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COVER NOTE

From:	Mr Oliver RÖPKE, President of the European Economic and Social Committee
Subject:	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 - 2023/0177 (COD)) – Opinion of the Economic and Social Committee

Delegations will find attached the opinion of the European Economic and Social Committee.

Encl.: ECO/623

European Economic and Social Committee

OPINION

European Economic and Social Committee

Environmental, social and governance ratings

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 - 2023/0177 (COD))

ECO/623

Summary of the legislative proposal

Rapporteur: **Krzysztof Stanislaw BALON**
Co-rapporteur: **Andrea MONE**

Referrals	European Parliament, 10/07/2023 Council of the European Union, 17/07/2023
Legal basis	Articles 114 and 304 of the Treaty on the Functioning of the European Union
Section responsible	Economic and Monetary Union and Economic and Social Cohesion
Adopted in section	05/10/2023
Adopted at plenary	25/10/2023
Plenary session No	582
Outcome of vote (for/against/abstentions)	166/2/2

I. RECOMMENDATIONS

THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE

1. fully supports the proposal of the Commission to regulate for the first time environmental, social and governance (ESG) ratings in order to facilitate their contribution to the transition to a climate-neutral economy; underlines that it had called for such a proposal in the EESC opinion *A Capital Markets Union for people and businesses (new action plan)*[1]; also believes that adding Articles 191 and 192 of the Treaty on the Functioning of the European Union (TFEU) on environment to the Regulation's legal basis, alongside Article 114 TFEU, will facilitate the achievement of the legislation's objectives, and that, in order to make the legislation fit for the European Pillar of Social Rights (EPSR), reference should also be made to the social and sustainability objectives of the Treaties, in particular to Article 9 TFEU on social protection;

2. recommends further clarifying the definitions of "ESG rating", "ESG data products" and "ESG rating providers" by adding the element of regular commercial basis, in order to avoid civil society organisations (CSOs) producing scoreboards as a non-major and non-profit activity, as well as academic research and journalistic work, unintentionally falling under the scope of the Regulation;

3. welcomes the transparency provisions proposed by the Commission and recommends increasing the share of information to be provided to the general public rather than exclusively to the rated entities and ratings users, as well as adding the disclosure of two particular types of data sources: data made available under existing EU legislation and data from stakeholders other than the rated entities[2];

4. welcomes the proposed introduction of an authorisation process and organisational requirements; believes that minimum requirements on the quality of the ratings should be included in order to prevent greenwashing, "social-washing" and other types of misinformation, and believes that mandatory inclusion of double materiality should be part of these minimum quality requirements for ESG ratings, and that the present Regulation should assist in leading ESG rating market to maturity by fostering reliable information and raising standards through regulated competition between ratings providers;

5. calls on the legislator to adopt solutions that encourage financial market players to factor in just transition requirements, making the complementarity of environmental and social objectives explicit;

6. recommends further strengthening the rules on conflicts of interest by separating activities at group level and by empowering the European Securities and Markets Authority (ESMA) to effectively put an end to conflicts of interest;

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1 OJ C 155, 30.4.2021, p. 20.

2 See point 3.3.

7. in order to prevent regulatory arbitrage, suggests only allowing access to third country ESG rating providers in the EU single market through equivalence decisions and endorsement of an EU-based ESG rating provider in conformity with all the requirements of the present regulation but not through company-by-company recognition by ESMA;

8. calls on the co-legislators to ensure a level EU playing-field so that small and medium-sized enterprises (SMEs), social economy enterprises, and providers of services of general interest (SGIs) get fair treatment in ESG ratings;

9. reiterates the need to start a political process in view to establishing a public EU sustainability agency that could provide ESG ratings for the benefit of the single market, alongside private providers[3]; believes that this will contribute to providing a level playing-field as explained above and also to restoring citizens' trust in financial markets.

II. RATIONALE/DEVELOPMENT OF THE RECOMMENDATIONS

1. Adding environmental and social protection to the legal basis

1.1 The objectives of the Regulation are stressed in Article 1 of the proposal for a Regulation: "enhance the integrity, transparency, responsibility, good governance, and independence of ESG rating activities, contributing to the transparency and quality of ESG ratings" and "contribute to the smooth functioning of the internal market, while achieving a high level of consumer and investor protection and preventing greenwashing or other types of misinformation, including social-washing". Article 114 TFEU on the approximation of laws that have as their object the establishment and functioning of the single market is an indispensable legal basis for the proposed legal instrument. The Committee recommends adding Articles 191 and 192 TFEU on preserving, protecting and improving the quality of the environment, in order to more effectively sanction and therefore prevent greenwashing. The Committee also recommends adding Article 9 TFEU in order to more effectively sanction and therefore prevent "social-washing". It is important to keep all elements of sustainability in balance, as required by the UN's 2030 Agenda.

2. Clarifying definitions

2.1 Environmental or other civil society organisations and possibly academics and journalists that compile rankings and evaluations of companies on different aspects for non-commercial, non-profit purposes and without this being a major part of their overall activities or consisting of a major source of income should be exempt from the scope of the Regulation.

3 OJ C 486, 21.12.2022, point 5.6.

3. **Enhancing transparency provisions**

3.1 Information such as metrics, key performance indicators (KPIs), data sources, and data quality controls should be published on the websites of ESG ratings and not exclusively communicated to ESG rating subscribers and rated entities.

3.2 ESG rating providers should demonstrate how they use the data made available under the Corporate Sustainability Reporting Directive, the Sustainable Finance Disclosure Regulation, and the EU Taxonomy Regulation. They should demonstrate how they use indicators provided both under the Sustainable Finance Disclosure Regulation-SFRD (principal adverse impacts (PAIs) under the SFDR Delegated Regulation 2022/1288) and the European sustainability reporting standards (ESRS) Delegated Regulation that relates to the Corporate Sustainability Reporting Directive (CSRD) as minimum cross-cutting quality thresholds, explaining how these indicators weigh in their ratings. It is important to improve and encourage the rating of the social elements of sustainability in order to reinforce the social dimension of the sustainable finance framework and ensure the effectiveness of the minimum safeguards in Article 18 of Regulation 2020/852/EU (Taxonomy Regulation).

3.3 ESG rating providers should demonstrate that they also take into account non-company data and information provided by consumer organisations, trade unions, reputable and credible communities, and other civil society organisations.

3.4 As a matter of transparency and reliability, all rating methodologies that refer to decent work, employment, decent wages to fight in-work poverty, and social dialogue as part of the United Nations Sustainable Development Goals (SDG 8 or SDG 16) should reveal how workers' representatives from the rated entities have been involved.

4. **Introducing minimum requirements on the quality of ratings**

4.1 ESG rating providers should be able to demonstrate that a significant percentage of their rating measures the companies' impacts on the outside world (outward materiality). ESMA should provide recommendations on the weighting of outward materiality ensuring that the impact of the activities of the rated undertaking on people and the environment in ratings weigh at least 30% on the rating. ESG ratings should never exclusively measure risks for companies (inward materiality). Thus, conformity with the principle of double materiality[4], which is already included in EU legislation, will be ensured.

4.2 ESG rating providers should be able to demonstrate that they include in their ratings a minimum number of specific absolute indicators included in the SFDR and CSRD delegated Regulations. ESG ratings cannot only compare companies with their sectoral peers. ESG rating providers should be able to demonstrate that their methodology considers contributing to social objectives as being aligned with the social requirements of the United Nation 2030 Agenda. As an instrument for those ESG rating providers that operate in the EU single market, the concept of

4 In the impact assessment for its legislative proposal, the European Commission gives the following definition of double materiality: "Requirement for undertakings to report both on the impacts of the activities of the undertaking on people and the environment, and on how various sustainability matters affect the undertaking."

"decent work" (SDG 8) should be defined as making a substantial contribution to the achievement of one or more of the 20 principles of the EPSRs and its implementing Action Plan. Additionally, a "do no substantial harm principle", referring to adverse events that affect the rights included in the EU Charter of Fundamental Rights, should also be part of the adopted methodology.

4.3 Separate "E", "S" and "G" ratings shall be provided rather than a single ESG metric that aggregates "E", "S" and "G" factors . Aggregating the "E", "S" and "G" dimensions hampers the reliability of the rating and can be used to hide problematic situations and lead to greenwashing and/or "social-washing".

4.4 In a manner consistent with the EU taxonomy of sustainable investments, the ESG rating should be able to demonstrate that negative scoring is attributed to performances of entities that are found to be in violation of fundamental rights, such as those of the European Charter of Fundamental Rights or those set out in Article 18 of Regulation 2020/852/EU (Organisation for Economic Co-operation and Development Guidelines for Multinational Enterprises and the United Nations Guiding Principles on Business and Human Rights, including the eight fundamental conventions identified in the Declaration of the International Labour Organisation on Fundamental Principles and Rights at Work and the International Bill of Human Rights).

5. Complementarity of green and social objectives

5.1 In the different blocks that make up the EU sustainable finance framework, one of the pillars of the Capital Markets Union, the social dimension of sustainable investments is underrepresented, which creates distortive effects on the ESG security market and acts as obstacle to a market segment, "S"-qualified securities, that was already in fast acceleration before the pandemic. Mandatory inclusion of both environmental and social indicators from the SFDR and CSRD delegated regulations will help ensure this complementarity.

6. Preventing conflicts of interest

6.1 The Commission proposes that entities providing consulting, credit ratings, benchmarks, investment, audit and banking, insurance or reinsurance activities are excluded from providing ESG ratings. Several groups combine ESG rating providers with provision of ESG data, analysis and research, benchmarking, advice and consultancies both to investors using the ratings as well as to rated entities. Advising a company on how to report on ESG issues or manage ESG risks, while at the same time defining the criteria of the ESG ratings and even of the credit ratings of that same company is a typical example of a conflict of interest. Academic research has found that "firms that have existing credit ratings business with some providers receive higher ESG ratings than those that do not"[5]. Separating activities at group level will ensure that ESG ratings are not biased so as to preserve some other business relation.

6.2 Where there is a risk of conflict of interest, ESMA should be obliged to take action. As an optional first step, ESMA may require measures for mitigating conflicts of interests, but where

5 X. Li, Y. Lou, L. Zhang, *Do Commercial Ties Influence ESG Ratings? Evidence from Moody's and S&P*, p. 30.

these measures are not adequate, ESMA should be obliged to order the cessation of some activities and relations or the cessation of a rating. If ESMA chooses to require the creation of an independent oversight function, trade unions, relevant CSOs and the affected communities should also be part of it, in addition to the users of and contributors to ESG ratings.

7. **Preventing regulatory arbitrage**

7.1 Granting access to third country ESG rating providers through endorsement by an EU entity of the same group or through case-by-case recognition of specific third country companies by ESMA might create a strange situation whereby non-EU entities have less administrative burden to comply with compared to their EU-based competitors.

7.2 Access through endorsement should only be granted to ESG providers from jurisdictions where there is no regulatory framework and by ensuring full compliance with the requirements of the current Regulation and not just with the International Organisation of Securities Commissions' (IOSCO) recommendations.

7.3 The option of case-by-case recognition of specific third country companies by ESMA should not be provided since it creates a lot of administrative burden for ESMA that should be rather carried by third country ESG providers through the creation of an EU entity.

8. **Level-playing field for SMEs, SGIs and social economy enterprises**

8.1 The study commissioned in the framework by the Commission's impact assessment to the consultancy firm ERM[6] shows that larger companies often obtain higher ratings than smaller ones, not necessarily because they perform better but rather due to their ability to invest more resources in sustainability reporting. SMEs, providers of SGIs and social economy enterprises remain largely unrated and this could lead to them being falsely perceived by investors as lagging behind. ESG rating providers should be encouraged to rate SMEs, providers of services of general interest (SGIs) and social economy enterprises, while tackling their particularities regarding data availability.

9. **Creating an EU sustainability agency**

9.1 The creation of an EU sustainability agency should contribute to filling a potential market gap by providing ratings for SMEs, providers of SGIs and social economy enterprises. It can also contribute to restoring citizens' trust in financial markets and set up a mediation point for dispute settlement or a complaint-handling mechanism as referred to in Article 18 of the Regulation.

Brussels, 25 October 2023.

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6 *Study on Sustainability-Related Ratings, Data and Research*, November 2020.

Oliver RÖPKE
President of the European Economic and Social Committee

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III. CLARIFICATIONS OF SELECTED RECOMMENDATIONS

For clarification of selected recommendations and without prejudice to other recommendations the EESC proposes changes to the Commission proposal as follows:

Modification 1

Linked to recommendation 1 of EESC opinion

Legislative proposal: Citations

Text proposed by the European Commission	*Modification*
Having regard to the Treaty on the Functioning of the European Union, and in particular ***Article*** 114 thereof,	Having regard to the Treaty on the Functioning of the European Union, and in particular ***Articles 9,*** 114***, 191 and 192*** thereof,

Modification 2

Linked to recommendation 2 of EESC opinion

Legislative proposal: Article 3, paragraph (4)

Text proposed by the European Commission	*Modification*
(4) 'ESG rating providers' means a legal person ***whose occupation includes the*** offering and ***distribution of*** ESG ratings or scores on a ***professional*** basis;	(4) 'ESG rating providers' means a legal person offering and ***distributing*** ESG ratings or scores on a ***regular commercial*** basis;

Modification 3

Linked to recommendation 4 of EESC opinion

Legislative proposal: Article 14, paragraph 11

Text proposed by the European Commission	*Modification*
11. ESG rating providers shall adopt, implement, and enforce measures to ensure that their ESG ratings are based on a thorough analysis of all the information that is available to them and that is relevant to their analysis in accordance with their rating methodologies. They shall adopt all necessary measures to ensure that the information they use in assigning ESG ratings is of sufficient quality and from reliable sources. ESG rating providers shall explicitly mention that their ESG ratings are their own opinion.	11. ESG rating providers shall adopt, implement, and enforce measures to ensure that their ESG ratings are based on a thorough analysis of all the information that is available to them and that is relevant to their analysis in accordance with their rating methodologies ***while fulfilling the quality requirements listed in point g of Annex I***. They shall adopt all necessary measures to ensure that the information they use in assigning ESG ratings is of sufficient quality and from reliable sources. ESG rating providers shall explicitly mention that their ESG ratings are their own opinion.

Modification 4

Linked to recommendation 5 of EESC opinion
Legislative proposal: Article 15, paragraph 1

Text proposed by the European Commission	*Modification*
1. ESG rating providers shall not provide any of the following activities: (a) consulting activities to investors or undertakings; (b) the issuance and sale of credit ratings; (c) the development of benchmarks; (d) investment activities; (e) audit activities; (f) banking, insurance, or reinsurance activities.	1. ESG rating providers ***and the groups of undertakings they belong to*** shall not provide any of the following activities: (a) consulting activities to investors or undertakings; (b) the issuance and sale of credit ratings; (c) the development of benchmarks; (d) investment activities; (e) audit activities; (f) banking, insurance, or reinsurance activities.

Modification 5
Linked to recommendation 5 of EESC opinion
Legislative proposal: Article 23, paragraph 3

Text proposed by the European Commission	**Modification**
3. Where there is a risk of a conflict of interest within an ESG rating provider due to the ownership structure, controlling interests, or activities of that ESG rating provider, of any entity owning or controlling the ESG rating provider, of an entity that is owned or controlled by the ESG rating provider, or of any the ESG rating provider's affiliates, ESMA may require the ESG rating provider to take measures to mitigate that risk. Such measures may include the establishment of an independent oversight function representing stakeholders, including users of the ESG ratings ***and*** contributors to such ratings, in a balanced manner. Where a conflict of interest as referred to in the first subparagraph cannot be adequately managed, ESMA ***may*** require the ESG rating provider to cease the activities or relationships that create the conflict of interest, or ***may*** require the ESG rating provider to cease providing the ESG ratings**.**	3. Where there is a risk of a conflict of interest within an ESG rating provider due to the ownership structure, controlling interests, or activities of that ESG rating provider, of any entity owning or controlling the ESG rating provider, of an entity that is owned or controlled by the ESG rating provider, or of any the ESG rating provider's affiliates, ESMA ***shall take action. As an optional first step, ESMA*** may require the ESG rating provider to take measures to mitigate that risk. Such measures may include the establishment of an independent oversight function representing stakeholders, including users of the ESG ratings**,** contributors to such ratings**,** ***trade unions, relevant civil society organisations and affected communities***, in a balanced manner. Where ***there is a risk of*** a conflict of interest as referred to in the first subparagraph ***and it*** cannot be adequately managed ***through specific risk mitigation measures***, ESMA ***shall*** require the ESG rating provider to cease the activities or relationships that create the conflict of

	interest, or ***shall*** require the ESG rating provider to cease providing the ESG ratings

Modification 6

Linked to recommendation 4 and 8 of EESC opinion

Legislative proposal: Annex I, point (g)

Text proposed by the European Commission	***Modification***
(g) a description of the procedures and methodologies used to issue and review ESG ratings implemented by the applicant;	(g) a ***publicly disclosed*** description of the procedures and methodologies used to issue and review ESG ratings implemented by the applicant; ***these should include the following three elements as quality requirements with a minimum weight that should be recommended by ESMA:*** ***(1) the impacts of the activities of the rated undertaking on people and the environment in the ratings;*** ***(2) 'E', 'S' and 'G' factors in ratings with an explanation of the alignment if the 'E' pillar has a 1.5°C pathway;*** ***(3) Demonstration of the use of the common indicators provided both under the Sustainable Finance Disclosure Regulation (SFDR, principal adverse impacts (PAIs) under the SFDR Delegated Regulation 2022/1288) and the ESRS under the Corporate Sustainability Reporting Directive (CSRD) Delegated Regulation as minimum cross-cutting quality thresholds***; ***ESG rating providers should provide an explanation as to how these indicators are weighted in their ratings.***

Modification 7

Linked to recommendation 3 of EESC opinion

Legislative proposal: Annex III, paragraph 1, point (d)

Text proposed by the European Commission	***Modification***
(d) information on the ratings' objective, clearly ***marking whether*** the rating is assessing risks, impacts or some other dimensions;	(d) information on the ratings' objective, clearly ***describing the extent to which*** the rating is assessing risks, impacts or some other dimensions;

Modification 8

Linked to recommendation 3 of EESC opinion

Legislative proposal: Annex III, paragraph 1, point (h)

Text proposed by the European Commission	*Modification*
(h) information ***on whether*** the rating is expressed in absolute or relative values***,***	(h) information ***describing the extent to which*** the rating is expressed in absolute or relative values***;***