June 2024

Insights and perspectives on governance, disclosure & litigation

ESG Matters

In this month's highlight, we discuss the new EU regulatory framework for ESG rating providers. Our monthly Spotlight section brings you up to date with the latest developments in ESG governance, disclosure, financial regulation and litigation.

1 Highlight – a new EU regulatory framework for ESG rating providers

The number of available ESG ratings has grown rapidly in recent years, in response to investor demand for assistance in assessing the sustainability performance of potential investments. The European legislator is first to introduce a regulatory framework for entities that develop ESG ratings, so called ESG rating providers.

ESG ratings – a wide variety

ESG ratings show the sustainability performance of an entity or a financial instrument using a defined ranking system, e.g. a score between 0 and 100 or from A to D. There is a wide variety of information that these ratings provide and what they mean exactly. For example, ESG risk ratings assess a company's exposure to and management of certain ESG risks. There are also ESG ratings that focus on a company's impact on the environment and society, and ESG ratings that assess compliance with certain (international) principles and guidelines.

Although the name may suggest otherwise, ESG ratings are fundamentally different from 'traditional' credit ratings. Traditional credit ratings are opinions on the creditworthiness of an entity or a fixed-income security, often including ESG factors. However, the inclusion of ESG factors does not mean that such ratings fall within the scope of the term 'ESG ratings' (as covered by the new regulatory framework).

EU regulation of ESG rating activities

The proposed Regulation on transparency and integrity of Environmental, Social and Governance (ESG) rating activities introduces the first regulatory framework for ESG rating providers. It aims to improve ESG rating practices by introducing organisational rules and transparency requirements for ESG rating providers in response to concerns about (i) the lack of transparency on the characteristics of ESG ratings, their methodologies and their data sources; and (ii) the lack of clarity on the operations of ESG rating providers. The European Parliament adopted the proposal in April 2024 and the European Council has yet to formally adopt it.

Scope of application

The new regulatory framework applies to ratings issued by ESG rating providers operating in the EU. The scope of application is intended to be broad, with the definition of ESG ratings covering any opinion, score or combination of both on a 'rated item' (public and private entities and financial instruments that are to receive an ESG rating) with respect to the exposure of risks on or the impact on environmental, social and human rights or governance factors, based on both an established methodology and a defined ranking system of rating categories.

The EU legislator aims to include ESG rating providers established inside and outside the EU territory by stipulating that an ESG rating provider established outside the EU is considered to operate in the EU if it issues and distributes its ratings by subscription or other contractual relationship to (i) EU regulated financial undertakings; (ii) EU companies falling within the scope of Directive 2013/34/EU; (iii) undertakings falling within the scope of Directive 2004/109/EC (publicly traded companies); and (iv) (parts of and entities related to) the EU and member states.

Investor reliance on ESG ratings

The proposed regulation explicitly states that the use of ESG ratings by investors is not regulated and that ESG rating providers must clearly and explicitly state that ESG ratings are their own opinions. It is therefore expected that (especially professional) investors will continue to have their own responsibilities in this regard. It is prudent for investors to also make their own assessment of the sustainability performance of a rated item.

Organisational and transparency requirements

The proposed regulation introduces rules on the organisation of ESG rating providers and the transparency of their rating methodologies. The rules are procedural in nature and do not affect the substance of the rating methodologies used.

In terms of organisational requirements, it stipulates that ESG rating providers must ensure the independence of rating activities, that ESG ratings should be based on thorough analysis in accordance with the rating methodologies and that employees shall be properly trained and independent. It also requires a separation of activities: ESG rating providers may not be involved in e.g. advisory activities, the issuance and distribution of credit ratings (as defined in Regulation 1060/2009) and the development of benchmarks (as defined in Regulation 2016/1011). The latter rule may be particularly relevant for traditional credit rating that have developed ESG rating activities in recent years.

In terms of transparency, the regulation includes rules on the disclosure of methodologies, models, and key rating assumptions used in ESG rating activities to the public and, in particular, to users of ESG ratings. It also requires ESG rating providers to provide separate E, S and G ratings rather than a single ESG metric that aggregates E, S and G factors. If ESG rating providers wish to provide an aggregated ESG rating, they must provide information on the weighting of the three overarching ESG factor categories and an explanation of the weighting methodology.

Mandatory complaints mechanism and provision of datasets to rated items

There are currently two types of business models for ESG rating providers: (i) the issuer-pays model (i.e. an entity pays an ESG rating provider to create an ESG rating); (ii) the subscription-based or user-paid model (i.e. the users (investors) pay an ESG rating provider for the use of ESG ratings mostly by means of paid subscriptions). While in the traditional credit rating market most credit ratings agencies employ an issuer pays model, the subscription-based model is more common in the ESG rating market. As a result, it is more common for an entity or its financial instruments to receive an unsolicited ESG rating without being consulted by the ESG rating provider. From this perspective, it is useful that the new proposal requires ESG rating providers to establish a complaints mechanism for rated items and entities (which can also be used by users). Furthermore, the proposal requires ESG rating providers to give a rated entity two working days' notice before issuing an ESG rating and, upon request, to disclose the dataset used to produce the ESG rating, so that the rated entity has the opportunity to inform the ESG rating provider of any factual errors.

ESMA supervision

The EU legislator entrusts the European Securities and Markets Authority (ESMA) with the supervision on ESG rating providers. If ESMA finds that an ESG rating provider has infringed the Regulation, ESMA is empowered to take supervisory measures such as imposing fines, issuing public notices and withdrawing authorisation. If a legal entity wishes to operate as an ESG rating provider in the EU, it must apply to ESMA for authorisation (for legal entities established in the EU) or for equivalence, endorsement or recognition (for legal entities established outside the EU). In order to increase competition and reduce barriers to entry for new ESG rating providers, small ESG rating providers (which qualify as a small undertaking or a small group according to the criteria set out in Article 3 of Directive 2013/34) will temporarily benefit from a lighter supervisory regime.

Next steps

Once adopted by the Council, the regulation will enter into force on the 20th day following its publication in the Official Journal of the European Union. It will apply 18 months from its entry into force. Finally, parts of the regulation will be specified by regulatory technical standards to be developed by ESMA.

What it means for you:

- **Investors:** ratings can be useful tools and the Regulation may add to their reliability but be aware that the introduction of a regulatory framework for ESG ratings does not remove an investor's own responsibility to assess the sustainability performance of rated items and that reliance on ESG ratings alone should be avoided.

- **'Rated items' (public and private entities and financial instruments that are the subject of ESG ratings):** be aware of the possibility of unsolicited ESG ratings and put in place mechanisms to ensure a timely response to notification of the issuance of an ESG rating by an ESG rating provider.

- **ESG rating providers:** (i) apply to ESMA in a timely manner for decisions on authorisation, equivalence, endorsement or recognition; (ii) adapt the business to the organisational and transparency requirements, and in particular consider whether separation of activities may be necessary and put in place complaint handling mechanisms.

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2 Spotlight on ESG developments

Governance & transition

Council gives final approval to right-to-repair directive

On 30 May, the Council adopted a directive promoting the repair of broken or defective goods, also known as the right-to-repair (or R2R) directive. This legislation will make it easier for consumers to seek repair instead of replacement and repair services will become more accessible, transparent and attractive. The adoption of the directive is the last step in the legislative decision-making process. The directive will now be published in the Official Journal of the EU and will enter into force 20 days later. Member states will then have two years to transpose the directive into national laws.

Council gives final approval to CSDDD

On 24 May, the Council formally adopted the Corporate Sustainability Due Diligence Directive (CSDDD). This is the final step in the EU decision-making process. The directive will now be published in the Official Journal of the EU and will enter into force 20 days later. Member states will then have two years to transpose the directive into national law. Our update on the CSDDD provides further information, including application timelines.

Council gives final approval to gas and hydrogen market package

On 21 May, the Council adopted a regulation and a directive establishing common internal market rules for renewable and natural gases and hydrogen and reforming the existing EU gas legislation. The new rules call for integrated and transparent network planning across the EU, based on the ‘energy efficiency first’ principle and with a forward-looking approach. Gas and hydrogen network operators will prepare a 10-year EU network development plan. The regulation and directive will now be signed and published in the Official Journal of the EU. The regulation will enter into force six months after its publication. Member states have two years to adapt their national legislation to the provisions of the directive.

EU's electricity market reform: Council adopts updated rules

On 21 May, the EU Council adopted the electricity market regulation, amending the current electricity regulation and the regulation on the Agency for the Cooperation of Energy Regulators (ACER). The changes aim to ensure more stable energy prices, less dependence on fossil fuel prices and better protection against future crises on the way to a decarbonised EU. The regulation will be signed and published in the Official Journal of the EU. It will be directly applicable in all Member States twenty days after publication.

ECB publishes working paper on the globalisation of climate change

On 17 May, the European Central Bank (ECB) published a working paper examining how climate-related physical risks are amplified through economic interdependencies, known as input-output linkages. The analysis provides an interesting country-level breakdown within the European Economic Area, identifying two main groups at risk of substantial aggregate losses: (i) countries with high direct exposure to physical risks associated with climate change; and (ii) those with significant trade links to parts of the world expected to suffer severe direct damages. The wholesale and retail trade, real estate services, and construction sectors are projected to experience the largest aggregate losses. In addition, substantial repercussions are foreseen for the financial and insurance sectors, raising concerns about potential financial stability spillovers from tangible economic setbacks. A key determinant of these outcomes is the ability of individual country sectors to adjust their input sourcing strategies. The findings suggest that sectors with greater flexibility in reallocating inputs may be able to mitigate some of these potential losses, while those with less adaptability may experience more adverse impacts.

Disclosure

EFRAG publishes three ESRS IG documents (EFRAG IG 1 to 3)

On 31 May, the European Financial Reporting Advisory Group (EFRAG) issued three ESRS Implementation Guidance documents (EFRAG IG 1 to 2), providing essential guidance to ensure organisations effectively implement and comply with ESRS standards, promoting transparency and consistency in sustainability reporting. EFRAG IG Materiality Assessment provides an illustrative materiality assessment process for undertakings, and develops the concept of impact and financial materiality with a number of examples, including how these two concepts interact. EFRAG IG 2 Value Chain outlines the reporting requirements for the value chain from materiality assessment to policies and actions to metrics and targets. It illustrates the group's reporting boundary for sustainability reporting, including the concept of operational control in environmental standards. EFRAG IG 3 ESRS Datapoints translates the full ESRS Set 1 list of detailed requirements in each Disclosure Requirement and related Application Requirements into Excel format. The file includes additional information, such as the types of requirement (for example, quantitative or qualitative) or whether these are subject to transitional provisions and can be used as the basis for a data gap analysis or data collection exercise.

EFRAG publishes compilation of Q&As on the implementation of the ESRS

On 30 May, EFRAG published a compilation of 68 answers to the questions received through its Q&A platform on the implementation of the European Sustainability Reporting Standards (ESRS). Key questions relate, for example, to the minimum number of material sustainability matters to be disclosed, the disclosure of thresholds and the role of administrative, management and supervisory bodies.

Joint EFRAG and ISSB guidance on interoperability with a focus on climate change reporting

On 2 May, EFRAG and the International Sustainability Standards Board (ISSB) published joint guidance on interoperability between the ISSB Standards and the ESRS, with a particular focus on climate reporting. The guidance describes the alignment of disclosure requirements and information necessary for both sets of standards to ensure interoperability. It shows that companies reporting under the EU standards can comply with the global standards with minimal additional effort.

Financial institutions & regulation

NZBA publishes supporting notes to the Guidelines for Climate Target Setting

In May, the Net-Zero Banking Alliance (NZBA) published supporting notes to clarify several aspects of the Guidelines for Climate Target Setting for Banks (version 2) which were adopted by NZBA members in March 2024. The supporting notes address, among other things, variations in methodological and technical approaches to setting climate targets. They also clarify considerations regarding the materiality of different emission types and sources, outline different scenario types that banks may encounter, define the scope of financial activities and sectors that should be included in target setting processes, and provide reporting expectations.

ESMA publishes position paper on EU capital markets

On 22 May, the European Securities and Markets Authority (ESMA) published a position paper entitled 'Building more effective and attractive capital markets in the EU'. The paper sets out 20 recommendations to strengthen EU capital markets and met the needs of European citizens and businesses. ESMA's recommendations for a well-functioning capital market focus on three dimensions: citizens, businesses and the EU regulatory and supervisory framework. One of the recommendations is to promote EU capital markets as a hub for green finance, which should include efforts to simplify sustainability disclosures, including through the use of sustainability labels and categories where appropriate.

NGFS publishes report on sustainable and responsible investment in central bank portfolio management

On 16 May, the Network for Greening the Financial System (NGFS) published a report with ten non-binding recommendations on sustainable and responsible investment (SRI) in central bank portfolio management. These recommendations outline how central banks can further integrate sustainability considerations into their investment practices without losing sight of the effectiveness of their approach. The first four recommendations focus on integrating sustainability considerations into governance. Recommendations five and six relate to the assessment of exposure to sustainability factors. Recommendations seven and eight deal with the implementation of SRI policies, and recommendations nine and ten with reporting practices and the evaluation process.

ESMA guidelines on fund names using ESG or sustainability terms

On 14 May, the ESMA published guidelines outlining the circumstances under which fund names using ESG or sustainability-related terms may be considered unfair, unclear, or misleading. The guidelines also clarify what investors may expect in terms of policies, practices and features of funds that meet sustainability standards. The guidelines will apply to UCITS and AIFs, EuVECA, EuSEF, and ELTIF, and money market funds. The guidelines will apply three months after their publication on the ESMA website, and immediately for newly created funds.

AFM publishes two reports on SFDR compliance

On 14 May, the Dutch Authority for Financial Markets (AFM) published two reports assessing financial institutions' adherence to the SFDR and their incorporation of sustainability considerations into product oversight and governance (POG) procedures and suitability assessments. The first report covers the use of templates in line with the Level 1 SFDR-requirements. The AFM expects all financial institutions to comply with these SFDR provisions. Insufficient compliance efforts will be addressed through regulatory action. In addition, further granularity is required in both the use and completion of these templates. The second report focuses on the POG and suitability standards within investment firms. While steps have been taken to integrate sustainability into policies and products, there is still room for enhancement, particularly in explaining sustainability preferences in a way that is understandable for clients. Investment firms are encouraged not only to incorporate sustainability considerations into their POG policies, but also to review their product offerings accordingly to avoid potential mismatches. Both reports offer guidance and illustrative examples.

ECB blog by Frank Elderson: "2024 is a crucial year for banks to make decisive progress in becoming more resilient to C&E risks"

On 8 May, the ECB published a blog post by its board member Frank Elderson. The blog outlines good and 'bad' practices in banks' materiality assessments and identifying climate-related risks. It also discusses the way forward for the ECB's expectations on the management of climate and environmental (C&E) risks. *"By the end of this year, we expect all banks under our supervision to be fully aligned with all our supervisory expectations on the sound management of C&E risks"*, says Elderson.

Litigation

Texas Court issues preliminary ruling in climate shareholder proposal case

On 22 May, the Court of Texas delivered a preliminary ruling in the case brought by ExxonMobil against NGOs Arjuna Capital and Follow This. ExxonMobil argues that it may exclude the NGO's' shareholder proposal on Exxonmobil's climate policy from its proxy statement. The NGOs have already withdrawn the proposal. In its ruling, the court assumed subject-matter jurisdiction over the case and personal jurisdiction over US-based defendant Arjuna Capital. It did not accept personal jurisdiction over Dutch defendant Follow This. The ruling comes after several institutional investors threatened to vote against the installation of ExxonMobil's new CEO, saying the case was an anti-climate action and an anti-shareholder move. The case will now move on to the merits with Arjuna Capital as the sole defendant.

ITLOS issues advisory opinion on climate change and the sea

On 21 May, the International Tribunal for the Law of the Sea (ITLOS) issued an advisory opinion on climate change and international law of the sea. The opinion was requested by a commission of small island states, and is based on a large number of amicus briefs and two weeks of hearings. The opinion states that the 1982 UN Convention on the Law of the Sea (UNCLOS) imposes a strict due diligence obligation on contracting states with regard to transboundary pollution caused by greenhouse gas emissions. In particular, states are required to take all necessary measures to prevent, control and reduce GHG emissions that directly or indirectly affect oceans and seas. They should adopt and enforce laws and regulations based on the best available science and climate change treaties such as the Paris Agreement, and cooperate and harmonise their policies in this regard. In particular, states should also protect, preserve and restore marine resources in relation to the impacts of anthropogenic GHG emissions. The advisory opinion is expected to influence the pending change-related advisory opinions at the Inter-American Court of Human Rights and the International Court of Justice.

Dutch authorities launch criminal investigation into wood importers

On 17 May, the Netherlands Food and Consumer Product Safety Authority (NVWA) announced that it is conducting a criminal investigation into two Dutch importers of wood. According to the authorities, the importers were not able to prove that they conducted sufficient due diligence on the origin of wood which they imported from Brazil and Suriname. This could constitute a breach of the Timber Regulation, to be replaced by the Deforestation Regulation as of 30 December 2024. The investigation is still pending.

German court orders federal government to adopt measures to achieve 2030 climate target

On 16 May, the higher administrative court of Berlin-Brandenburg ruled that the German federal government's climate protection plan is not sufficient to achieve the climate target of 65% reduction in 2030 compared to 1990, as set out in the Climate Protection Act (CPA). The court finds that it is foreseeable that most of the sectoral annual targets of the CPA will be exceeded, and that the plan suffers from methodological flaws and is partly based on unrealistic assumptions. The federal government is ordered to take measures to align the climate protection plan with the targets of the CPA. The ruling is subject to appeal. It follows an earlier administrative judgment of November 2023, which ordered the federal government to adopt an immediate action programme for the buildings and transport sectors.

UK High Court rules that UK climate protection plan is unlawful

On 3 May, the administrative UK High Court ruled that the UK government's climate protection plan is in breach of the Climate Change Act (CCA). The court ruled that the plan was an 'irrational decision' by the secretary of state because he was not sufficiently informed about the risk that the proposed policies would be insufficient to meet the carbon budgets set out in the CCA. The secretary of state also failed to demonstrate that the climate protection plan sufficiently contributes to sustainable development. The parties will now make submissions on the court's order to revise the plan. The ruling follows a judgment in July 2022, which ordered the UK government to adopt a revised climate protection plan.

Dutch energy provider withdraws climate claim

On 2 May, the Dutch Authority for Consumers and Markets (ACM) announced that the Dutch energy company Eneco will remove the claim 'faster towards climate neutral' (in Dutch: *'sneller klimaatneutraal'*) from its advertising. The announcement follows 'normative discussions' with the company. The ACM assessed the claim as potentially misleading, because it does not make clear that it concerns an ambition for the year 2035. In its announcement, the ACM states that it must be clear to consumers what companies will actually do in terms of sustainability, referring to its guidelines on sustainability claims.

Do you have any questions or comments on a specific ESG topic? Do not hesitate to contact our Sustainable Business & Climate Change team. If you or members of your team would like to receive our updates, please subscribe.

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