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Public Comment on ESG Ratings and Data Products Providers

Response to IOSCO CR02/21

From Morningstar Inc. and Sustainalytics, a Morningstar Company

Submitted 6th September 2021 **by email to** consultation-02-2021@iosco.org

Dear Sirs,

Morningstar welcomes the opportunity to comment on the proposed climate-related disclosures and ESG topics in capital markets. We bring several perspectives to this comment letter. First, we have a long track record of categorizing and rating mutual funds that pursue different sustainability strategies. Second, our equity analysts use environmental, social, and governance (ESG) analysis as part of their approach to assessing investments. Third, Sustainalytics, which is now part of the Morningstar family, is a leading global provider of ESG ratings, research and data to asset owners, investment managers, financial institutions, issuers/corporates, and a variety of other financial intermediaries. For the avoidance of doubt, references in our response to either Morningstar or to Sustainalytics apply equally to both entities.

Regulatory attention on ESG ratings reflects that they are increasingly meaningful factors in investor decisions, as the flow of investments into ESG strategies continues to escalate. We caution that resultant regulation be a meaningful starting point, serving as a floor, rather than ceiling of expectations and requirements. Investors, and market forces, should be able to demand more in determining what will be meaningful in their decision-making. The IOSCO recommendations will help in constructively moving the discussions forward toward that end.

A principles-based approach focused on the integrity, independence and quality of ESG ratings should reflect their nature, rather than be retrofitted into other regulatory frameworks. For example, there are distinct differences between ESG ratings and credit ratings, whereby the latter have a widely accepted common definition and the former are multi-dimensional and still evolving. Such differences, in part informed by the feedback provided by Morningstar's independent credit rating subsidiary, DBRS Morningstar, are referenced further in our response, as appropriate.

Diversity of views about the relative weights of the multi-dimensional E, S and G factors exists across users of ESG ratings and should be able to vary across rates, as it does for example across equity research firms more broadly, provided that the methodologies meet transparency requirements.

We thank you for the opportunity to comment.

Yours faithfully,

Andy Pettit,

Director, Policy Research (EMEA), Morningstar

1: Regulators may wish to consider focusing more attention on the use of ESG ratings and data products and ESG ratings and data products providers in their jurisdictions.

Regulatory attention is warranted because asset managers and investors increasingly need quality sustainability-related ratings. The focus on providers of this information reflects reality: sustainability ratings will play an ever-increasing role in fund flows and is an integral part of investing. Regulation should focus on “ESG ratings”, with there being no policy argument to single out and regulate “ESG data providers” (entities that aggregate, create and/or distribute ESG data) since data aggregation/ distribution is not otherwise regulated in any other sphere of financial services industry. To the extent an ESG rating provider also offers ESG data services, and such data (aggregation/distribution) services may represent potential conflicts in the context of provision of ESG ratings, such conflicts can be identified, managed and mitigated as part of the governance of all potential conflicts that are relevant for ESG rating business. Presence of any such potential conflicts does not necessitate regulation of ESG data.

Key elements of a regulatory framework should be the transparency of ratings processes and methodologies; transparency and quality of the resultant ESG ratings and disclosures; and management of conflicts of interest.

Transparency and disclosure are important across the value-chain, from issuers, through ESG rating providers and to financial product manufacturers. The challenge is in defining meaningful disclosures, which provides relevant information to users, which they can find and interpret without it being obfuscated within overly long disclosures, that incorporate impenetrable levels of detail. While making this information available, rating providers also need to be able to balance doing so with protection of their intellectual property which is developed to provide differentiated and innovative information and services.

Potential conflicts of interest are an important issue and at a minimum, ESG rating providers should publicly disclose the sources of potential conflicts of interest in their business model as well as the steps they take to mitigate these conflicts of interest. Beyond these public disclosures, ESG rating providers should disclose any potential conflicts of interest to specific clients if those conflicts could be relevant. We believe this could be beneficial to all players involved and promote plurality and innovation in this market.

Associated governance processes to manage the above aspects are vital and having a culture of compliance and written processes is a necessary requirement for ensuring quality, although public disclosure of such processes would seem excessive. We provide further specific comments in our responses to subsequent IOSCO recommendations below.

2: ESG ratings and data products providers could consider issuing high quality ESG ratings and data products based on publicly disclosed data sources where possible and other information sources where necessary, using transparent and defined methodologies.

Morningstar remains committed to the quality and integrity of its ESG ratings. Our ESG ratings are informed by logical and thoughtfully structured methodologies. We strive to incorporate the relevant information available to us in our assessments and to be transparent regarding the way our engagement assessments are conducted. We are committed to providing clients and prospects with relevant information about our research and rating methodologies, as well as information about the sources of information that are used.

High level information is already available for the public, free of charge, via our website and additional details are provided to our clients, via delivery channels, subject to confidentiality commitments.

Furthermore, Sustainalytics is supporting its investor clients in using its research to meet their own disclosure requirements such as disclosure requirements under the EU Taxonomy Regulation and other similar requirements. As part of this exercise, we provide the users of our ESG ratings arm with the relevant information about our assessment processes, methodologies and the source of information used in our assessment.

We also believe that sufficient and highly competent and professional resources are a key element to ensure the quality and integrity of the ESG Ratings. To that effect, within the Morningstar group, Sustainalytics has 1100+ employees located across 17 offices, including over 350 analysts with multidisciplinary expertise across more than 40 sectors. As we strive to create a culture of operational excellence across the company, we support employees` professional development through access to CFAs and PRI trainings or skill-based trainings like leadership training and Lean Six Sigma principles to enhance business processes and quality management tools, and by leveraging technology in our research processes.

3: ESG ratings and data products providers could consider ensuring their decisions are, to the best of their knowledge, independent and free from political or economic pressures and from conflicts of interest arising due to the ESG ratings and data products providers' organizational structure, business or financial activities, or the financial interests of the ESG ratings and ESG data products providers' employees.

4: ESG ratings and data products providers could consider on a best efforts basis, avoiding activities, procedures or relationships that may compromise or appear to compromise the independence and objectivity of the ESG rating and ESG data products provider's operations or identifying, managing and mitigating the activities that may lead to those compromises.

For recommendations 3 and 4 Morningstar would highlight that management of conflicts of interest is important for the independence of our ESG ratings and providers should be required to put in place and disclose the measures that ensure such independence.

We would also highlight that both issuer and investor pay models have worked well within current supervised financial entities. At a minimum, ESG rating providers should publicly disclose the potential conflicts of interest in their business model as well as the steps they take to mitigate these conflicts of interest to become real.

This is no different for Sustainalytics, which operate multiple lines of business that serve a variety of client types. Therefore, the way in which we manage and safeguard against the potential conflicts of interest becoming real is germane to our research objectivity and critical to the good reputation we have built over the last 25 years.

Our goal is two-fold: first, to establish and enforce effective conflicts of interest management policies, practices and procedures to ensure that potential conflicts of interest do not become real conflicts and secondly, to protect the interests of key stakeholders by implementing and enforcing satisfactorily comprehensive conflicts of interest management policies and procedures.

Sustainalytics uses a combination of conflict management policies, procedures, organizational and technical measures to mitigate potential conflicts of interest. Ultimately, our goal is to maintain the integrity of our ESG ratings and research. Our conflict management framework specifically addresses analytic independence, systems' separation, process consistency and data protection.

Personnel are expected to take all necessary measures to avoid any possible conflicts of interest and to avoid engaging in activities that might jeopardize – or appear to jeopardize – the integrity of their conduct or Sustainalytics' reputation. In addition, Sustainalytics Personnel are organized in different teams with specific and separated roles and responsibilities. Commercial Personnel are separate from Research Personnel and from Support Personnel. Commercial Personnel, Research Personnel and Support Personnel are managed by different executives.

Fuller details covering personnel organization; facilities and IT infrastructure; data usage, storage and separation; managing private interests; research process; and communication with clients and assessed companies, can be found here - https://www.sustainalytics.com/docs/default-source/default-document-library/abstract_of_conflicts.pdf?sfvrsn=bfc858b3_0

Additionally, Morningstar's Code of Ethics, applicable to all Sustainalytics' personnel, sets out certain standards of conduct that all employees are expected to abide by, including standards of conduct in the workplace, professional business practices, avoidance of potential conflicts of interest, consistency and integrity of research, internal and communication restrictions, insider trading, accepting gifts, fair dealing and handling of confidential data. Personnel are required to review and sign the Code upon hiring and annually thereafter.

Sustainalytics embraces diversity, including political opinions, and supports the civic and democratic participation of our Personnel within the public life in their respective locations. Political activity however is not permitted in the workplace. Further, Sustainalytics does not knowingly, directly or indirectly, at any time: (a) make contributions to a candidate for political office; (b) fail to fully disclose any such contribution, in violation of a law requirement; or, (c) make a payment to any state, foreign or government official or officer, or other person charged with similar public duties, other than payments or contributions required or allowed by applicable law.

Morningstar is supportive of and practices the principle of not remunerating analytic staff on the basis of revenues derived from companies which we provide analysis to.

5: ESG ratings and data products providers could consider making high levels of public disclosure and transparency an objective in their ESG ratings and data products, including their methodologies and processes.

Our assessments are informed by structured methodologies and frameworks. We strive to be transparent regarding the way our research is conducted, in order to support the quality and integrity of our products and services. We are committed to providing clients and prospects with information about our research and rating methodologies, as well as information about the sources that are used.

High level information is already available for the public, free of charge, via our website and additional details are provided to our clients, via delivery channels, subject to confidentiality commitments.

Furthermore, Sustainalytics is supporting its investor clients in using its research to meet their own disclosure requirements such as disclosure requirements under the EU Taxonomy Regulation and other similar requirements. As part of this exercise, we provide the users of our ESG ratings arm with the relevant information about our assessment processes, methodologies and the source of information used in our assessment.

6: ESG ratings and data products providers could consider maintaining in confidence all non-public information communicated to them by any company, or its agents, related to their ESG ratings and data products, in a manner appropriate in the circumstances.

As a general practice, we endeavor to base our research on publicly disclosed, publicly available or disclosable information. Our research processes involve the collection and analysis of information made publicly available by a variety of third parties, including civil society, corporate, government, industry association, investor, media and regulatory sources.

Where non-public or non-published information is provided to Sustainalytics, such information should be (a) non-material and (b) disclosable by the issuer upon request by third parties. While some other, non-ESG ratings products may entail use of confidential information by a provider, we recommend that such scenarios be addressed separately and not confused with or embedded within ESG ratings regulation.

The non-public information provided by issuers may be reflected in our research provided that: (a) Such information is non-material; (b) Such information cannot be extracted from or identified in our research, unless otherwise agreed in writing between Sustainalytics and the issuer owning the information. It is the issuer's responsibility to determine the materiality of any information so provided, and to take the necessary steps to publicly disclose material information in a timely manner. Sustainalytics accepts no responsibility for determining the type of information shared with us, or for verifying that material information intentionally or unintentionally shared with us has been properly disclosed. This is solely the responsibility of the issuer, whether the company is publicly-traded or privately-held.

7: Financial market participants could consider conducting due diligence on the ESG ratings and data products that they use in their internal processes. This due diligence could include an understanding of what is being rated or assessed by the product, how it is being rated or assessed and, limitations and the purposes for which the product is being used.

We are in favour of such processes and strive to provide the users of our ESG ratings arm with the relevant information about our assessment processes, methodologies and the source of information used in our assessment. ESG ratings are intended to be taken into consideration by market participants in their decision-making process. An appropriately calibrated regulatory framework for ESG ratings should foster market participant engagement with the ESG rating providers and enable such participants to perform reasonable diligence in respect of the ESG ratings provider, as they do with other service providers. Such an approach would also dovetail with the other IOSCO recommendations to ESG rating providers.

8: ESG ratings and data products providers could consider improving information gathering processes with entities covered by their products in a manner that is efficient and leads to more effective outcomes for both the providers and these entities.

9: ESG ratings and data products providers could consider responding to and addressing issues flagged by entities covered by their ESG ratings and data products while maintaining the objectivity of these products.

Companies should have a right to respond to ESG rating providers, while preserving the independence of the ratings and opinions. Morningstar already submit our ratings and research for pre-publication feedback to around 4,500 companies because we agree with the importance of providing them with a chance to inform us of any factual errors in our assessments.

On a related item, we also embrace the current solution in US for voting recommendations, whereby providers are required to share the recommendation with the issuers. Issuers may decide to publish additional information in response to that recommendation. The provider is expected to enable its clients to become aware of such additional information/ comments received, without being required to amend the recommendation (research).

10: Entities subject to assessment by ESG ratings and data products providers could consider streamlining their disclosure processes for sustainability related information to the extent possible, bearing in mind regulatory and other legal requirements in their jurisdictions.

As shown in our attached report, *Corporate Sustainability Disclosures: An Improving Picture, But Regulation Would Induce a More Complete and Comparable Baseline of Material Information for Investors*, voluntary disclosures by issuers have increased over time. While those rates of disclosure remain sub-optimal, the increased rates indicate that mandated disclosures would not be a significant overhead for many companies.

Ultimately, more complete and consistent issuer disclosures will feed through to more informed ESG ratings.