SIFMA Response: ESMA Consultation on ESG Ratings Providers:

6.2 Questionnaire B for Users of ESG Rating Providers:

[*LL Note: the actual submission was made using an online form. Contribution ID: 9bc994c2-8109-4e4b-a61b-caabadfce1cd*]

Q1: Name of respondent or organisation (including Legal Entity Identifier).

The Asset Management Group of the Securities Industry and Financial Markets Association ("**SIFMA AMG**") is making this submission on behalf of its members.

Q2: Nature of establishment in EU

(A) Legal entity established in EU

- **Please indicate Member State(s) of legal entities**

(B) Legal entity *and* corporate headquarters established in EU

- **Please indicate country of corporate headquarters**

(C) *No* legal entity or corporate headquarters established in EU

- **Please indicate country of corporate headquarters**

(D) Other

- **Please explain**

(D): SIFMA AMG is a US based trade association that represents the asset management community, provides views on U.S., European and global policy and seeks to create industry best practices.

SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

Our members are active participants in the sustainability journey and have first-hand experience of utilising ESG ratings products and data providers. SIFMA AMG welcomes the opportunity to provide feedback on ESMA's Consultation on ESG Ratings Providers.

Q3: Respondent subject to any existing financial regulatory authorisation, registration or supervisory regime.

(A) Yes

- **Please provide further details of regime including name of authorisation, registration, or supervisory body and reference to supporting legal acts.**

Although SIFMA AMG itself isn't regulated, our members include a variety of regulated firms, that have an authorised presence in leading financial jurisdictions such as the US, EU and the UK (among others).

(B) No

Q4: General description of business model and main area of economic activity.

As noted above, SIFMA AMG's members represent U.S. and global asset management firms whose clients include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. The combined assets under management of SIFMA AMG's members exceed $45 trillion i.e. approx. EUR41 trillion.

Q5: Estimate total value (in EUR) of administrated assets and/or asset under management (if applicable).

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Q6: Estimate total value (in EUR) of investments for which *ESG rating* and/or other *ESG data products* are used as input in investment decision making process (if applicable).

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6.2.2 Use of ESG ratings (if applicable)

Q1: Currently contracting for ESG ratings

(A) Yes

(B) No

(A) Yes – our members contract with various ESG rating providers for their business.

Q2: Currently contracting for other ESG data products

(A) Yes

(B) No

(A) Yes – our members contract with various ESG data providers for their business.

Q3: If *yes* to *Q1* or *Q2*, please list the providers you contract with for each ESG rating and/or other ESG data products and identify the categories of product.

Our members use a number of different providers of ESG ratings and data, including leading providers such as Sustainalytics, MSCI, Bloomberg, FTSE, S&P Trucost, Clarity, ISS and Refinitiv. The categories of product include ESG ratings, ESG scores, ESG data streams and estimations.

Our members would like to draw a clear distinction between ESG ratings and ESG data in our response to this consultation – as the two are used differently in practice by the market. ESG data is used as an input by asset managers and other financial services firms for the purposes of measuring, tracking and reporting on the sustainability impacts or adverse impacts of their / their investments' business activities.

ESG ratings on the other hand are primarily used by investors and our clients to compare and rate different products from an ESG perspective – e.g. our clients may ask us to report on the ESG performance of their managed portfolio by reference to an ESG rating selected by them.

Q4: Please provide the length of time in months which you have contracted with each provider.

In practice our members find that the contracts tend to have a term of at least 1 year. Users will then have the ability to extend / renew the contract annually, but this is usually accompanied by price increases from the providers.

In our members' experience, there is generally little transparency on the minimum term and fee rates of ESG data / ratings contracts – and different users are likely subject to different commercial terms for the same ESG products.

Q5: Please explain reason behind the choice of the ESG rating or data provider(s) listed in Q3.

These ESG data and ratings providers would have been selected by our members, because they are leading providers in this space and for their perceived specialisms.

However, as set out in the response to Q6 below, in practice our members have had to rely on multiple ESG data and ratings providers for reasons such as coverage, data quality, specialisms, client preferences and transparency (among others). This then results in an expensive and fragmented model – particularly for certain asset classes such as fixed income, for which there is very limited coverage across many products.

Q6: Please explain reason for choosing more than one ESG rating provider (if applicable).

ESG data

One of the key reasons is coverage – be it across regions, asset classes or specific instruments. Our members therefore find that they need to consume ESG data from multiple providers in order to ensure appropriate coverage across their managed portfolios and investments (and even there are significant data gaps). Additionally, different ESG data providers have different strengths / perceived specialisms for certain asset classes, ESG indicators etc., which then drives the selection process.

Other reasons include data quality and costs (e.g. the data from some providers will be of a better quality for certain regions / asset classes, or their methodologies may be more transparent / robust in that regard) as well as the transparency given on methodologies and sources of the data.

Additionally, given the significant ESG data gaps, our members find that most ESG data providers use estimations (rather than actually reported data) which differ significantly across different providers and so our members end up purchasing ESG data from multiple providers in order to validate and cross-check their conclusions based on the ESG data received.

ESG ratings

Coverage and methodology tend to be the key drivers here – as often the ESG ratings with the broadest coverage don't have a methodology that is as robust compared to those that cover a more limited universe. The methodologies used by different ESG rating providers can also differ significantly and focus on different ESG indicators or objectives, and our members often find that even where 2 sets of ratings focus on the same objectives, the overall rating differs notable between providers. As a result our members need to contract with a number of ESG ratings providers

As noted previously, our members often have to use ESG ratings because of client demand (as clients commonly use ESG ratings to compare different products in the market) and in those cases the selection decision for the ESG rating provider is made by the client, again based on reasons such as coverage and perceived specialisms.

Accordingly there are a range of factors underpinning SIMFA AMG members' choice of ESG ratings and data providers. However, as noted previously, users often need to sign up with multiple providers which results in a cost-intensive and fragmented framework. Our members also have to dedicate significant internal resources to understand, interrogate and align the ESG ratings and data they receive from different providers – which could be avoided if there was more standardization and comparability within this space (particularly regarding the transparency of methodologies).

Q7: In case you changed ESG rating provider, please provide the rationale behind the choice.

Please see our response to Q6 above – any changes will be for reasons such as coverage, methodologies used, transparency provided, client demand and costs.

Q8: Please outline and explain any shortcomings in the ESG rating or ESG data products you currently contract for.

There are significant shortcomings in the ESG ratings or ESG data products consumed by our members currently – although our members are seeing some improvement in the ESG data received.

The main shortcomings tend to be coverage (please see our response to Q6 above) and also the lack of correlation and comparability across different products. Different vendors use different methodologies and criteria, and often provide limited or no transparency on their methodological approach, which makes it difficult for users such as our members to be able to understand and explain the divergences between the data / ratings received from different vendors. A key underlying issue is the absence of a globally accepted reporting or accounting standard, which would in due course help ensure consistency and comparability in the information that is reported by corporates and other market players and also help promote better financial stability. Accordingly, our members would strongly recommend for the EU to aim for international convergence and consistency in this regard.

As noted above, there are often notable divergences in the ESG ratings and data obtained from different providers for the same ESG objectives and assets / investees. For example, different providers will report significantly different GHG emissions figures for the same company, and our members are generally able to get limited information from them on the underlying methodology or data sources to then try and align the divergences. Additionally, it is often difficult to obtain information from vendors on whether their ESG data or ESG ratings are based on estimations or actually reported / audited company data. On occasion, our members also find that the ESG data / ratings are not up to date because they have either received different information from corporates through their stewardship efforts, or because the vendors haven't updated their information to capture latest publicly available information on the corporate (and in some cases, this lag has existed for at least a few months before the data is updated). By way of example, following the recent international sanctions against Russia, it has taken a week for ESG ratings on Russian sovereigns to be downgraded by ESG data providers, and it has taken even longer for Russian State Owned Enterprise ESG ratings to be downgraded – by which point most asset managers and other market players had already taken actions to divest (either due to the sanctions or by choice).

Finally, the price of ESG data / ratings and the lack of regulation on the pricing policy adopted by such vendors tends to be a big concern for our members. As noted above, our members usually rely on a number of ESG data and ratings providers in their business – which all add up to amount to significant costs for users. Additionally, the pricing policy of such vendors has been changing, in a manner that isn't justified on the basis of different or additional services rather than a restructuring or split of services already provided or additional sub-licensing– this restructuring is often also linked to the increasing mandatory ESG reporting and disclosure requirements for our members and therefore vendors are able to capitalize on the pricing opportunities provided to them by the regulatory framework in the EU and other regions.

Additionally, the terms of the ESG vendor contracts tend to be restrictive with respect to (i) the onward sharing of ESG data / ratings – whereas most of our members will be obliged under current or upcoming EU regimes to provide such information to clients and investors upon request or as part of their reporting; and (ii) even the internal sharing of data / ratings, because of usage restrictions (e.g. only certain teams are permitted to use the data / ratings) or increased costs for the same information based on the number of employee logins – when in fact it is quite important for all employees and teams within the organization to have access to the same ESG information to form a consistent firm-wide view on the ESG impact of, or risks associated with, a particular security.

We would therefore recommend that the EU bring forward a proportionate regime to regulate ESG data and ratings providers within the EU, to help address and regulate the concerns raised by our members above.

Q9: Please outline whether you are satisfied with the level of methodological transparency for the products you contract for, including transparency around data sourcing.

Please see our response to Q8 above – overall are members are only somewhat satisfied with the level of methodological transparency. As noted above, often our members get limited or no transparency on the methodology used, or the methodology does not appear to be robust or clear enough to map across to the reporting and other requirements our members are subject to (e.g. some vendors claim to provide EU Taxonomy alignment scores – however, the methodology for deriving those scores and how it compares to the technical screening criteria under the EU Taxonomy rules, is not always clear). Additionally, it is difficult to get transparency on the extent to which estimated vs. actual reported data is used / provided by the vendor.

The onus therefore tends to be on SIFMA AMG members to demand this transparency and interrogate the methodologies used – and this may cause smaller users / firms to be at a competitive disadvantage vs. others.

Q10: If *no* to *Q1* and *Q2*, please list ESG rating and/or other ESG data products providers you are currently using.

Our members may from time to time use ESG ratings or data provided by leading ESG vendors (such as the ones noted in Q3 above), without a formal contract, but this will generally not be a common occurrence.

Q11: Please outline and explain any shortcomings in the ESG rating or ESG data products you are currently using on a non-contractual basis.

Please see our response to Q8, as the same concerns are relevant here.

Q12: Please outline whether you are satisfied with the level of methodological transparency for the products are currently using on a non-contractual basis.

Please see our response to Q9, as the same concerns are relevant here.

6.2.3 Contractual Characteristics

Q1: If you currently contract for ESG rating or ESG data products, please briefly describe the terms of use of your ESG rating provider, including:

(A) Time horizon of the contract

- **Please provide details of break clauses and frequency of renewal.**

As noted previously, such contracts tend to have at least a 1 year minimum term with the ability to renew annually (and in some cases the contract may also renew automatically) but usually on the basis of increased fee rates.

(B) Products included in contract

- **<u>Please outline if the contract covers a single product offering or a package of product offerings.</u>**
- **<u>Please outline if products were available only under the form of packages of multiple service and/or products.</u>**

In some cases the data is available on an unbundled basis, but in other cases, it is difficult to get the data on a disaggregated basis.

- **<u>Please provide a more specific description of the products including their intended area of focus.</u>**

As we are submitting this response on behalf of our members who use ESG ratings and ESG data products in different ways across their business, we are not able to provide precise information to this question. Our members would however generally use ESG data and ratings for the purposes of assessing and monitoring the ESG impact of specific investments or managed portfolios, for meeting their reporting and disclosure obligations and to help clients meet their own regulatory obligations.

<u>(C) The Fees structure for contracted products</u>

- **<u>Please outline if there is a flat fee for each product offering, or discount for bundled offerings.</u>**

Although there are usually base fee cards offered by providers, overall our members tend to find that there is generally little transparency or comparability on the fee paid by different users (because providers will offer different levels of discounts) – and we expect therefore different users have negotiated different fee terms for the same products.

- **<u>Please outline the main characteristics of the fee structure, including frequency and transparency of revisions.</u>**

As noted above, there is generally little transparency on fee structures and terms. The terms for revising the fees and fees structure aren't generally clear, and do not appear to be based on objective, transparent and non-discriminatory criteria. It also seems that the fee setting policy and revisions follow, on several occasions, the opportunities arising for data / ratings providers because of the regulatory obligations applicable to asset managers under the EU ESG framework or other jurisdictions, rather than because of enhanced or additional services being provided.

<u>(D) Any usage limitations (e.g. use of ratings, access to ESG ratings, time restrictions, others).</u>

- **<u>Please outline if there are any usage limitations placed on the products which are contracted for, for example, ability to disclose or share with third parties.</u>**

As noted in our response to Q8, the contracts tend to restrict the user's ability to share / disclose the data with its investors or clients – unless the user is willing to pay for more expensive additional licences. There are usually also limitations on sharing the data / ratings with multiple teams within the same organisation because of usage restrictions and login limits – which are unhelpful because firms need to be able to share the data internally to ensure they have a common and consistent position on the ESG Additionally, some contracts may also impose time limitations for the use of the ESG data / ratings.

6.2.4 General views on ESG ratings in EU Financial Markets

Q1. Please provide your views on the level of relevance of ESG ratings to EU financial markets and financial market participants. Do you consider this level will increase in the coming years.

Although ESG ratings are commonly used by our members' clients for the purposes of comparing different products, we don't consider them to otherwise be used prevalently within the market, as the ESG infrastructure is still development. In our members' view, an ESG rating only presents part of the picture and we note that there are concerns regarding the coverage and methodologies of many common ESG ratings in the market today.

However, we do consider that ESG ratings will used more extensively within the EU financial markets and internationally over time – please see our comments below for Q2.

Q2. Please provide your views on the level of risk ESG ratings currently pose to orderly markets, financial stability and investor protection in the EU. Do you consider this level will increase in the coming years.

If ESG ratings are not calibrated properly, in our members' view, they would pose a risk to market stability and investor protection. This would be a growing risk for users of ESG ratings going forward.

SIFMA AMG also supports the views detailed in ESMA's January 2021 letter ('ESMA calls for legislative action on ESG ratings and assessment tools'). This letter highlights the need to ensure ESG ratings and products meet appropriate regulatory requirements, to ensure their quality and reliability. Otherwise, issues of greenwashing and product mis-selling are high, which create risks for investors.

However, SIFMA AMG cautions against making ESG ratings the primary focus of markets. There should not be an overreliance on ESG ratings. If ESG ratings and the risks associated with them preoccupy investors, there is a risk of creating a universe where only a select number of companies are investable. SIFMA AMG is therefore hesitant with a model that is over reliant on ESG ratings.