

Flash note: ESG Ratings

First political trilogue – 11 January 2024

The first political trilogue on ESG Ratings took place in the European Parliament on 11 January 2024, chaired by the Chair of the ECON Committee, Ms Irene Tinagli. The rapporteur Ms Aurore Lalucq, as well as several shadow rapporteurs were present. The Council Presidency was represented by Jean-Paul Servais, Chairman of the FSMA and of IOSCO. The Commission was initially represented by Commissioner McGuinness and, for the remainder of the meeting, by Ugo Bassi, Director at DG FISMA. In the discussions, which were cordial and efficient, the parties considered this file a priority and mentioned the need to reach an agreement under the current legislative cycle.

In the **introductory remarks**, a strong alignment of objectives by the three institutions was visible, even if there were differences in the approaches pursued by the co-legislators. The Presidency started by highlighting the need to increase transparency regarding ESG ratings and to limit conflicts of interest at the level of ESG ratings providers, as well as to deliver clarity to the market and to prevent greenwashing. The Presidency also highlighted the need to set up a regime adapted to smaller ESG rating providers, amongst others to help the development of a European market of providers. The COM stressed the importance of the file for the EU's sustainable finance agenda. ESG ratings are important for capital markets, particularly for investors, in order to understand what ESG ratings are about and to determine the profile of their portfolios. The COM also pointed out that bringing clarity to the market and combating greenwashing are important objectives of this regulation. Therefore, transparency is an important topic but should not go beyond transparency and regulate the ratings. For the COM, many topics are technical and should be delegated to technical level. However, some topics are more sensitive: conflicts of interest and transparency. The EP concurred with the objectives highlighted by the COM, stressing the need for speed as rules are required for the proper functioning of the market. The EP expressed its wish to deliver as regards expectations of increased transparency and the prevention of conflicts of interest, as well as reinforcing the participation and emergence of EU market participants.

The ensuing discussion started with **the scope**. The Presidency highlighted its confidence in being

able to agree to a text at technical level. An important point highlighted by the Presidency was “reverse solicitation”, a concept familiar to other financial regulations like MiCA and MiFID. It is important for the Council to exempt non-EU ESG ratings providers that provide ratings in the Union only at the request of the user (lines 49 c-49f). This exemption is subject to strict conditions: no solicitation, promotion or advertisement by the provider, but also no substantial size of business in the EU and no substitute for ratings by another authorized provider in the Union. The Presidency explained that the objective is to enable users to request ratings from outside the EU when they cannot find a substitute in the EU without requiring the non-EU provider concerned to comply with the Regulation when it has not approached EU users. The rapporteur expressed her concerns over the exemptions proposed by the Council. The COM, henceforth represented by Director Bassi, stressed that the concept of “reverse solicitation” already exists, echoing the Presidency’s remarks, and should not be problematic so long as conditions are included to avoid circumvention. Although not in the trilogue agenda, the COM also brought up the question of in-house ESG ratings, citing fears of taking the exclusion too far given the amendments introduced by both co-legislators. The rapporteur accepted to take it to the technical level. Reacting to this, the Presidency highlighted that Member States wish to avoid duplicate supervision, amongst others because this would be placing a disproportionate burden on already regulated entities. The COM took note of the point and reiterated the need to look into the matter in detail so as to determine what issues are already covered by existing legislation and showed openness to work on a compromise that will avoid gaps or overlaps. The rapporteur accepted the COM to undertake this work, including an assessment to what extent all these exemptions to the scope undermine the level playing field that the Commission’s original proposal was trying to attain. The COM reassured the EP that the scope would not be overly affected if the exemption on reverse solicitation and the exclusion of in-house ESG ratings were properly calibrated. Co-legislators agreed to mandate the technical level to discuss the wording of the various exemptions (in particular lines 49, 49a, 49b, 49c-49f) to further clarify them.

As regards the **third-country regime**, the rapporteur defended the EP’s proposal for ESG ratings providers from equivalent jurisdictions to obtain an authorisation by ESMA (line 140b) and the rating-by-rating approach for ESMA to endorse individual ratings provided by a third-country ESG ratings provider. Thirdly, as regards the recognition of third-country ESG rating providers, the EP is asking to remove the 12 million EUR threshold, opting instead for a qualitative assessment based on an analysis by ESMA. Reacting to the first point, the Presidency stressed that Member States found a notification sufficient, pushing against the need for ESMA to authorise ESG providers from third countries in relation to which the Commission has adopted an equivalence decision. As regards endorsement of third-country ESG ratings established in countries that have not been granted equivalence, the

Presidency stressed that an endorsement rating-by-rating would be too burdensome for ESMA, as reflected by the Commission in its revised version of the BMR (where the benchmark-by-benchmark endorsement was replaced with a more global approach). In relation to the recognition of third-country ESG ratings, the Presidency expressed its preoccupation as to the removal of the quantitative threshold of 12 million EUR. Member States, it reasoned, found the alternative supported by the EP difficult to implement. The COM supported the Council in all points. It explained that the EP insertion of an authorisation linked to equivalence departed from existing EU law, that a rating-by-rating approach towards endorsement of individual ratings was not possible for ESMA (despite it being its original proposal) and that the quantitative threshold of 12 million EUR for recognition was there as a way of avoiding circumvention. The COM insisted on the importance of this and therefore asked the EP to reconsider as moving towards a qualitative assessment by ESMA risked giving third-country providers the possibility of going through recognition to benefit from lighter rules than those applicable to EU industry, which will have to apply this Regulation in full. This would create an unlevel playing field and the interplay of endorsement and recognition would no longer work. The rapporteur asked for more time to secure a mandate from the EP negotiating team in relation to recognition, as it was an important point internally. On equivalence and endorsement, the EP showed willingness to follow up at technical level, taking note of the Council's and the Commission's concerns.

Moving to **governance**, the EP wishes to reinforce rules on the prevention of conflicts of interest. This, the rapporteur described, was the guiding principle behind the amendments enshrining the independence of the oversight function, the separation of business activities, and on the independence of rating analysts and employees. The use of multiple ESG rating providers was conceived as a way to inject some competition into the ESG ratings sector to the benefit of smaller EU providers. In this line, the rapporteur expressed her sympathy towards the temporary mechanism for smaller EU providers included in the Council's mandate, which she believed went in the same direction as that of the EP proposal on the use of multiple ESG ratings providers. The rapporteur also highlighted Article 23(3) on conflicts of interest, inspired by CRA, which appears to be important for the EP. The Presidency was sympathetic towards the EP's aims, insisting at the same time on the need to have proportionality and scalability. In essence, rules on governance should not be so overburdening that they hinder the development of EU operators while the market is open largely to third country's providers. The separation of business activities was a case in point: Chinese walls, inspired by other pieces of EU law, could be put in place without the need to force the creation of separate legal entities. This, the Presidency countered, was a crucial point for Member States. It also mentioned the handling of complaints which should, also for reasons of proportionality, be limited to the stakeholders. At any rate, all these provisions, including those related to the prevention of

conflicts of interests, could be worked out at technical level, in particular to check that they are not already covered by other provisions of the regulation. Supporting the Presidency, the COM cautioned against erecting excessive entry barriers for smaller operators but saw great alignment overall between co-legislators. The COM attaches importance to establishing a balanced governance regime. On the separation of business activities, the COM supported the EP's amendments, which it saw as striking a balance between the original COM proposal and the Council mandate, but is also sensitive to the Presidency's argument of not favouring third country providers against European providers. On the use of multiple ESG ratings providers, the COM also found the EP's changes acceptable as they are not binding. In relation to complaints-handling, the COM voiced its support for the Council mandate. On the rules related to independence and avoidance of conflicts of interests, the COM agrees with the Presidency's approach that we should check what is already covered and seek a balance between the rules. Co-legislators agreed to send the entire governance chapter to the technical level in order to propose a balanced package deal (including the proportionality section) at the second trilogue.

On **proportionality**, the Presidency cautioned against the EP's proposals as they would exempt a wide swath of the EU market, which is mostly composed of small and medium sized operators. Member States wish to be stricter, providing exemptions for small operators only. For the market to function properly and avoid legal uncertainty, exemptions have to be predictable, a key principle the Council wishes to uphold and that the EP's amendments partly undermines. The Presidency also insists on keeping the temporary regime proposed by the Council. The COM believes that technical work could be done to balance both approaches as regards the scope of the exemption. COM finds that Council's addition of "shall" in line 278 which renders automatic the granting of the exemption by ESMA is problematic and unprecedented. The rapporteur was open to leave this to technical level acknowledging the points raised by the Presidency and the COM. The EP, she argued, could be willing to adjust the scope of the exemption but was less inclined to do so as regards the automaticity proposed by Council, echoing the Commission's fears. It was agreed to delegate this to the technical level.

Finally, in relation to **transparency**, there was wide agreement among co-legislators on ensuring maximum transparency without interfering with the methodologies and the Commission was tasked to start working on a compromise based on that principle. The Presidency made clear that any such interference was a red line for Member States, while the Rapporteur indicated the importance she attached to the EP amendment on disaggregation of E, S and G ratings (lines 285a and b). The Presidency took note but reiterated its concern that too many detailed rules on transparency could lead to implicit interference regarding methodologies. The Presidency also highlighted the need to

find a balance between transparency and the cost it represent for providers. It was agreed to discuss about transparency at technical level, bearing in mind the underlying principle of non-interference with methodologies.

Enclosed: Trilogue agenda

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Proposal for a Regulation on the transparency and integrity of ESG rating activities

First trilogue - 11 January 2024 (12:45-15:30)

Meeting room: SPINELLI 5G3 (EP- Brussels)

PROVISIONAL DRAFT AGENDA

I. Welcome and adoption of the agenda

II. Opening statements

ECON Rapporteur *Ms. Aurore LALUCQ*
Presidency of the Council *Mr. Jean-Paul SERVAIS*
European Commission *Ms. Mairead McGUINNESS*

III. Exchange of views on political provisions

1. Scope

- Exclusions: ESG ratings produced by providers outside the Union (Art. 2(2)(ba) - *lines 49c to 49f* - Council)

2. Third country regime

- Equivalence regime (Art. 9):
 - additional conditions (*lines 140a, 140b*)
- Endorsement regime (Art. 10):
 - additional conditions (*lines 155a, 155b, 156, 157, 158, 160a*)
- Recognition regime (Art. 11):
 - threshold (*line 168*) vs. safeguards (*line 168a*)
 - provision of information to ESMA (*lines 170a, 171, 172a, 173*)

3. Governance

- Oversight function (Art. 14(10) - *line 230* - EP)
- Separation of business activities (Art. 15 - *lines 240, 242, 242a to 242e, 242f to 242h, 242i, 243a to 243c*)
- Independence of rating analysts and employees (Art. 16(8a)-(8c) - *lines 258a to 258e* - EP)

- Use of multiple ESG rating providers (Art. 16a - *lines 258f to 258i*- EP)
- Complaint handling (Art. 18, Art. 14 (11a) - *lines 262 to 272d, 232a* - Council)
- Independence and conflicts of interest (Art. 23(3) - *lines 298a to 298g* - EP)

4. *Proportionality*

- Exemptions for SMEs (Art. 20)
 - Requirements exempted (*line 278*)
 - SMEs not part of a group (*line 279*)
- Temporary regime for small ESG rating providers (Art. 4a - *lines 103a to 103f*-Council)
 - *Supervision fees* (Art. 40 - *line 442* - Council)

5. *Transparency*

- Aggregation of E, S, G factors (Art. 21 - *lines 285a, 285b, 539* - EP)
- Extra transparency requirements if the subscriber or rated entity discloses or distributes (Art. 22(1a) - *lines 290a, 209b* - EP)
- Notification requirement (*line 290c* - EP)
- Unsolicited rating (*line 290d* - EP)
- ESMA ITS to specify the data standards, formats and templates (*lines 286a, 291a* - EP)
- Information to be provided in the application for authorisation (Annex I):
 - Ownership structure and potential conflict of interest (*line 504a* - EP)
 - Number of entities, financial products and instruments for which the applicant will provide ESG ratings (*line 506a* - EP)
 - Use of common data points under SFDR, CSRD (*line 507* - EP)
 - Use of scientific evidence and alignment to Paris agreement (*line 507a* - EP)
 - Data processes (*line 507b* - EP)
 - Expected endorsements of ESG ratings (*line 510a* - EP)
 - Track records (*line 510b* - EP)
- Disclosure requirements (Annex III)
 - Disclosure on methodologies and limitations (*lines 535b, 538, 542, 545e, 554a* - EP)
 - Use of other EU sustainable finance legislation (SFDR, CSRD, Taxonomy) (*lines 536, 555c, 557*)
 - Alignment to international standards (*lines 545b, 545c, 545d* - EP)
 - Weighting method (*lines 552a, 540* - EP)
 - Data processes (*lines 561a-562a* - EP)
 - Specific information for each rating (*line 564a* - EP)

IV. **Mandates and delegation**

1. *Mandates to the European Commission*

- a. Overview of SME market participants

- b. Overview on market share
- 2. *Delegation of work to the technical level (see technical mandate)*

V. Any other business

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