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To:	Ms Thérèse BLANCHET, Secretary-General of the Council of the European Union
No. Cion doc.:	SWD(2023) 207 final
Subject:	COMMISSION STAFF WORKING DOCUMENT EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT REPORT Accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities

Delegations will find attached document SWD(2023) 207 final.

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COMMISSION STAFF WORKING DOCUMENT

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT REPORT

Accompanying the document

Proposal for a Regulation of the European Parliament and of the Council

on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities

{COM(2023) 314 final} - {SEC(2023) 241 final} - {SWD(2023) 204 final}

Need for action

Environment, social and governance (ESG)/sustainable investing is becoming an important part of mainstream finance, with some estimates valuing it at USD 40 trillion globally. The EU has put in place the building blocks for a sustainable finance framework. Stakeholders are now pointing out the remaining market inefficiencies and regulatory gaps, which have the potential to hinder the development of the EU sustainable finance market and market integration. Many concerns have been raised about the functioning of the ESG ratings market.

This initiative is part of the strategy for financing the transition to a sustainable economy, published in July 2021. It follows work started in 2018 with the 'Financing Sustainable Growth' action plan. This is one of the measures proposed by the European Commission to contribute to the objectives of the European Green Deal by improving the flow and quality of information on which investors, businesses and other stakeholders base decisions. ESG ratings play an important and enabling role in the proper functioning of the EU sustainable finance market, by providing important sources of assessments that can be used by investors and financial institutions for investment strategies, risk management and internal analysis. They are also used by companies that seek to better understand sustainability risks and opportunities linked to their activities or those of their partners, and assess how they compare with their peers on these issues.

Above all, this initiative aims to address the deficiencies in a market which is not functioning properly. Users' and rated companies' needs regarding ESG ratings are not being met and confidence in ratings is being undermined. This problem has a number of different aspects, mainly lack of transparency as to the methodologies and objectives of ESG ratings and lack of clarity on the operations of ESG rating providers, in particular how they manage potential conflicts of interest.

Consequently, ESG ratings do not serve their purpose and do not sufficiently enable users, investors and rated companies to take informed decisions on ESG-related risks, impacts and opportunities. Since decisions by investors and businesses are crucial for the transition to a climate-neutral and more sustainable economy, this ultimately hinders the market's potential to contribute to the European Green Deal and achievement of UN Sustainable Development Goals. At the same time, it is crucial to foster trust in the operations of ESG rating providers by ensuring that the market operates properly and that ESG rating providers prevent and manage conflicts of interest. Reliable and high-quality ESG ratings will also contribute to the integrity of the financial markets and investor protection. The functioning of the internal market would be improved by greater clarity about the actions of entities which play an increasingly important role in channelling finance.

To this end, there are two specific objectives: (i) increased clarity on ESG ratings objectives, characteristics, the methodologies and the data sources used to obtain them; and (ii) increased clarity on the operations of ESG rating providers, and the prevention and mitigation of risks arising from conflicts of interest within providers.

With sustainable investing and ESG ratings attracting increasing attention in jurisdictions around the world, it is becoming essential for the EU to engage with its partners on the basis of a coherent and comprehensive European approach. Similarly, greater attention is being paid to the role of ESG ratings and the operations of ESG rating providers. In 2022, the International Organization of Securities Commissions (IOSCO) issued a number of recommendations for ESG rating providers and regulators. Several jurisdictions started by adopting codes of conduct for ESG rating providers.

Possible solutions

A number of legislative and non-legislative policy options were analysed for entities (ESG rating providers) and for products (ESG ratings). Regarding the regulatory treatment of ESG rating providers, the three options considered are: an industry code of conduct (Option 1); registration and light supervision (Option 2); and authorisation, principle-based organisational requirements, transparency requirements and risk-based supervision (Option 3). Regarding the extent of transparency requirements on ESG ratings and their methodologies, objectives, the two options considered are: minimum public disclosure requirements (Option 1); and minimum public disclosure requirements and more comprehensive requirements for disclosure to clients of ESG rating providers and rated companies (Option 2). The analysis also carefully considers the cost-effectiveness and coherence of the options.

As to the scope, the widely agreed IOSCO definition of ESG ratings would form the basis of the definition of ESG ratings for this initiative. A definition of ESG ratings is needed to define the scope of legislation and application of its requirements. This initiative would target entities providing ESG ratings or scores to the public or to subscribers and would not cover financial institutions or other market participants developing ESG ratings for their own purposes.

Impacts of the preferred options

Based on a comparison of the effectiveness, efficiency and coherence of the options analysed, the preferred option would be a combination of Option 3 on ESG rating providers (rules on authorisation, organisational requirements and supervision) and Option 2 on ESG ratings (minimum transparency disclosures on methodologies and objectives of ratings to the general public and more comprehensive disclosures to users of ESG rating providers and rated companies). The preference is for the combination of options that meets the objectives of the initiative in the most effective and efficient way.

Even though the preferred option may entail higher upfront costs, in the long-term the benefits would be expected to outweigh the costs. The preferred option is expected to bring significant economic benefits. This initiative would be expected to have a positive impact on the functioning of financial markets and the conditions for ESG investing. It should further enable investors and rated entities to understand the ESG ratings on the market, make informed choices about them and reduce both the cost of gathering information and the need to use additional providers, thus decreasing the cost of doing business and of due diligence. It would also be non-discriminatory and would apply equally to domestic and non-EU market

participants. This initiative is likely to increase the cost of doing business in the short term, but increased trust in ESG ratings could enhance market growth, eventually boosting profitability. For small providers, in order to mitigate the administrative burden and potential concerns about loss of access to the market, a transitional period is envisaged, to allow them more time to adjust.

The initiative is also expected to have positive, though marginal, indirect social and environmental impacts.