8 June 2022

Mr. Sven Gentner
Head of Unit
FISMA.C.1
Corporate reporting, audit & credit rating agencies
Directorate-General for Financial Stability, Financial Services and Capital Markets Union
European Commission

Submitted via file upload

Dear Mr. Gentner,

TARGETED CONSULTATION ON THE FUNCTIONING OF THE ESG RATINGS MARKET IN THE EUROPEAN UNION AND ON THE CONSIDERATION OF ESG FACTORS IN CREDIT RATINGS ("THE CONSULTATION")

MSCI welcomes the initiative by the Commission to consult on the development and use of environmental, social and governance (ESG) ratings in the European Union (EU). We are encouraged by the renewed commitment to the capital markets union (CMU) at the High-level conference *Capital Markets Union: Investing for a stronger, prosperous and sustainable European Union* on 1 June 2022. Creating a single market for capital and supporting a green, inclusive and resilient economic recovery are important objectives and we look forward to assisting investors achieving the goals of the CMU.

MSCI has a unique perspective on the ecosystem for ESG ratings. MSCI ESG Research LLC is a leading provider of ESG ratings to the global investment community and MSCI Limited is a user of ESG ratings as a benchmark administrator. In our view, the EU capital market would be best served by **creating a regulatory pathway for ESG ratings starting with a code of conduct sponsored by the EU Commission that incorporates principles of conduct for ESG rating providers and protects the independence and objectivity of ESG ratings.** We set out below our reasons for this view and, in our response to the questionnaire, set out our comments as a user and provider of ESG ratings.

The regulatory pathway should start with a code of conduct for the industry

In our response to the consultation of the International Organisation of Securities Commissions (IOSCO) on ESG ratings and data providers [CR02/21|July 2021],[1] MSCI agreed that it was important that ESG ratings are, and are seen to be, credible. We welcomed the introduction of principles of conduct that seek to create the foundations for ESG rating best practices. Given the nascent ESG market, these principles should be introduced through non-legislative means, such as an industry code of conduct, developed under the administration of IOSCO or the Commission. This approach would provide the necessary agility for ESG rating providers and policymakers to respond to as-yet-unknown future risks, developments and opportunities. It also

[1] Consultation Report - Environmental, Social and Governance (ESG) Ratings and Data Products Providers (IOSCO | July 2021)

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avoids the significant challenges with any new regulatory framework, such as increased costs, reduced competition and the issues of scope which risk 'freezing' the sector at a point in time. There is strong and successful precedent for this approach in the benchmark and credit rating agency sectors.

Furthermore, important challenges that arise from the lack of underlying raw data will improve over time once new EU legislative frameworks[2] come into effect. There are important timing challenges related to implementing the various legislative initiatives, and by starting with a code of conduct, the Commission will allow for these underlying issues to be resolved whilst establishing expected principles of conduct for ESG rating providers.

An industry code of conduct should reflect the principles of transparency and management of conflicts of interest

In our discussions with market participants, there was a clear consensus that:

- the objectives of ESG ratings must be clearly communicated;
- users must be able to understand the rating methodology and have comfort in its consistent application; and
- conflicts of interest must be identified and managed.

We agree with these views, which are reflected in our rating practices:

- *Transparency* – MSCI has made our ESG ratings and the key elements of our ratings process and underlying methodology publicly available at no cost on our website. Our clients and issuers have access to fully documented methodologies, extensive rating reports and underlying rating data.

- *Conflicts of interest* - MSCI operates under strict policies and procedures that (1) protect against conflicts of interest (arising from, for example, relationships with or pressures from issuers, investors or governments) impacting our ESG ratings and (2) ensure that our ratings are independent. All employees of our ESG ratings business are trained on, and certify to, our policies and procedures at least annually, with additional targeted training taking place throughout the year.

- *Assignment of ratings* – We have over 200 analysts globally who analyse data originating from corporate disclosures as well as from media, academic, non-governmental organisations (NGOs), and regulatory and government sources. MSCI has an established governance process to ensure that ratings are assigned consistently and in accordance with our rating methodology.

There are no material shortcomings in terms of market expectations versus industry practice that require legislative intervention at this stage. Rather, by formally adopting a code of conduct and creating a platform for industry dialogue, the market will be able to work together more effectively and respond to the changing dynamics of the sector.

[2] Commission's proposal for a Corporate Sustainability Reporting Directive (CSRD), proposals for a Regulation to establish a European Single Access Point (ESAP) and associated delegated acts.

Independence and objectivity of ESG rating providers should be protected

MSCI maintains a strong internal culture supported by policies and procedures that protect our independence in assigning ESG ratings. It is important that ESG rating providers are not placed under any undue pressure by issuers, investors, regulators or governments in assigning an ESG rating. Only where ESG ratings are assigned without any perception of interference will investors have confidence in the overall transparency and integrity of the rating.

The Consultation raises a few questions regarding the correlation, or lack thereof, between ratings assigned by different providers. Attempting to harmonise or standardise ESG ratings, methodologies, models or rating scales will have a negative impact on the market and materially impair the independent judgment and assignment of high quality ESG ratings. Investors look for a diversity of opinion from ESG providers, an ability to hold an independent opinion that is best-in-class and is not simply a weighted average of industry views. Measures that specify a harmonised/standardised approach may create a static, inflexible system that is inherently unsuitable for such a rapidly evolving sector and could ultimately make rating providers less capable of responding to innovations and meeting demands in a continuously evolving market.

Today, the lack of uniformity in ESG ratings is often described as a weakness; we believe it demonstrates the diversity of opinions and methodologies. By analogy, there would be limited utility if all investment advisers came to the same buy/sell/hold determinations in their assessments of securities. Dispersion of views and approaches demonstrates a dynamic and competitive market where investors have choices to select providers that reflect their perspective or multiple providers that provide varying and diverse inputs. A mandated one-size fits-all approach to ESG ratings would reduce the thoroughness, innovation, effectiveness and evolution of the ratings.

Our responses to the targeted consultation are attached as Annex.

We welcome ongoing engagement with the Commission and would be pleased to participate in the development of a code of conduct for ESG rating providers.

Yours faithfully,

/s/
Neil Acres
Managing Director
Global Head of Government and Regulatory Affairs

Annex – MSCI response to the targeted consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings

Note: 1. We respond to the Targeted Consultation as follows: **Part A – I A** – MSCI Ltd. (Users of ESG ratings as Benchmark Administrator) **Part A – I B** – MSCI Inc (Company subject to ratings) **Part A – I C** – MSCI Ltd. (Questions for all respondents) **Part A – II & III a)**– MSCI Ltd. (Users of ESG ratings as Benchmark Administrator) **Part A – III b)** – MSCI ESG Research LLC **Part B** – MSCI Ltd. (Users of Credit ratings as Benchmark Administrator) 2. The responses (options) have been underlined

PART A – ESG RATINGS

I. Use of ESG ratings and dynamics of the market

A. Questions for investors, asset managers and benchmark administrators

1. Do you use ESG ratings?

- Yes, very much
- Yes, a little
- No

Please explain

Benchmark administrator: ESG ratings are used as a methodological input into the construction and maintenance of selected MSCI indices.

2. Which type of ESG ratings do you use (non-exhaustive list – multiple answers possible):

ESG ratings providing an opinion on companies:

- ESG ratings providing an opinion on opportunities
- ESG ratings providing an opinion on the compliance of companies with frameworks and rules
- Exposure to and management of ESG risks
- ESG ratings providing an opinion on a company performance towards certain objectives
- ESG ratings providing an opinion on the impact of companies on the society and environment
- ESG ratings providing an opinion on the ESG profile of the company

3. ESG ratings providing an opinion on investment funds or other financial products (please specify which financial products):

- Investment funds
- Others (comment box)

If Investment Funds selected, ESG ratings providing an opinion on investment funds:

- Exposure to and management of ESG risks
- Impact on the society and environment
- ESG characteristics
- Other specialised ratings
- None
- Not applicable

If you responded that you use specialised ratings, please indicate which one(s):

4. To what degree do you use ESG ratings in investment or other financing decisions on the a scale of from 1 to 10 (1- very little, 10 – decisive)?

If you don't use ESG ratings, or use on them to a very small degree, what do you use on in your investment or other financing decisions?

5. Do you use overall ESG ratings or ratings of individual Environmental, Social or Governance factors?

- Overall ESG ratings
- Ratings of an individual Environmental, Social and Governance factors
- Ratings of specific elements within the Environmental, Social and Governance factors,
- <u>Other types, please specify</u>

We use overall ESG ratings, as well as ratings of an individual Environmental, Social and Governance factor or specific elements within those factors.

6. Do you buy ESG ratings as a part of a larger package of services?

- Yes

- No
- Not applicable

7. What are you using ESG ratings for? (multiple choice)

- as a starting point for internal analysis
- as one of many sources of information that influence the investment decisions
- to meet regulatory or reporting requirements
- as a decisive input into an investment decision
- as a reference in financial contracts and collaterals
- for risk management purposes
- other(s).

If you use ESG ratings for other purposes, please specify which ones?

As a methodological input into the construction and maintenance of selected indices.

8. As a benchmark administrator, how do you take into account ESG ratings for the construction of a benchmark and/or in disclosures around a benchmark?

As a methodological input into the construction and maintenance of selected indices. For example, the MSCI EMU (European Economic and Monetary Union) Sustainable Select 50 Index uses MSCI ESG Ratings to identify companies that have demonstrated an ability to manage their ESG risks and opportunities. Companies having an MSCI ESG Rating of 'AAA', 'AA' or 'A' are eligible for inclusion in the MSCI EMU Sustainable Select 50 Index. The relevant index methodology available on MSCI.com provides an explanation of how ESG ratings are used as an eligibility criterion for the construction and maintenance of the relevant index.

9. Do you refer to ESG ratings in any public documents or materials?

- Yes
- No

If you responded yes to the previous question, specify the type of documents of materials

As a benchmark administrator, where ESG ratings are used as a methodological input into the construction and maintenance of a particular index, the qualifying threshold levels are disclosed in the relevant published index methodology. In addition, ESG ratings of the top ten index constituents of specific index families may be disclosed on MSCI.com.

10. What do you value and need most in ESG ratings:

- <u>transparency in data sourcing and methodologies,</u>
- <u>timeliness, accuracy and reliability of ESG ratings,</u>
- <u>final score of individual factors</u>
- <u>aggregated score of all factors</u>
- <u>rating report explaining the final score or aggregated score</u>
- specific information, please explain
- data accompanying rating
- other aspects

Please explain your answer:

From a benchmark administrator perspective, the most important values of ESG ratings are that they are assigned consistently in accordance with a methodology that is available to the administrator. In addition, the rating provider should disclose the meaning of the ESG rating and whether the rating is a point in time rating or monitored on an ongoing basis. With this information, the benchmark administrator can consider the appropriateness of using ESG ratings in our indices.

11. To what degree to you consider the ESG ratings market to be competitive and allows for choice of ESG rating providers at reasonable costs, on a scale from 1 (not competitive) to 10 (very competitive)?

Don't know / no opinion / not applicable

The methodologies underlying our indices currently use ESG ratings assigned by one provider. We continually assess the information we use in our indices and are aware of multiple providers of ESG ratings using different methodologies and approaches to ESG ratings which we may consider in the construction of indices, as appropriate.

B. Questions for companies subject to ratings

12. Do you have access to ESG ratings of your own company?

- <u>Yes</u>
- No
- No opinion

13. To what degree do you use ESG ratings to assess the way you manage sustainability risks and opportunities and your impact on the outside world, on a scale from 1 (not determinant) to 10 (determinant)?

5

Please explain your answer:

MSCI Inc uses ESG ratings as an additional, independent source of information to our own risk assessment of ESG risks impacting the company. We also use ESG ratings to benchmark ourselves against our peers.

14. If you do not use ratings, what do you use to assess the way you manage sustainability risks and opportunities and your impact on the outside world?

ESG ratings are not used as an either/or assessment tool by MSCI Inc. Rather, we use ESG ratings as a complementary tool to supplement our understanding of ESG risks and opportunities affecting the company. ESG ratings are only one part of this assessment. In addition to ESG ratings, we use assessments by third party consultants and consider standards published by the Task Force on Climate-Related Financial Disclosures and SASB audits.

15. Does this vary between individual E, S and G factors?

No. MSCI Inc. may use different consultants for the E, S and G assessments.

16. Do you provide information on ESG ratings you have received in any of your public documents?

- Yes
- No
- No opinion

If you do provide information on ESG ratings you have received in any of your public documents, please specify where you disclose this information:

MSCI Inc. publishes our CDP score on our website at Sustainability Reports and Policies - MSCI. Please note that many ESG rating providers operate under a "subscriber-pays" model where the company does not request the ESG rating provider for a rating and may have no, or limited, engagement with the provider. These ESG rating providers may publish the ESG ratings, with or without supporting material, on their website.

C. Questions for all respondents

17. Do you consider that the market of ESG ratings will continue to grow?

- Yes
- No
- No opinion

If you responded ‘yes’ to the previous question, to what extent do you expect the following factors to be decisive, on a scale from 1 to 10? [1=not at all to 10=very much]

10	Growth in demand from investors in ratings of companies for their investment decisions
10	Growth in demand from companies in ratings including on rating future strategies
10	Further standardisation of info disclosed by companies and other market participants

Please specify what other reason(s) you see for this market to continue to grow:

Over the last decade, ESG has gone from fringe to mainstream. Investors and companies have seen increased regulation, demands for transparency and a quest for standards. They recognise that ESG ratings are tools that help provide valuable investment information and assess progress towards and management of challenges like climate change.

Over the next 10 years we expect to see that:

- Investors and companies will be required to provide better ESG & climate-related disclosures as compelled by regulators and other stakeholder globally, thus providing the market with higher quality ESG and climate data with which to make financial investment decisions.
- The translation of ESG & climate risk into financial risk will be rapidly standardised, regulated and integrated into financial risk management toolkit (e.g.: banks’ prudential risk measures, corporate enterprise risk management)
- Investors and companies will continue to prioritise ESG, not just climate, propelled by rising societal expectations of acceptable corporate behaviour. But conceptions of ESG will become more fragmented than climate by region, driven by ‘localised’ stakeholder activism.

Companies that are raising capital will be subject to minimum ESG criteria and rigorous climate disclosure. They will also increasingly see the benefit of managing their ESG and climate risks well as research has and will continue to show a high correlation between highly rated ESG companies and those with a lower cost of capital in the market.

18. Are you considering to use more ESG ratings in the future?

- Yes, to a large degree
- <u>Yes, to some degree</u>
- No
- No opinion

If you responded ‘yes’ to the previous question, please explain why

As noted in our response to the previous question 16 “Do you provide information on ESG ratings you have received in any of your public documents?”, many ESG rating providers assign ratings on an unsolicited basis based on demand from investors. As a rated company, we will continue to use ESG ratings assigned to MSCI as a supplementary tool for our internal risk analysis. We may also consider mandating an ESG rating provider to conduct an independent assessment of our ESG risk profile or an ESG consultant to conduct a review of our ESG risk and opportunities.

As a benchmark administrator, MSCI Limited continually reviews the methodologies which may result in the use of additional ESG ratings.

19. Do you mostly use ESG ratings from smaller or larger market players?

- Exclusively from large market players
- Mostly from larger market players
- Mixed
- Mostly from smaller market players
- Exclusively from smaller market players
- Not applicable

If you use mostly or exclusively ratings from large ESG rating providers, what are the main reasons for this?

MSCI Limited as a benchmark administrator uses ratings from one provider. However, multiple rating providers assign ESG ratings to MSCI Inc. on an unsolicited basis, including niche-based providers.

20. Do you consider there is a sufficient offer of ESG ratings from providers located in the European Union?

- Yes
- No
- Don't know / no opinion / not applicable

21. Finally, do you use other types of ESG assessment tools than ESG ratings (e.g. controversy screening, rankings, qualitative assessments, etc.)?

- Yes
- No

If you responded 'yes' to the previous question, how important are these tools in relation to the implementation of your investment strategies and engagement policies?

As a benchmark administrator, MSCI Limited's indices use additional ESG tools as methodological inputs in the index construction process. For example, in the MSCI EMU Sustainable Select 50 Index, we use:

- MSCI ESG Controversies Scores to identify those companies that are involved in very serious controversies involving the ESG impact on their operations and/or products and services; and - MSCI ESG Business Involvement Screening Research and MSCI Climate Change Metrics to identify companies that are involved in compliance with the United Nations global compact principles, controversial / banned weapons, nuclear weapons, thermal coal, oil sands, civilian firearms, conventional weapons, tobacco, gambling, alcohol, adult entertainment and nuclear power.

22. Do you believe that due diligences carried out by users of ESG research are sufficient to ensure an acceptable level of quality?

- Yes
- No
- No opinion

23. Do you further believe that ESG research products have reached a sufficient level of maturity and comparability to allow users to fully understand the products they use?

We have responded to this question with respect to the use of ESG ratings in our indices, as a benchmark administrator. The ESG ratings market is still nascent and there is a multitude of different providers and different methodologies. We are only in a position to comment on the ESG ratings we use in our indices. MSCI has conducted the necessary review in the construction of the relevant indices to ensure that where ESG ratings are used in an index, those ratings have been, and continue to be, assigned consistently under the relevant methodology. We have access to the rating methodology and sufficient information on the individual ratings for the intended use of the ratings in our indices.

II. Functioning of the ESG ratings market

24. How do you consider that the market of ESG ratings is functioning today?

- Well
- Not well
- Don’t know / no opinion / not applicable

25. To what degree do you consider that the following shortcomings / problems exist in the ESG ratings market, on a scale of from 1 to 10 (1- very little, 10 – important)?

1	Lack of transparency on the operations of the providers
5	Lack of transparency on the methodologies used by the providers

5	Lack of clear explanation of what individual ESG ratings measure
1	Lack of common definition of ESG ratings
1	Variety of terminologies used for the same products
1	Lack of comparability between the products offered
5	Lack of reliability of the ratings
5	Potential conflicts of interests
1	Lack of supervision and enforcement over the functioning of this market

26. What do you think of the quality of the ratings offered on a scale from 1 (very poor) to 10 (very good)?

10 (very good)

Please explain why:

The ESG ratings used in the construction and maintenance of our indices are assigned consistently under a rating methodology which is available to the benchmark administrator. Conflicts of interest are identified and mitigated which provides us with the comfort that the ratings are assigned objectively and with the necessary independence. Furthermore, the ratings are assigned under a stringent governance process. The underlying data used to assign the ratings is subject to quality control at the ESG rating provider.

27. Do you consider that there are any significant biases with the methodology used by the providers?

- Yes
- <u>No</u>
- No opinion

28. Do you think the current level of correlation between ratings assessing the same sustainability aspects is adequate?

- <u>Yes</u>
- No
- No opinion

Please explain your answer to question:

Please see our response to the question 31 below on "Do you consider that a variety of types of ESG ratings (assessing different sustainability aspects) is a positive or negative feature of the market?" As a benchmark administrator, MSCI Limited is not concerned with the lack of correlation between rating providers. Provided we can access the methodology of a rating provider and understand what the rating is designed to measure, we can assess whether it is appropriate for inclusion as a methodological input into our indices.

29. To what degree do you consider that a low level of correlation between various types of ESG ratings can cause problems for your business and investment decision, as an investor or a rated company, on a scale from 1 (no problem) to 10 (significant problem)?

1 – no problem

30. How much do you consider each of the following to be an issue, on a scale from 1 (no issue) to 10 (very significant issue)

1	Lack of transparency on the methodology and objectives of the respective ratings
1	The providers do not communicate and disclose the relevant underlying information
1	The providers use very different methodologies
1	ESG ratings have different objectives (they assess different sustainability aspects)

31. Do you consider that a variety of types of ESG ratings (assessing different sustainability aspects) is a positive or negative feature of the market?

- <u>Rather positive</u>
- Rather negative

Please explain your response to the previous question:

As a benchmark administrator and user of ESG ratings, we do not support the harmonisation or standardisation of ESG ratings, methodologies, models or rating scales. Benchmark administrators look for a diversity of opinion from ESG providers. A mandated one-size fits-all approach to ESG ratings would reduce the thoroughness, innovation, and evolution of the ratings.

32. To what degree do you consider this market to be prone to potential conflicts of interests on a scale from 1 (very little) to 10 (very much)?

5

Please explain your answer:

As a benchmark administrator, we see conflicts of interest arising where an ESG rating provider provides a consultancy service to the rated entity to assist the company in improving their ESG rating. In order to establish integrity in the system, ESG rating providers should proactively identify conflicts of interest and seek to mitigate these conflicts in their business operations.

33. To what degree do you consider that the ESG ratings market as it operates today allows for smaller providers to enter the market on a scale from 1 to 10 (1- hard to enter, 10 – easy to enter)?

Don’t know / no opinion / not applicable

34. What barriers do you see for smaller providers?

Costs associated with a proliferation of standards and new regulatory requirements.

35. Do you consider that the market currently allows for smaller providers who are already present in this market to remain competitive on a scale from 1 (does not allow) to 10 (fully allows)?

Don’t know / no opinion / not applicable

36. To what degree do you consider the fees charged for ESG ratings to be proportionate to the services provided, on a scale from 1 (not proportionate) to 10 (very proportionate)?

10

37. Do you consider that information on the fees charged by the providers is sufficiently transparent and clear?

- <u>Yes</u>
- No
- No opinion

III. EU intervention

a) Need for an EU intervention

38. Taking into account your responses to the previous sections, do you consider that there is a need for an intervention at EU level to remedy the issues identified on the ESG rating market?

- Yes
- No
- No opinion

Please explain why:

MSCI ESG Research operates to the highest standards of ethical conduct in our business operations. ESG ratings are being used more widely in the market and for different use cases making it more important that ESG ratings are, and are seen to be, credible. We therefore welcome principles of conduct that create the foundations for ESG rating best practices.

If you responded yes to the previous question, what type of intervention would you consider necessary?

- Non-regulatory intervention (e.g. guidelines, code of conduct)
- Legislative intervention

Given the nascency of the market and the rapid development of services to support the understanding of ESG risks and opportunities, MSCI ESG Research is of the view that policy intervention should start at the level of an industry-supported code of conduct. This has served as an effective approach in other sectors. For example, in the benchmark sector, IOSCO published Principles for Financial Benchmarks (FR07/13 | July 2013)[3] which served as a road map for future regulatory intervention in the EU (Ref: EU Benchmark Regulations 2016/1011 of the EU Parliament and of the Council of 8 June 2016).[4] Similarly, in the credit rating agency sector, IOSCO published a Code of Conduct Fundamentals for Credit Rating Agencies before legislative initiatives adopted the principles into global regulatory frameworks.[5] The code of conduct could be developed under the auspices of IOSCO at the global level and the EU Commission in the EU. MSCI ESG Research stands ready to participate in the development of a Code. The Code/s would be developed with broad industry participation and allow for the market to develop under the principles set out in the Code whilst allowing time for policymakers and the market to coalesce around the scope, and need for, regulatory intervention. As the market reaches a level of maturity, the Commission will be in a strong position to identify areas requiring regulatory intervention.

[3] Principles for Financial Benchmarks (FR07/13 | July 2013)
[4] EU Benchmark Regulations 2016/1011 of the EU Parliament and of the Council of 8 June 2016
[5] Code of Conduct Fundamentals for Credit Rating Agencies (FR05/2015 | March 2015)

However, if the Commission proceeds with regulatory intervention, it is important that the framework is based on principles of conduct expected in the assignment of ESG ratings (and not ESG data, more broadly) and should address those principles that serve as the foundation for ESG ratings, such as identification and management of conflicts of interest, transparency and the consistent application of methodologies. Hard-coded rules applicable to other industries, such as credit rating agencies would not be suitable for ESG ratings.

Importantly, any legislative intervention should not attempt to harmonise or standardise ESG ratings, methodologies, models or rating scales. Such an outcome would materially impair the independent judgment and assignment of high quality ESG ratings. A well-functioning market ensures that there are sufficient levels of information published by issuers. As a supplement to their own analysis, investors may refer to ESG ratings as one of many inputs to, or to benchmark, their own assessment. Investors look for a diversity of opinion from these providers, an ability to hold an opinion against the herd, that is best-in class and is not simply a weighted average of industry views. Measures that specify a harmonised/standardised approach may create a static, inflexible system which is inherently unsuitable for such a rapidly evolving discipline and could ultimately make rating providers less capable of responding to innovations and meeting demands in a continuously evolving market. Today, the lack of uniformity in ESG ratings is often described as a weakness; we believe it is a strength that demonstrates the diversity of opinions and methodologies. By analogy, there would be limited utility if all investment advisers came to the same buy/sell/hold determinations in their assessments of securities. Dispersion of views and approaches demonstrates a dynamic and competitive market where investors have choices to select providers that reflect their perspective or multiple providers to give them varying and diverse inputs.

If you responded yes to the previous question, what do you consider should be the prime focus of the intervention? (multiple choice)

- Improving transparency on the operations of the providers,
- <u>Improving transparency on the methodology used by the providers,</u>
- Improving the reliability and comparability of ratings,
- <u>Clarifying what is meant by and captured by ESG ratings, to differentiate from other tools and services,</u>
- <u>Clarifying objectives of different types of ESG ratings,</u>
- Improving transparency on the fees charged by the providers,
- <u>Avoiding potential conflicts of interests,</u>
- Providing some supervision on the operations of these providers,
- Other measures (please specify)

Please explain what solutions and options you would consider appropriate in order to improve transparency on the methodology used by the providers:

MSCI ESG Research has made important parts of our ESG ratings, ratings process and underlying methodology available to subscribers. Our clients have access to fully documented methodologies and to regular feedback processes for methodology enhancements.

ESG rating providers operate under various business models, including an issuer-pays model and subscriber-pays model. The ability for these providers to select the most appropriate model for their business should be protected. For example, under a subscriber-pays model, disclosure is typically only made to the clients of the provider and the relevant issuer. Any principles should require the methodology to be made available to users of the rating but not require this information (and other disclosures) to be free and public because this would fundamentally undermine this business model and may force providers to change their business model.

An ESG rating provider should disclose sufficient information about its rating process and its rating methodologies, so that subscribers of ESG ratings can understand the rating level. In addition, an ESG rating provider should disclose a material modification to its rating methodology prior to the modification taking effect unless doing so would negatively impact the integrity of an ESG rating by unduly delaying the taking of a rating action.

Please explain what solutions and options you would consider appropriate in order to clarify what is meant by and captured by ESG ratings, to differentiate from other tools and services:

MSCI ESG Research supports principles that would require ESG rating providers to clearly publish the objectives of the rating. The term “ESG” captures a broad range of investment approaches. Some investors try to improve social and environmental outcomes through their investments which is known as “impact investing.” Others seek to align their investments with moral and ethical concerns by screening out certain industries and companies which is known as “values-based investing”. “ESG integration” represents a third approach to sustainable investing, one that aims to maximise risk-adjusted returns by incorporating ESG considerations into long-term investment strategies. The needs of investors are addressed by a variety of ESG rating providers whose ratings speak to different objectives, but it is important for the providers to explain clearly to users of the rating what this objective is for the relevant rating. For example, MSCI ESG Research designs our ESG ratings to support ESG integration. Our ESG ratings are not a report card on corporate citizenship. They are tools that measure a company’s resilience to long-term, financially material environmental, social, and governance risks.

Please explain what solutions and options you would consider appropriate in order to clarify objectives of different types of ESG ratings:

Please see our response to “Clarify what is meant by and captured by ESG ratings, to differentiate from other tools and services”.

Please explain what solutions and options you would consider appropriate in order to avoid potential conflicts of interests:

MSCI ESG Research operates under strict policies and procedures that (1) protect against conflicts of interest (arising from, for example, relationships with or pressures from issuers, investors or government officials) impacting our ESG ratings and (2) ensure that our ratings are independent. All employees of our ESG ratings business are trained on, and certify to, our policies and procedures at least annually, with additional targeted training taking place throughout the year.

Principles that require the identification of conflicts of interest and the mitigation or elimination of these conflicts will be important principles for any conduct standard.

39. Do you consider that the providers should be subject to an authorisation or registration system in order to offer their services in the EU?

- Yes
- No
- No opinion

40. Do you consider that the providers should be subject to an authorisation or registration system in order to provide ESG ratings on EU companies or non-EU companies' financial instruments listed in the EU even if they offer services to global or non-EU investors?

- Yes
- No
- No opinion

Please explain why

It would be challenging to establish regulatory jurisdiction over a company outside of the EU providing an opinion on a company in the EU where that company has not requested the rating. Rather the regulatory scope should cover the activity of assigning an ESG rating where that rating is used in the EU for regulatory purposes. This model applies to credit rating agencies under the Credit Rating Agency Regulation (Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies.)[6]

41. Do you consider that there should be some minimum disclosure requirements in relation to methodologies used by ESG rating providers?

- Yes
- No
- No opinion

Please explain why

[6] Regulation (EC) No 1060/2009 of the European Parliament And Of The Council Of 16 September 2009 On Credit Rating Agencies

MSCI ESG Research supports principles-based disclosure requirements and not prescriptive rules-based disclosure which may not provide users of the rating with the key information needed to understand the rating. In this regard, an ESG rating provider should disclose sufficient information about its rating process and its rating methodologies, so that subscribers of ESG ratings can understand the rating level assigned by the ESG rating provider. In addition, an ESG rating provider should disclose a material modification to its rating methodology prior to the modification taking effect unless doing so would negatively impact the integrity of an ESG rating by unduly delaying the taking of a rating action.

42. Do you consider that the providers should be using standardised templates for disclosing information on their methodology?

- Yes
- No
- No opinion

Please explain:

Standardised templates would not be in the interests of the market. Users of MSCI ESG ratings are sophisticated institutional investors who do not require templated, boiler-plate explanations of methodologies. A standardisation of templates is more suited to a product or service which is meant to be standardised whereas, rating methodologies, by their nature, will differ depending on rating provider and will address certain key issues different to other providers. By forcing a standardisation of these metrics onto a template, there is a material risk that the nature and substance of the methodology will be lost. Rather, we support the principles-based approach proposed in the previous question 41 "Do you consider that there should be some minimum disclosure requirements in relation to methodologies used by ESG rating providers?" and as found in other legislation and codes of conduct, such as in the credit rating agency sector.

43. Do you consider that the rules should be tailored to the size of the provider and hence have smaller providers subject to a lighter regime?

- Yes
- No
- No opinion

Please explain your answer:

If ESG ratings are available for (regulatory) use in the EU, they should all meet minimum standards regardless of the size of the rating provider. By setting different standards for large and small providers, the framework would re-enforce the large/small distinction and risk creating a perception that ratings assigned by smaller providers are of a lower quality than those assigned by larger providers.

However, the Commission should consider the appropriateness of exemptions for smaller providers where certain provisions would not be conducive to the business operations of

the provider. For example, in the Credit Rating Agencies Regulations, there are exemptions for analyst rotation and independent directors for Credit Rating Agencies with less than 50 persons in the relevant corporate entity.

44. Should the providers located outside of the EU, not providing services to the EU investors but providing ratings of the European companies/financial products be subject to a lighter regime?

- Yes
- No
- Don't know / No opinion / not applicable

b) Costs of an EU intervention

Questions for ESG rating providers

45. Assume that in order to offer services to investors in the European Union or to rate European companies/financial products, ESG rating providers would be subject to an authorisation or registration requirement. How high would you estimate the one-off cost of applying for such an authorisation/registration? (please provide an estimate in EUR)

An application for authorisation/registration will trigger significant direct and indirect costs for which is hard to assess as the cost will be determined by the scope and details of the registration framework. Direct costs will include a substantial number of work hours from the internal workforce across various departments as well as legal and consultant fees. Indirect costs are more difficult to predict and will largely be affected by the magnitude of changes to the current business model. As a result of new regulation, ESG ratings providers may have to set up new legal entities in the EU, adapt their governance structure, relocate staff, hire new staff, modify technology platforms, and/or implement new operational/IT capabilities.

46. In order to increase transparency, there may be considerations to introduce disclosure obligations on ESG rating providers. This could include, for example, disclosures on websites or annual reports on the operations and methodologies used by ESG rating providers and/or providing more information on how these methodologies were applied to specific ratings. Please estimate the number of hours needed to produce the following disclosures:

	Disclosures on the operations and methodologies		Additional disclosures in ratings (hours/rating)
	One-off costs (total hours)	Ongoing costs (hours/week)	
Negligible			

Less than 5 hours (but not negligible)			
5 to 9 hours			
10 to 19 hours			
20 to 39 hours			
40 to 79 hours			
80 to 160 hours			X
More than 160 hours	X	X	

If you chose more than 160 hours in the table above, please provide an indication of how many hours would be needed (for the costs in each column, as applicable). You may also use the following comment box if you wish to provide any further explanations.

Operations and methodologies: It is unclear what is meant by "operations" but if this includes disclosure on internal control systems, policies and procedures, we would expect that such disclosure would require the input from all three lines of control and include various support functions, including IT and legal. We would expect this to take approximately 4 weeks and over 400 hours.

Ongoing costs: Depending on the scope of the requirements, we would expect ongoing costs could require at least ten FTEs to manage the system of disclosure on an ongoing basis.

47. What percentage of these costs would be incurred even in the absence of legislation?

1-20%

Please explain your answer:

In the absence of legislation, MSCI ESG Research would continue to adapt its disclosures in accordance with the needs of our subscribers. This may take different forms other than website disclosure and leverage technology solutions to meet subscriber needs. A "one size fits all legislation" will trigger additional costs with the need to adjust business operations. As an illustration, certain requirements, pending their degree of details, such as requirements about location of disclosure (e.g. in a press release versus website versus client portal), uniformity of disclosures using certain terminology, colour-coding etc. will generate significant additional costs.

48. Do you see any other costs related to providing these disclosures (e.g. adjustment of IT systems, external consultants, etc.)?

Yes

If yes, please specify what type of cost and provide an estimate of its amount where feasible:

Costs associated with the adjustment of IT systems will be significant for ESG rating providers. The requirement of detailed disclosures may require building new IT platforms and the integration of data between legacy systems which will typically entail migration of data, testing etc. Depending on the scope and extent of the requirements, the cost could reach EUR 30-40m over a period of years.

49. How many hours per week would you consider necessary to perform tasks that would be linked to fulfilling ongoing supervisory requirements?

More than 40 hours

If more than 40 hours, please provide an indication of how many hours would be needed:

An application for registration will require a significant number of hours. The exercise may involve an assessment of the regulation, including a detailed gap analysis, drafting additional compliance and operational documents to precisely conform with the regulation provisions, training, adjustments of IT systems, risk controls, assessment of legal and regulatory risk, adjustments to the governance framework as required by the regulation, establishment of new legal entities, redesign of staffing model and the introduction of new controls. This will also likely require engagement with external service providers, such as lawyers, accountants and consultants. This could constitute at least 3 months of work, with approximately 10-20 FTEs.

50. If there were similar conflict of interest provisions introduced for ESG rating providers as in Article 6 and Annex I to Regulation (EU) 1060/2009 (CRA regulation), would you consider the associated costs to be of similar magnitude?

- Yes
- <u>No</u>
- Don't know

Please explain

Implementation of similar provisions as in Article 6 and Annex I of the CRA Regulation will significantly increase the cost of regulation. The rules in the CRA Regulation are extensive and would require a significant increase in resourcing and systems. For example, provisions that relate to the rotation of analysts, review function, independent directors and extensive shareholder restrictions alone will impose significant changes to our current governance structure in the EU. A way to mitigate these costs would be, as specified in Article 6 of the

CRA Regulation, to provide for exemption mechanisms for entities below a certain employee threshold. However, even such exemption mechanisms may not sufficiently reduce the burden of such provisions.

Moreover, in order to limit the costs, as for credit rating agencies, it is imperative that any regulatory regime takes into account the global nature of ESG rating providers and enables them to leverage their global structure, compliance function, internal control mechanisms and organisational structure on a global level.

Finally, any regulatory initiatives should consider that ESG rating providers may operate under different business models to the credit rating agencies administered under the CRA Regulation.

51. Do you expect that you would face any further costs as an ESG rating provider as a result of a possible legal framework besides those mentioned above?

- Yes
- No
- Don’t know

If yes, please explain what types of costs, whether they would be one-off or ongoing and provide estimates if possible:

In addition to the one-off costs associated with registration, costs associated with supervision should be considered. Over time, it should be anticipated that management of the relationship with the regulator and its/the regulatory requirements will involve a very significant increase in compliance, internal controls and IT systems costs.

52. Do you estimate that possible additional compliance costs implied by a minimum requirement framework for ESG ratings would be compensated by the benefits of higher quality and more reliable ratings?

Not at all

Please explain your answer:

A principles-based code of conduct would the most appropriate tool for introducing minimum expected standards of conduct for the industry whilst keeping cost of implementation at a manageable level. The introduction of a regulation framework that would include prescriptive rules set out in the CRA Regulation would be wholly disproportionate to the expected benefits.

The legislature should be cognisant of risks of conflicting regulations as many ESG ratings providers operate on a global basis. Conflicting regulations impede innovation and create unnecessary burdens.

53. What other impact(s) of a regulatory and supervisory framework on the operations of ESG rating providers would you see (e.g. potential impacts on competition, SMEs assessed by ratings, users of ratings, sustainable development)?

Costs associated with overly burdensome regulation will reduce innovation, increase costs to the users of ratings and likely reduce competition because of high barriers to entry.

Questions for supervisors

54. How many hours of work would you consider necessary to perform tasks that would be linked to granting an authorisation for one ESG rating provider?

- Negligible time
- Less than 5 hours (but not negligible)
- 5 to 9 hours
- 10 to 19 hours
- 20 to 40 hours
- More than 40 hours

If more than 40 hours, please provide an indication of how many hours would be needed

N/A

55. How many hours per week would you consider necessary to perform supervisory tasks per ESG rating provider?

- Negligible time
- Less than 5 hours (but not negligible)
- 5 to 9 hours
- 10 to 19 hours
- More than 20 hours

If more than 20 hours per week, please provide an indication of how many hours would be needed

N/A

PART B – INCORPORATION OF ESG FACTORS IN CREDIT RATINGS

I. Questions to users of credit ratings

56. Do you use credit ratings for investment decisions?

- Yes, as a starting point for internal analysis
- Yes, as one of many sources of information that influence investment decisions
- Yes, as a decisive input into an investment decision
- No
- <u>Other</u>

If you use credit ratings for other purposes, please explain:

Credit ratings are used as one of the data inputs to determine eligibility for inclusion in the MSCI Fixed Income Indices.

57. Do you use credit ratings for regulatory purposes (e.g. stemming from the Capital Requirements Regulation or Solvency II)?

- Yes
- <u>No</u>
- These requirements don't apply to me

58. Is it important for you to understand to what extent individual credit rating actions have been influenced by sustainability factors?

- Not important at all
- Slightly important
- <u>Important</u>
- Very important
- No opinion

Please explain your answer:

MSCI Limited, as a benchmark administrator, is a consumer of credit ratings. We use credit ratings as a measure of credit risk and do not expect that the credit ratings we use in our indices address factors other than credit risk. It is important that credit rating agencies are transparent about the factors that drive the credit rating which should be disclosed in a publicly available rating methodology and rating report. Where an ESG factor impacts the credit risk of a company/security, we expect that factor to be incorporated into the credit risk assessment.

59. Do you find information about the extent to which CRAs methodologies or the rating process incorporate sustainability factors sufficiently well disclosed?

- <u>Yes</u>
- No
- No opinion

60. Where do you look currently for the information on how ESG factors impact the credit rating? (multiple choice)

- Press release accompanying credit ratings
- Additional analysis and reports available to subscribers
- Additional information materials available publicly
- Description of methodologies or rating process for specific asset classes, sectors or types of entities
- Frameworks or documents describing general approach to incorporation of ESG factors in credit rating process
- I don't know where to find such information
- <u>Other</u>

If you responded 'other' please explain where:

As a benchmark administrator, we do not seek out how ESG factors may affect the credit rating. Rather, we are interested in the rating level which incorporates various factors, including ESG risks to the credit profile of an issuer/security.

61. Does the level of disclosure differ depending on individual CRAs?

- Yes
- No
- <u>Don't know / No opinion / Not applicable</u>

62. What are the trends on the market in relation to disclosure of information as to which credit ratings actions have been influenced by sustainability factors? (multiple choice)

- The level of disclosure has improved sufficiently since the entry into effect of ESMA guidelines (April 2020)
- In general the level of disclosure has improved sufficiently although some CRAs are lagging behind
- The overall level of disclosure is insufficient although some CRAs have sufficiently improved
- The extent to which CRAs incorporate ESG factors in credit ratings depends on the asset classes methodologies and the importance assigned to the given factor by a CRA's methodology. In addition, some CRAs have developed overall frameworks explaining how they incorporate ESG factors in credit ratings across asset classes, some publish reports

reviewing past credit rating actions or specific sections accompanying credit rating actions.

63. In your opinion, what are trends in the relation to the incorporation of ESG factors in the credit rating process and methodologies?

- CRAs have sufficiently improved the incorporation of ESG factors in their methodologies and rating process,
- In general CRAs have sufficiently improved the incorporation of ESG factors in credit ratings although some CRAs are lagging behind
- In general the development is insufficient although some CRAs have improved the incorporation of ESG factors in their methodologies and rating process,
- CRAs have insufficiently improved the incorporation of ESG factors in their methodologies and rating process
- <u>Don't know / No Opinion / Not applicable</u>

II. Questions to Credit Rating Agencies

64. Do you explicitly incorporate ESG factors in your methodologies?

- Yes
- Yes, but only for asset classes and sectors where relevant
- Partially
- No

Please explain your reply

5000 characters maximum

65. Which individual E, S and G factors do you consider in your methodologies? (multiple choice)

- Environmental factors
- Social factors
- Governance factors
- Other – sustainability related factors

Please explain in more details

5000 characters maximum

66. In addition to methodologies, do you have a framework or a document describing how you incorporate ESG factors in the credit rating process? By framework, we mean any general approach to the incorporation of ESG factors in credit rating process, in addition to methodologies for asset classes and sectors.

- Yes

- No
- Other

If you answered other, please explain

5000 characters maximum

67. Have you improved disclosure on ESG factors in credit ratings since April 2020 when ESMA guidelines became applicable?

- Yes
- Partially
- No, but we plan to improve
- No, because we have already been disclosing such information
- No

If you replied no to the previous question, please explain why

5000 characters maximum

III. Questions on the need for EU intervention (all respondents)

68. Do you consider that the current trends in the market are sufficient to ensure that CRAs incorporate relevant ESG factors in credit ratings?

- Yes
- No
- Don't know / No opinion / Not applicable

69. Do you consider that the current trends in the market and application of ESMA guidelines on disclosure applicable to CRAs are sufficient to ensure understanding among users as to how ESG factors influence credit ratings?

- Yes
- No
- Don't know / No opinion / Not applicable

If you responded 'no' to the previous questions, what type of intervention would you consider necessary? (multiple choice)

- Further detailing of ESMA guidelines on the disclosure of ESG factors in credit ratings
- Further supervisory actions by ESMA
- Legislative intervention.
- While improvements are insufficient, we do not see further scope for EU intervention
- Other, please specify

If you responded 'other' to the previous question, please specify the other type of intervention you consider necessary:

5000 characters maximum

70. Regarding the possible regulatory intervention, what type of requirements do you find relevant? (multiple choice)

- Press releases: introduce mandatory requirements mirroring the provision of ESMA guidance on the disclosure ESG factors in credit ratings
- Press releases: in addition to the previous option require CRAs to publish information not only about the impact of ESG factors on credit ratings, but also the lack of it,
- Methodologies: require CRAs to explain the relevance of ESG factors in methodologies,
- Methodologies: require CRAs to take into account ESG factors where relevant,
- <u>Other</u>.

If you responded other, please explain:

MSCI Limited uses credit ratings to understand the credit risk profile of constituents in our indices. We expect credit rating agencies to incorporate relevant risk factors in accordance with their rating methodologies. We would have concerns with the credit ratings if rating actions are taken that are not in accordance with the relevant methodology.

71. What kind of risks or merits of the EU intervention do you see?

- Provide further clarity on the impact of ESG factors on the creditworthiness of creditors and financial instruments
- More coherent approach of CRAs to the incorporation of ESG factors into credit ratings
- Concerns about too much prominence given to ESG factors
- Others

If you responded 'others', please explain:

5000 characters maximum

72. What would be the consequences of the lack of the EU intervention? (multiple choice)

- Market trends are sufficient to meet investors demands for information on the impact of ESG factors on credit ratings
- CRAs will respond to market pressure and ensure the incorporation of ESG factors in credit ratings
- The existing gap between approaches of CRAs to the incorporation of ESG factors in credit ratings will grow
- Concerns about the insufficient incorporation of ESG factors in credit ratings lack of understanding among investors why certain credit rating actions are not impacted by ESG factors

Costs of EU intervention - questions for CRAs

73. Where applicable, what are your costs in EUR to disclose information based on the current Guidelines on disclosure of ESG factors in credit ratings?

5000 characters maximum

74. Would you foresee any additional compliance costs if the current Guidelines on disclosure of ESG factors in credit ratings were to become part of the EU legislation?

5000 characters maximum

75. To what degree do CRAs overall already follow the guidelines in the absence of an obligation to do so?

- 0%
- 1-40%
- 41%-60%
- 61%-80%
- 81%-90%
- 91%-99%
- 100%

76. Would you expect additional compliance costs if EU legislation explicitly required CRAs to take into account ESG factors where relevant in the rating process?

- No or negligible additional costs
- Low additional costs
- Moderate additional costs
- High additional costs
- Do not know

If you do expect additional compliance costs, how high would you expect these additional costs, as compared to current practice?

5000 characters maximum

Please explain

5000 characters maximum