

With the regulation on environmental, social and governance (ESG) rating provider activities, the EU is the first jurisdiction in the world to move to regulate the ESG rating market. While credit ratings assess the default risk of a company, which can be influenced by ESG factors and other risks through various issues, ESG ratings assess the “sustainability” of companies. On 5 February 2024¹, the European Union (EU) published a [draft proposal](#) (Draft Proposal) for the regulation of ESG ratings.

It marks a significant step towards resolving the concerns raised by the European Securities and Markets Authority (ESMA) in early 2021 regarding the lack of transparency and potential risks for investors in the unregulated ESG rating sector. According to this, ESG rating providers that provide their services within the European Economic Area (EEA) should be subject to authorisation and supervision by ESMA. To achieve this aim, the Draft Proposal requires ESG rating agencies to evaluate and record the effects of companies on ESG factors in a more thorough manner, with the goal of enhancing transparency and integrity in the industry, with the social factor also including human rights.

According to the Draft Proposal, ESG ratings are to be clearly distinguished into environmental, social and governance categories, with the weighting of these three categories clearly defined. If the rating provider deviates from this, e.g. if this division is not viable, it must clearly indicate which category will be given the highest weight in relation to the others when it comes to the company ESG rating.

Furthermore, the parameters that define the future scope of the regulation and the conditions under which ESG ratings are subject to it are clearly outlined. While providers outside the EU/EEA will require the endorsement of an EU-authorized provider or recognition based on a quantitative criterion, EU-authorized providers will need to obtain an authorisation from ESMA; alternatively, they can obtain an equivalence decision through a dialogue between a relevant authority from their home country and ESMA. In addition, a temporary, lighter and voluntary registration program of three years is introduced for small ESG rating providers to facilitate their market access. At the same time, the principle of separation of business and activities is introduced. This means that rating providers can choose not to create a separate legal entity for specific activities if there is a clear separation, and if suitable measures are taken to prevent conflicts of interest. Nevertheless, ESG rating providers that carry out consulting, audit and credit rating activities are an exception to this. If ESMA determines that adequate steps have been taken to address conflicts of interest, ESG rating providers may still create a benchmark.

The EU Council and EU Parliament must approve the Draft Proposal before it can proceed with the formal adoption procedure. The regulation is anticipated to go into effect fully 18 months after it is enacted. It was one of the final missing pieces for the European Commission to deliver on its sustainable finance commitments outlined in its EU Action Plan.

¹ Proposal for a Regulation of the European Regulation and the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities, and amending Regulation (EU) 2019/2088 – Confirmation of the final compromise text with a view to agreement, 2023/0177(COD), 9 February 2024.