ESMA Call for Evidence On Market Characteristics for ESG Rating Providers in the EU

ESMA will consider all comments received by 11 March 2022.

Fields marked with * are mandatory.

Who should read this paper

While all interested stakeholders are invited to respond to this call for evidence, this call for evidence contains a dedicate questionnaire for each of the following three target groups:

1. ESG Rating Providers (Questionnaire A in Section 6.1), including but not limited to:
    - **Legal entities established in the EU** whose occupation includes issuing ESG ratings on a professional basis.
    - **Legal entities not established in the EU** whose occupation includes issuing ESG ratings on a professional basis t EU clients.
    - **Legal entities not established in the EU** whose occupation includes issuing ESG ratings on a professional basis o EU listed and unlisted entities and financial instruments distributed in the EU.
2. Users of ESG Rating Providers (Questionnaire B in Section 6.2), including but not limited to:
    - **Financial market participants** such as credit institutions, investment firms, asset managers, insurance undertaking: reinsurance undertakings, that are either already using or considering the use of ESG ratings.
    - **Public Sector Authorities** such as financial supervisors, ministries of finance, debt management offices and centr banks.
    - **Individual users acting in a professional capacity** such as financial advisors and analysts.
    - **Other individual users** such as retail investors, non-governmental organisations, international organisations, member of the press, and academics.
3. Entities covered by ESG Rating Providers (Questionnaire C in Section 6.3), including but not limited to:
    - **Publicly listed entities** who are covered by ESG ratings provided on a professional basis by entities located inside c outside the EU.
    - **Private unlisted entities** who are covered by ESG ratings provided on a professional basis by entities located inside c outside the EU.
    - **Sovereign issuers** who are covered by ESG ratings provided on a professional basis by entities located inside c outside the EU.

Abbreviations and definitions

Abbreviations

- **EC**: European Commission
- **ESG:** Environmental, Social, Governance
- **EU:** European Union
- **ESMA**: European Securities and Markets Authority
- **IOSCO**:International Organization of Securities Commissions

Definitions

For the purposes of this paper the terms ESG ratings and ESG data products are understood as those set out in Internation Organization of Securities Commissions's (IOSCO) Final Report on Environmental, Social and Governance (ESG) Ratings an Data Products Providers[1].

- **ESG data products**: refer to the broad spectrum of data products that are marketed as providing either a specific E, S, or focus or a holistic ESG focus on an entity, financial instrument, product or company's ESG profile or characteristics c exposure to ESG, climatic or environmental risks or impact on society and the environment, whether or not they are explicitl labelled as "ESG data products".
- **ESG ratings**: refer to the broad spectrum of ratings products that are marketed as providing an opinion regarding an entity, financial instrument or a product, a company's ESG profile or characteristics or exposure to ESG, climatic or environment risks or impact on society and the environment that are issued using a defined ranking system of rating categories, whether c not these are explicitly labelled as "ESG ratings".

[1] FR09/21 November 2021 (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf)

1.Introduction

1. On 28 January 2021, ESMA wrote to the European Commission (EC) to advise that it considered the unregulated nature ESG ratings and data assessments posed a potential risk to investor protection. To mitigate these risks ESMA highlighted th need to match the growth in demand for these products with appropriate regulatory requirements, to ensure their quality an reliability.
2. This letter was followed by the publication of the EC's Strategy for financing the transition to a sustainable economy on 6 Jul 2021. As part of this strategy, the EC announced that it will take action to improve the reliability, comparability an transparency of ESG ratings[1]. In order to achieve this, the EC committed to launching a public consultation. This publi consultation is intended to gather information on the issue, with a view to developing an impact assessment on the costs an options of a possible EU intervention.
3. With a view to receiving supporting evidence for this process, the EC addressed a request for support to ESMA on 1 November 2021. This request noted that ESG ratings are used by a wide variety of investors to take into account risks an opportunities linked to ESG issues. In addition, it noted that these products are having an increasingly important impact o the operation of capital markets and on the confidence of investors in sustainable finance products. As a result, the E requested that ESMA conduct a call for evidence with a view to identifying those ESG rating providers that are currently eithe present in the EU or located outside but operating in the EU.
4. This call for evidence seeks to develop a picture of the size, structure, resourcing, revenues and product offerings of th different ESG rating providers operating in the EU. ESMA is looking to complement this picture by collecting views an experiences from the users of these ESG rating providers, as well as those entities covered by ESG rating providers.
5. It is anticipated that this consultation from ESMA will be followed by a complementary consultation on this topic from the EC The latter should seek stakeholder views about the use of ESG ratings by market participants and the functioning an dynamics of the market, potential issues, but also help inform on potential costs of an intervention at EU level.

[1] Action 4c of Annex to the European Commission's Strategy for financing the transition to a sustainable economy. (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021DC0390)

2. ESG Rating Providers

1. As highlighted in ESMA's correspondence to the EC in January 2021, recent legislative initiatives in the EU have increase financial market participants' needs for information on entities' sustainability characteristics. ESG ratings are just one exampl of a product that is suited to providing this type of information. However, without regulatory safeguards for these product several issues and risks reduce the potential benefits of these ratings.[1] In addition, a study commissioned by the EC an published in January 2021 identified a lack of transparency of ESG rating providers' operations, a low level of comparabilit between ESG ratings, and potential conflicts of interest.[2]
2. While ESMA's supervisory mandate does not currently extend to ESG rating providers, ESMA does have existing supervisor relationships with entities affiliated with ESG rating providers through their wider group structure.

3. Through its participation at IOSCO, ESMA has also been involved in recent work to promote good practices for ESG ratin providers, the users of these products as well as entities covered by these providers[3], at a global level. However, despit the valuable information that has been received through these interactions, a comprehensive understanding of the currer market structure for ESG rating providers active in the EU has yet to be established.

4. For this purpose, the term "ESG rating provider" is used to refer to entities that develop, offer or provide ESG ratings meetin the description provided on page 3 of this Call for Evidence. In addition, the term "active in the EU" is used to refer to ES(ratings providers who are either, for example, located in the EU, have clients who are based in the EU or who are locate outside the EU but provide ESG ratings on entities that are headquartered in the EU.

5. Developing this understanding means establishing a reliable picture of the number, size, business models and produc offerings of the different ESG rating providers that are relevant for the EU market.

[1] See ESMA Report on Trends, Risks and Vulnerabilities, No.1, 202 (https://www.esma.europa.eu/sites/default/files/library/esma50-165-1524_trv_1_2021.pdf), "ESG ratings: Status and key issue ahead", pp.105-115.
[2] See ERM, Study on sustainability-related ratings, data and researc (https://www.esma.europa.eu/sites/default/files/library/esma50-165-1524_trv_1_2021.pdf), January 2021.
[3] IOSCO FR09/21 Environmental, Social and Governance (ESG) Ratings and Data Products Provider (https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf)

3. Users of ESG Ratings

1. In order for ESMA to be able to validate and expand on the information received from ESG rating providers, ESMA is also gathering information from the users of ESG ratings. This information is intended to allow ESMA to understand the different ways in which financial market participants make use of ESG ratings from rating providers who are active in the EU as well a: the market dynamics within the industry.

2. The approach of these questions is similar to the section for ESG rating providers. It aims to first establish the legal and regulatory characteristics of those entities contracting with ESG rating providers. It then looks to assess what products they are using and contracting for from ESG rating providers, for which objectives, the nature of the licensing agreements and whether any limitations are placed on the use of this data.

3. On the basis that the business model for providers of ESG ratings is predominantly an investor pays model in the current state of play, clients of ESG rating providers are likely to also be the users of their ESG ratings. However, it is possible that alternative business models exist where the users of an ESG rating providers' products do not have a contractual relationshi with the provider, for example in the case of not for profit ESG rating providers. To accommodate these two situations the term "users" in this call for evidence refers to both users who have access to ESG ratings on the basis of a contractual relationship with ESG rating providers as well as those users who use ESG ratings on a non-contractual basis.

4. Entities Covered by ESG Rating Providers

1. In addition to the views of ESG ratings providers and their clients, it is also important to receive information from the entities covered by these providers. Given the predominantly 'investor pays' model of the market for ESG ratings in its current form, i is less common that these entities would have contractual relationships with the entities who are assessing their businesses.

2. Nevertheless, it is important to establish the modalities of these interactions to understand if they pose wider issues for investor protection. For example, the nature of links between ESG rating providers and entities covered could create issues for conflicts of interest management in situations where the rated entity is also a client of the ESG rating provider for other services.

3. The approach of the questions in this section is to build a general picture of whether and how rated entities interact with ES(rating providers active in the EU. In particular, whether their interactions are subject to any contractual agreements an whether there are common problems with the nature, frequency and transparency of these interactions.

5. Next steps

1. Based on the feedback received, ESMA intends to collate the responses to each section and provide the Europea Commission with an overview of the market for ESG rating providers present or operating in the EU. It is intended that this wi be delivered before the end of Q2 2022.

*** Do you agree that your contribution to this survey can be published?**

- ○ Yes
- ◉ No

*** Please select your category:**

- ◉ ESG Rating Provider
- ○ ESG Rating User
- ○ Entity covered by ESG Rating Providers

Questionnaire A- ESG Rating Provider

1. Background information

* Q.1 Name of respondent or organisation (including Legal Entity Identifier where applicable).

Sustainalytics B.V. D-U-N-S® Number 407297741

Q.2 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 Member State for each)
- ○ (C) No legal entity or corporate headquarters established in EU (please indicate country of corporate headquarters)
- ○ (D) Other (Please explain)

If you answered Q.2, please explain:

Sustainalytics B.V. is a subsidiary of Morningstar Inc. Morningstar Inc has a number of subsidiaries in the EU in France, Germany, Denmark, Norway, Sweden, Spain, Romania,Poland, Italy, Luxembourg and the Netherlands. Morningstar Inc. is listed on NASDAQ.

Q.3 Nature of Legal entity

- ○ (A) Parent company witihin group structure.
- ◉ (B) Subsidiary within group structure.
- ○ (C) Independent legal entity, no group structure.

Q.4 If you answered (A) or (B) to Q3, please provide further detail on the nature of the group structure.

See answer to Q.2.

Q.5 Respondent subject to any existing financial regulatory authorisation, registration or supervisory regime.

- ○ Yes
- ◉ No

If you answered Yes to Q.5, please provide further details of the regime including name of authorisation, registration or supervisor body and reference to supporting legal acts.

The Morningstar group of companies does include certain subsidiaries / affiliates who are regulated, such as a Credit Rating Agency and our Investment Management activities.

Q.6 General nature of business model:

- (●) (A) For-profit large provider: offering ESG ratings, ESG data products as well as as non-related financial information products or services.
- ( ) (B) For-profit specialist provider: offering ESG ratings and ESG data products.
- ( ) (C) Non-Profit provider: offering ESG rating and ESG data products.

Q.7 ESG Rating Provider:

- (●) Yes
- ( ) No

If you selected "No" in Q.7, please indicate whether ESG rating products are provided by an affiliated entity or a parent company.

Q.8 ESG Data Products Provider

- (●) Yes
- ( ) No

If you selected "No" in Q.8, please indicate whether ESG data products are provided by an affiliated entity.

Our current Sustainalytics business model distinguishes between investor and corporate solutions rather than distinguish between ratings and products. Please see https://www.sustainalytics.com/esg-data for details on how we distinguish ESG ratings and other products / services.

Q.9 Please describe the aspects and features of an issuer or entity's profile your ESG ratings assess, and the criteria considered.

Information about our methodology for ESG ratings can be found here: https://connect.sustainalytics.com/hubfs/INV/Methodology/Sustainalytics_ESG%20Ratings_Methodology%20Abstract.pdf

Q.10 Please describe the purposes for which you consider your ESG ratings would be suitable.

Information relating to the purposes (use cases) for which we provide our ESG ratings can be found here: https://www.sustainalytics.com/corporate-solutions/esg-risk-ratings#use & https://www.sustainalytics.com/esg-data#usecases

Q.11 Please list the different categories of ESG data products that you currently offer to your clients together with a short description (objectives of the product and principal characteristics).

We do not categorise data products separately from our ratings. The current Sustainalytics business model is split between Investor and Corporate Solutions. Full details of our solutions can be found at https://www.sustainalytics.com/esg-data

Q.12 Please describe the mechanisms you have designed and put in place to deal with the identification and management of possible conflicts of interest in relation to your product offerings

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 our operations or identifying, managing and mitigating the activities that may lead to those compromises. 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-documentlibrary/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

2. Corporate Structure

Q.1 Publicly Listed:

- ○ (A) Inside the EU
- ◉ (B) Outside the EU
- ○ (C) Not Listed

Q.2 Size Of Balance Sheet in EUR for each of the years 2019, 2020 and 2021:

	Balance sheet > 500 m	Balance sheet 100 m > 500 m	Balance sheet 43 m > 100 m	Balance sheet 10 m > 43 m	Balance sheet < 10 m	N/A
2019	○	○	○	○	◉	○
2020	○	○	○	○	◉	○
2021	○	○	○	○	◉	○

3. Business Model

Q.1 Total Revenues (in EUR) for 2020:

	EUR Total Revenues
Global	73,524,024.65 for the global Sustainalytics
EU clients / Accounted for in the EU	28928388.22

Q.2 Revenues (in EUR) for 2020 from ESG ratings specifically:

	ESG rating Revenues (EUR)
Global	
EU clients / Accounted for in the EU	
N/A	we do not currently separate out ratings

Q.3 Revenues (in EUR) for 2020 from other ESG data products:

	ESG rating Revenues (EUR)
Global	
EU clients / Accounted for in the EU	
N/A	we do not currently separate out ratings

Q.4: Please explain the fees model for the below product offerings, including whether they are offered on a predominantly investo pays or issuer pays basis, and the rationale for any exceptions:

	ESG Rating products	ESG Data products
Fee Model	both models are offered	we currently do not separate out ratings /

4. Clients Profile (based on location of contracting legal entity)

Q.1 Total number of clients

	ESG rating Revenues (EUR)
Global	1028 - see Q1 for revenues
EU (% Breakdown by Member State, if possible)	143 - see Q1 for revenues
N/A	we do not currently separate out rating and

Q.2 Number of clients who contract for ESG ratings

	ESG rating Revenues (EUR)
Global	
EU (% Breakdown by Member State, if possible)	
N/A	We do not breakdown between ESG ratings /

Q.3 Number of clients who contract for ESG data products

	ESG rating Revenues (EUR)
Global	
EU (% Breakdown by Member State, if possible)	
N/A	We do not breakdown between ESG ratings /

5. Resourcing

Q.1 Total number of staff in your organisation, in Full-Time Equivalent (FTE):

	2021
EU based staff	725
Non-EU based staff	643

Q.2 Total number of outsourced staff in your organisation, in Full Time Equivalent (FTE):

	2021
EU based staff	0
Non-EU based staff	0

Q.3 Total number of office locations in EU (Please indicate member states)

8 Sustainalytics entities in Sweden, Spain, Romania, Poland, Netherlands, Germany, France, Denmark.

Q.4 Total number of staff performing analytical functions, in FTE:

	2021
EU based staff	319
Non-EU based staff	358

Q5 Total staff performing analytical functions, in FTE:

	2021
ESG ratings	we do not break down between ratings / data
Other ESG data products	we do not breakdown between ratings / data

6. General views on ESG ratings in EU Financial Markets

Q.1 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?

Global sustainable fund assets expanded by 9% in the fourth quarter to USD 2.74 trillion at the end of December 2021. Inflows grew 12% relative to Q3, to USD 142 billion, driven by continued investor interest in environmental, social, and governance issues and by regulation. Europe accounted for close to 80% of fourth-quarter inflows. Product development remained strong, with 266 new sustainable fund launches globally in the fourth quarter. The Sustainable Finance Disclosure Directive goes some way to identify different types of ESG products but financial market participants continue to look for more granular information about securities, while placing different relative weights on the multi-dimensional E, S and G factors that exist. Together with disclosures, taxonomies and labels, ESG ratings play a part in satisfying these investor needs and we expect that to continue.

Yes - we do consider that the level of relevance will increase in coming years.

Q.2 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?

Whilst financial market participants continue to look for more granular information about securities, there are several on-going and evolving disclosure requirements and initiatives (the EU Non-Financial Reporting Directive, the proposal for Corporate Reporting Directive) that call for more transparency from the issuers regarding their ESG performance and products. As such disclosures are still not consistent in practice across different issuers and ESG products, ESG rating providers play an important role in defining the estimation and ESG risk assessment models. Where the actual issuers or ESG products don't follow the estimations or ESG risk assessment models there may be increased risk of "green washing".

We believe that if ESG ratings methodologies are transparent, supported by quality data and are based on the principles of independence and integrity that there is negligible risk to orderly markets, financial stability, and investor protection. Additionally, as the issuers' disclosures mature, ESG rating providers will be able to rely on data of better quality and quantity, which will in turn improve ESG ratings and further reduce risk to markets, financial stability and investor protection in the EU will reduce.