    - 1 (no issue)
- Other issue(s)
    - 7

If you responded 'other issue' in the previous question, please explain which one(s)

- There is a lack of transparency on basic features of ESG ratings products, such as the product coverage, and timing and frequency of data collection

Comment:

As we noted in the response to the previous question, the use of different methodologies is healthy and necessary in the ESG space, given that there is no one-size-fits-all way to measure even one sustainability aspect. Likewise, we think the variety of ESG ratings reflecting different sustainability aspects is positive and aligns with the variety of sustainability-related funds and strategies being developed and offered to meet investor preferences.

We believe that transparency from ESG ratings providers to users of those products about methodology, objectives, and underlying data should be improved. Additional transparency around methodology and specific objectives of the ratings products would be beneficial to investors to understand what is being rated, and how. For example, it is often unclear whether a rating is intended to assess risks to a company due to climate change or other environmental and social factors (*i.e.*, to inform integration of ESG risks), or if it is an assessment of the company's impacts on external environmental or social factors (*i.e.*, to inform impact investing strategies). Additionally, access to raw data is essential to investors' understanding of company sustainability features and how the ratings can inform their investment analysis.

As an important first step, we support the concept of an industry code of conduct for ESG ratings and data providers that could be developed using IOSCO's November 2021 recommendations.

Do you consider that a variety of types of ESG ratings (assessing different sustainability aspects) is a positive or negative feature of the market?

- Rather positive
- Rather negative

Please explain your answer:

Sustainable investing means different things to different people and can take many different forms, resulting in different factors to consider. Depending on an investor's strategy, different elements of the ESG equation might be important to an investment decision. The existence of a diverse array of ratings reflects the wide variation in how investors are assessing sustainability aspects of companies, as well as the range of sustainability-related strategies found in regulated funds, which may have different ways of approaching sustainability assessments.

Fund managers may use multiple ratings on multiple sustainability aspects as points of information in an investment analysis at both the company and portfolio level. Similar to ratings on the same sustainability aspect, there is no one-size-fits-all for ratings on *different* sustainability aspects. For example, when rating the "S" in ESG, it may be helpful to look at ratings focused on gender equality as well as ratings focused on health and workplace safety. Fund managers are best-placed to determine which ratings will help to inform which investment strategies.

When paired with sufficient transparency from ratings providers on methodology, objectives, and data, variety among ratings products is beneficial to investors. To reiterate, transparency is key. Ratings should have a clearly defined purpose (*e.g.*, performance risk-based or impact-focused), and the name of the rating should reflect that purpose.

SECTION III: EU intervention

a) Need for an EU intervention

Taking into account your responses to the previous sections, do you consider that there is a need for an intervention at EU level to remedy the issues identified on the ESG rating market?

- Yes
- No
- No opinion

Please explain why:

As we noted to IOSCO when it was developing recommendations for a principles-based approach to improve transparency in the ESG ratings market, we believe ESG ratings and data providers should provide to users:

- the product's intended purpose, including its objective. This information enables the user to determine if the product fits their needs and helps users understand differences among ratings;
- data and information sources, explicitly stating if any estimates were used, which should include – being as specific as possible – the type of estimates used (*e.g.*, industry averages, model outputs) and the reasons for their use;
- policies, procedures, and methodologies underlying ESG ratings products to enable users to understand how the outputs are determined to ensure the product meets the user's intended objective;
- the product coverage (*e.g.*, public vs. private companies, equity vs. debt, geographic coverage)
- timing and frequency of data collection to help users understand how current the data is; and
- any potential or actual conflicts of interest.

The implementation of these measures by ESG ratings and data providers could contribute to a greater level of confidence in the use of these products within the financial system, supporting a greater up-take in usage while simultaneously helping to protect investors. We believe an industry code of conduct focused on these transparency measures would be sufficient to resolving the concerns raised by the European Commission's study on sustainability-related ratings, data and research published in January 2021.

If you responded yes to the previous question, what type of intervention would you consider necessary?

- Non-regulatory intervention (e.g. guidelines, code of conduct)
- Legislative intervention

Please explain your answer:

We do not believe that regulatory intervention is needed at this time, and we are concerned with regulatory initiatives aimed at increasing consistency rather than improving transparency. Additionally, regulatory initiatives that would introduce specific and detailed standards may hinder product innovation that ICI members find valuable, as well as access to the market resulting in coverage gaps.

In our view, it is not appropriate or beneficial for policymakers to prescribe methodologies or dictate how sustainability aspects should be weighted, analyzed, or incorporated into investment processes alongside financial analysis, in order to make ratings more consistent. Fund managers acting as fiduciaries are best placed to choose appropriate opinions – financial, ESG, or otherwise – and how to use them in a broad analysis tailored to specific investment mandates.

At the same time, we are convinced that improvements are necessary to improve transparency of the underlying methodologies, assumptions, and objectives of ESG ratings and data. Policymakers should take steps to convene industry experts to develop common industry standards or codes of conduct.

European regulators have previous experience encouraging the development of a concrete and actionable industry-based code of conduct. As an example of an industry-based solution, we would like to draw your attention to the principles developed by the Best Practice Principles Group (BPPG) for providers of shareholder voting research and analysis in the EU (known as 'proxy advisors'). These principles operate on an 'apply or explain' basis, in line with the requirements of the revised EU Shareholder Rights Directive II (SRD II).

We think the Commission should consider taking a similar approach to improving market practices related to ESG ratings for two reasons: (i) there is no market failure that necessitates a regulatory action, as evidenced by the findings of IOSCO in 2021, and the Commission's own study on sustainability-related ratings, data and research published in January 2021; and (ii) we see striking similarities between the concerns around transparency of proxy advice and ESG ratings.

In 2013, ESMA determined that an industry code of conduct was the appropriate way to address those concerns for proxy advisors.

"After analysis of the inputs received, ESMA concludes that it has not been provided with clear evidence of market failure in relation to how proxy advisors interact with investors and issuers. On this basis, ESMA currently considers that the introduction of binding measures would not be justified. … Consequently, ESMA considers that the appropriate approach to be taken at this point in time is to encourage the proxy advisory industry to develop its own Code of Conduct." [ESMA Final Report Feedback statement on the consultation regarding the role of the proxy advisory industry (February 2013).]

The BPPG stands as an exemplary model of a well-functioning code of conduct, and we see no reason why additional measures would be needed in the case of ESG ratings. Regulatory action should be considered as a last resort.

If you responded yes to the previous question, what do you consider should be the prime focus of the intervention? (multiple choice)

- Improving transparency on the operations of the providers,
- Improving transparency on the methodology used by the providers,
- Improving the reliability and comparability of ratings,
- Clarifying what is meant by and captured by ESG ratings, to differentiate from other tools and services,
- Clarifying objectives of different types of ESG ratings,
- Improving transparency on the fees charged by the providers,
- Avoiding potential conflicts of interests,
- Providing some supervision on the operations of these providers,
- Other measures (please specify).

Please specify the "Other measures" the intervention should focus on and explain what solutions and options you would consider appropriate.

- Transparency around potential or actual conflicts of interest

Policymakers should take steps to convene industry experts to develop common industry standards or codes of conduct.

For each of the points you selected in the previous question, please explain what solutions and options you would consider appropriate

Policymakers should take steps to convene industry experts to develop common industry standards or codes of conduct.