September 1st 2023.

To: European Commission

Re: Draft Regulation on ESG Ratings

We welcome the opportunity to comment on and present proposals of improvement to the draft, in a very summarized and objective way, hoping they are carefully analysed and considered.

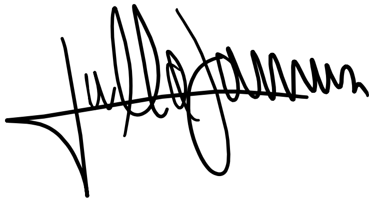
The Association Soluções Inclusivas Sustentáveis (SIS – Sustainable Inclusive Solutions, in English) is a Brazilian-based non-profit organisation focused on the connections between Sustainability and Finance, with a deep expertise on ESG financial regulations and voluntary standards at global-level, as well as best market practices. Since 2017, its seed-organisation, a small consultancy founded also by me, has been contributing to public consultations of financial regulators, including in the European Union, USA, Brazil, China, Chile and India. We have also been delivering training to financial regulators and financial institutions and providing consulting services to organisations such as the Taskforce on Nature-related Financial Disclosures (TNFD), the IFC-hosted Sustainable Banking and Finance Network, the German international cooperation agency GIZ, the World Wildlife Fund (WWF), Principles for Responsible Investment (PRI), the Chain Reaction Research, and others. Previous to that, I have developed a broad and deep research on ESG finance including financial regulations and market best practices at global level from 2014 to 2016, and have worked as Legal Counsel at the Brazilian Central Bank, who is also the national banking regulator, from 2007 to 2016. My PhD research (mostly developed in the USA) was focused on consensus-building on public policies disputes and I have also delivered dozens of trainings and acted in real conflicts on the field in Brazil. I have several scientific publications on both knowledge fields and have been talking in many relevant multistakeholder Sustainable Finance forums.

SIS is a member of the Laboratory for Financial Innovation (LAB – www.labinovacaofinanceira.com), the main Sustainable Finance multistakeholder forum in Brazil, of Coalition Brazil Climate, Forests and Agriculture (http://coalizaobr.com.br/) and of the

TNFD Forum (website: tnfd.global). SIS has currently three workstreams: a) advocacy on ESG financial regulations (banking, insurance, pensions and capital markets); b) ranking of Brazilian financial institutions on their ESG policies and actions; c) contributions to a Brazilian Green Taxonomy (classification system of economic activities according to their environmental, social and climate impacts) – as such, we have been able to write a bill (proposal of law) to the Brazilian Parliament that brings the principles of this Taxonomy (PL 2838/2022). As most of the economic activities that cause climate change (or can contribute to mitigation and adaptation) are financed through lending and/or investments and many times use insurance, we believe that our mission can have a relevant impact on climate change mitigation and adaptation.

Should you have any queries concerning the matters pointed out in this comment letter, or wish to discuss them in further detail, please contact me via e-mail at: lumoessa@hotmail.com or luciane.moessa@sis.org.br.

Yours sincerely,



Luciane Moessa

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I – Positive changes in the proposed regulation

With the increasing trend of mainstreaming ESG finance (at least in developed financial markets), the demand of environmental, social and governance data from companies is of course growing accordingly. And many investors and banks are relying to a certain extent in ESG ratings and data providers in order to fill in the many existing gaps. It is necessary to recognise that these gaps are caused in first place by the fact that capital markets regulations do not require the disclosure of ESG data with sufficient comprehensiveness, clarity and granularity, so it's not actually possible to compare the data disclosed by public companies themselves, once they are not standardised either in contents or in format. The EU CSRD and ESRS can change this state, but only if their contents is really considered to its full extent.

The rising offer of ESG ratings (and also uncertainty on if it is really possible to rely on them to fill in the gaps) led IOSCO, the global association of capital markets regulators, to make a market assessment and public consultation, whose final report was published on November 2021 and brought a **clear picture on the limitations of these sources of information** and somehow shed some lights on how they might undermine a reliable decision-making process that aims to integrate ESG factors in a sound manner. However, the final recommendations of the report are very shy in addressing the many concerns outlined. The summary of the report itself on which are the main critical points on the topic is a good departure point, anyway:

- *there is little clarity and alignment on definitions, including on what ratings or data products intend to measure;*
- *there is a lack of transparency about the methodologies underpinning these ratings or data products;*
- *while there is wide divergence within the ESG ratings and data products industry, there is an uneven coverage of products offered, with certain industries or geographical areas benefitting from more coverage than others, thereby leading to gaps for investors seeking to follow certain investment strategies;*
- *there may be concerns about the management of conflicts of interest where the ESG ratings and data products provider or an entity closely associated with the provider performs consulting services for companies that are the subject of these ESG ratings or data products; and*
- *better communication with companies that are the subject of ESG ratings or data products was identified as an area meriting further attention given the importance of ensuring the ESG ratings or other data products are based on sound information.*

The proposed EU regulation on ESG ratings addressed the 5 points to a certain extent. The governance requirements, the mechanisms to prevent conflicts of interests and ensure independence and the definition of ESMA authority over ESG ratings are essential issues that were duly addressed. The complaints mechanism is a very interesting strategy to improve the system as well.

The transparency requirements are also key and the way they are addressed in the draft are already very relevant, specially regarding: a) data sources (including use of artificial intelligence and any limitation in the data sources); b) if the methodologies are backward-looking or forward-looking; c) if methodologies are based on scientific evidence; d) if risks, impacts or other dimensions are assessed; e) the rating thematic scope and if they correspond or not to the ESRS; f) the weighting of each factor; g) if the rating is expressed in absolute or relative values; h) how fees to clients are calculated.

II – Key missing points

Nevertheless, some key issues in terms of ensuring the usefulness and value of ESG ratings for investors that want to use them in their investment management in order to better integrate ESG factors were left unaddressed.

2.1. **Real data X fake data**

The same referred IOSCO report describes (p. 20): "*a lack of reporting can either lead providers to use industry averages, thereby possibly creating an incentive for poor performers not to report their information, or lead the provider to negatively assess the company.*"

This common market practice calls it use of "industry averages", "proxies" or "estimations", when they are simply "fake data", they are not data at all. However, this point is totally left unaddressed by the proposed regulation, which even considers it acceptable, as can be seen on item "b" of Annex III (Disclosure requirements), Minimum disclosures to the public:

> "*high level overview of data processes (data sources, including if they are public or non-public, and if they are sourced from sustainability statements required by Directive (EU) 2022/2464,* ***estimation of input data in case of unavailability****, frequency of data updates*".

Item "b" of "Additional disclosures to users of ESG ratings" also includes:

> "*(2) where applicable, the use of estimation and industry average and explanation of the underlying methodology*".

In no way it is acceptable to attribute industry average data in case of non-disclosure of information. Non-disclosure can only be caused by one of two reasons: 1) the company doesn't even measure the indicator, which means a very poor governance; 2) the performance is poor (under average) and therefore it decides not to disclose (also because capital markets regulation do not define minimal mandatory information). How can this lead to consider the average of the market players that disclose relevant information is a question without an answer. The obvious solution when data are not disclosed should be the negative assessment (a score zero or any minimal score) – **this solution would be an incentive to disclose, while assigning market average**

is an incentive to poor performers not to disclose or to companies who do not even measure key performance indicators continue to do so.

It is the role of capital markets regulators to protect investors' interests and ensure transparency, which means it is not possible to ignore a common market practice (actually, a clear market failure) that discourages it.

So, we strongly advocate that the wording of item "b" is replaced by this one:

"*description of data processes (data sources, including if they are public or non-public, and if they are sourced from sustainability statements required by Directive (EU) 2022/2464, frequency of data updates, solution adopted in case of unavailability. In the case of unavailability, the use of market averages is not allowed, being possible either consider a "0" or any other minimum grade that is technically possible for the topic assessed*".

Regarding "Additional disclosures to users of ESG ratings and rated undertakings, item "b, (2)" should be simply excluded and the following items re-numbered.

2.2. **Concept of materiality**

As pointed out, Annex III, Minimum disclosures to the public, of the draft already requires, in its item "d", that "*information on the rating's objective, clearly marking whether the rating is assessing risks, impacts or some other dimensions*" is disclosed. However, it should be made more clear the concept of "impact" or, as usually named, the **concept of materiality** adopted - if it refers only to the financial risks and impacts incurred by the company that are linked to ESG issues or if it includes the ESG risks plus (both negative and positive) impacts that the company's activities generate.

The mention to "impacts" tends to point out to a "double materiality" perspective – which is already adopted by the EU Corporate Sustainability Reporting Directive (CSRD), but it is also possible to interpret it as only financial impacts, rather than include the environmental and social impacts caused by the companies' activities.

As a consequence, we strongly advocate that the wording of item "d" is replaced by:

"information on the rating's objective, clearly marking whether the rating is assessing only financial risks and impacts that arise from climate, environmental or social factors or also the climate, environmental and social risks and impacts posed by the company's activities".

2.3. Minimum thematic coverage and inclusion of the value chain

Also, Annex III, Minimum disclosures to the public, of the draft already requires, in its item "g", that: "*within the E, S or G factors, specification of the topics covered by the ESG rating/score,*

and whether they correspond to the topics from the sustainability reporting standards developed pursuant to Article 29b of Directive 2013/34/EU".

However, it does not require minimum thematic coverage, which allows that "ESG" ratings do not address key-performance issues, and that they even exclude the risks and impacts of the companies' activities across the value-chain – a minimum requirement that is already included in the CSRD, new wording of article 19a of Directive 2013/34/EU, as follows:

"*f) a description of:*
(i) the due diligence process implemented by the undertaking with regard to sustainability matters, and, where applicable, in line with Union requirements on undertakings to conduct a due diligence process;
(ii) the principal actual or potential adverse impacts connected with the undertaking's own operations ***and with its value chain, including its products and services, its business relationships and its supply chain****, actions taken to identify and monitor those impacts, and other adverse impacts which the undertaking is required to identify pursuant to other Union requirements on undertakings to conduct a due diligence process;*
(iii) any actions taken by the undertaking to prevent, mitigate, remediate or bring an end to actual or potential adverse impacts, and the result of such actions;"

How could it be possible that an ESG rating does not include the minimum Sustainability Reporting information of companies that have access to the EU capitals market?

So, we strongly advocate that the wording of item "g" is replaced by this one:

"within the E, S or G factors, specification of the topics covered by the ESG rating/score, which should include ***at least*** *the topics from the sustainability reporting standards developed pursuant to Article 29b of Directive 2013/34/EU,* ***across the entire value chain***".

2.4. **Compliance and/or performance – need of industry specific key-performance indicators**

Another potential issue is if compliance with ESG regulations is verified or if only best practices (or ESG performance according to KPIs) are considered – and to which extent. Many ratings currently available do not even consider industry-specific KPIs, while others only consider performance, without assessing compliance with environmental and social regulations (the term "regulations" here is used as the whole set of Regulations, Directives, Delegated Acts and others that apply to the activity) – which is a basic expectation of any investor who integrates ESG factors in its decision-making. So, we strongly advocate that an extra item (which could be placed just after the "g" on item 1, Disclosures to the public) should be added:

"*when any specific E, S or G factor is assessed, compliance with applicable regulations in the jurisdiction where the company operates should always be included; regarding performance, key-performance indicators of the specific industry for that factor should*

always be included as well, adopting, as a minimum, the criteria referred in EU sustainability reporting norms that are addressed at that industry".