SOMO Comments on IOSCO on the issue of Environmental, Social and Governance (ESG) Ratings and Data Products Providers

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Introduction

The Centre for Research on Multinational Corporations (hereafter SOMO[1], a non-profit public interest research organisation) is providing comments to IOSCO's consultation on its report on Environmental, Social and Governance (ESG) ratings and data products providers. The role of these unregulated entities is a growing concern for civil society groups, and efforts towards providing clarity on their functioning and promoting effective regulation of the sector is timely. However, we feel the potential negative implications for vital human rights, social and environmental protection agendas, posed by the way in which the ESG industry is developing, requires a wider view than that presented in the IOSCO consultation report, which focuses on risks for the financial sector and capital markets. We hope our observations will support the efforts of IOSCO to assist its members "in understanding the implications of the activities of ESG ratings and data products providers" and providing "recommendations to mitigate risks associated with ESG ratings and data products".[2]

Before making some specific comments on the 10 recommendations set out in IOSCO's consultation report, we would like to explain our concerns.

SOMO's primary concern about the growing ESG industry is th**e significant potential for misuse of ratings and data products, due to the lack of clarity about their purpose and content.** Specifically:

There is a significant gap between what is assessed by ESG ratings and data products and what is assumed to be assessed: ESG ratings and data products increasingly focus on risks that are relevant to the investor. That means that environmental, social and governance *impacts* of companies (for example, actual impacts on climate, the environment, people and societies) are not the primary consideration. As one participant quoted in the IOSCO consultation report notes: "Of the negative externalities that companies in an industry generate" the issue is "which issues may turn into unanticipated costs for companies in the medium to long term."

It becomes problematic when the marketing of these products as "environmental, social and governance" ratings or assessments is increasingly leading to the perception that such tools measure how well a company is doing in terms of its social, environmental and good governance impacts, while not clarifying that, often, what they actually assess is how well a company manages financial risks that stem from ESG factors and/or the material financial risk to the investment.[3] ESG related

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[2] Quoted from the Foreword of the IOSCO consultation report, page iii.
[3] See: ESG investing is a term that is too often misused | Financial Times. Also: Why we need better standards for ESG ratings | The Times & The Sunday Times. Even within the IOSCO report there is evidence of this. The report notes: ESG ratings and data product offerings are constantly evolving to respond to new topics of interest (e.g., share of green activities, contribution to the United Nations' Sustainable Development Goals) and emerging areas of attention (e.g., environmental, diversity and inclusion, and biodiversity). However, we would argue that this is, often, not what they respond to – they respond to the new or evolving risks to investment and to perceived market opportunities.

investment products that use and refer to these ratings may also mislead (retail) investors who want to invest in companies that have positive ESG impacts.

This perception issue merits greater attention. While the focus of the IOSCO report is on investors, there are many other stakeholders whose rights and interests can be negatively impacted by the way the ESG data industry is developing, and the challenge of how ESG ratings and data products are perceived and used. One challenge is that positive ESG ratings can be used to counter legitimate concerns, put forward by CSOs or affected individuals and communities, about harmful practices by companies. Another challenge is that companies, fearing the impact of negative reporting by civil society actors on their ESG rating, may seek to suppress investigations into, and publication of, reports that expose harmful corporate impacts on ESG issues.

The methodology and the information used: SOMO welcomes the attention given to this issue in the IOSCO consultation report. As many commentators have noted there is a lack of transparency in relation to both methodology and sources of information, and their verification. This lack of transparency is a critical concern; the foundation of any credible information tool must be full transparency on sources and assessment methods, weighing and clustering of criteria, as well as means of verification and quality checking. That ESG ratings and data products largely fail to meet these basic standards of good research, is a significant concern.

Over-reliance on data and input from the rated entities: The consultation report also underscores the reliance of ESG rating and data providers on data provided by the companies being assessed. While data from companies is one important source of information, over-reliance on such data can lead to bias and significant methodological weaknesses.

Firstly, there is an assumption that corporate ESG data is accurate. As investigations and reports from numerous NGOs have shown, this is not always the case.[4] Despite this, there is little evidence to suggest corporate data are verified in any meaningful way. On the contrary, as the consultation report notes, the methodology of some ESG data providers involves substantial checking with the company, but not with independent sources or those impacted by a company's operations. For example, a response in table 115 notes: "If it cannot without doubt be determined which information is correct or the most comprehensive, it will not be considered performance assessment, unless all doubt can be eliminated through company dialogue (emphasis added). This level of reliance on the assessed entity for verification is clearly problematic. Moreover, as the IOSCO consultation report also notes, users of the ESG data also do not check veracity of information: "Responses to the questionnaire revealed that users generally do not conduct any formal verification of the ESG ratings and ESG data products."

Secondly, over time reliance on corporate disclosures (and making such disclosures consistent, without robust regulations and verification) risks leading to an ESG data system that rated companies can easily manipulate, even if unintentionally. The risk of biased, misleading and incomplete corporate information should be kept fully in view in any recommendations or regulatory action on ESG data disclosures by companies. There are critical questions to be addressed: will ratings shape corporate disclosures?; With growing concentration (and power) within the ESG industry, will ESG providers promote and lobby for corporate disclosure regimes that more easily enable them to be efficient and profitable?

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[4] See, for example: Earth Day 2021: Companies Accused of Greenwashing | Truth In Advertising; Greenpeace calls out Nestle for false claims on plastic neutrality - Greenpeace Philippines;

Robust regulatory requirements and their enforcement by authorities are needed to assure that companies disclose accurate information and that the ESG industry provides data and ratings that are accurate, independently verified information.

Risk of misleading data on the levels of investment that are supporting climate mitigation and energy transition: Many countries globally are making efforts to encourage private investment in areas such as energy transition and climate change mitigation. Such private sector investment is seen as critical to help generate the capital needed for a transition to a more environmentally sustainable economy. As the consultation report notes, asset managers use ESG ratings to, amongst other things, *"*develop and oversee sustainable products". However, given the data and methodological concerns outlined above, this is potentially leading to whole product classes based on methodologically problematic data. In this way, ESG investing may be of little help to often-stated goals of securing more investment that improves the sustainability impacts of companies. A range of ESG investing products, based on narrowly framed and methodologically unsound ratings and data products, risks obscuring the limits of actual investment in genuinely sustainable economic activity. This can also create risks for financial market stability when such ESG investment products create a financial bubble, given that currently demand is higher than supply; and when trust in these investment products declines due to their poor quality and limited real impacts, as well as criticism from civil society and other stakeholders.

Limited consultation process: SOMO notes that IOCSO consulted stakeholders, but this group did not include non-governmental organisations (NGOs) that work on corporate ESG issues. The environmental, social, human rights and governance impacts of business have been on the global agenda for decades.[5] The constituencies involved in these international initiatives – which include NGOs – should be considered as stakeholders in ESG. While we understand the limits of IOCSO's mandate and capacity, IOSCO should be aware of these stakeholders and the growing disquiet about the developing ESG industry and its impact on legitimate and long-standing environment, social, human rights and governance issues.

The IOSCO report states: "the lack of standards in this area may present the risk of greenwashing or misallocation of assets and could lead to a lack of trust in ESG ratings or in the data products' robustness or relevance". SOMO would concur with this observation. A poorly defined, unregulated and misleading set of products would not only lead to distrust but can have far-reaching consequences for human rights and environmental sustainability, if ESG ratings are misused to delegitimize, discredit or side-lining social justice movements.

General recommendations

In making a number of suggestions for IOSCO's ongoing work program on ESG, we strongly recommend that IOSCO consider the wider context within which the ESG industry is being developed, particularly the longstanding efforts, referred to above, to protect human rights and the environment in the context of corporate operations; efforts to improve corporate impacts on human rights and the environment; and to reach the Paris climate commitments and Sustainable Development Goals through reorientation of investments. The ESG industry should not be allowed to derail progress in these areas. Moreover, policy and regulatory coherence with international human rights and environmental norms is imperative.

[5] For example, through efforts related to the climate crisis; the development of the UN Guiding Principles on Business and Human Rights; the OECD Guidelines for Multinational Enterprises and associated sectoral guidance; mandatory human rights and environmental due diligence on the legislative agenda of many EU countries.

We make the following proposals which we believe regulators should consider:

- The purpose of ESG data products (including ESG ratings) needs to be substantially clarified, and regulators should take action to make sure the title and marketing of products accurately reflects their purpose and limitations, specifically, whether they are to be used as financial risk tools for investors (i.e. investor risks), or whether and how they provide insights into the ESG impacts beyond material and financial risks for the company or the investor. When financial market authorities and IOSCO only focus on the material financial ESG risks for investors, and related standards for the ESG industry, they should acknowledge the limitations of their supervisory and regulatory mandates.
- ESG products should include an explicit health warning, with appropriate guidance from the national authorities, making clear what a rating or data product measures and the extent of reliability of data. Such health warnings should clarify that ESG ratings do not provide a full picture of a company's impact on people or the environment.
- ESG ratings and data providers should be required to be transparent, list all sources used, and clarify how data, including corporate data, is verified (independently, on the ground, involving stakeholders, etc.). They should also be required to respond to third-party concerns about inaccuracies.
- Potential conflicts-of-interest between providers and assessed entities is such that the risks of manipulation of data requires far more robust rules to prevent conflicts-of-interest. All ESG ratings providers should be required to disclose if they (or any other entity in which they are financially involved) provides other services to the rated or assessed entity. The total commercial value of the relationship should also be disclosed.
- ESG data and rating providers should also disclose how their own companies or groups are being rated according to robust ESG data and rating processes.
- Official corporate ESG data disclosure requirements should not be shaped by the ESG industry. Regulators should ensure that disclosure requirements are based on clear policy objectives and reporting regulations, and that lobbying from the ESG industry does not influence the scope and the quality of the disclosures.
- The concerns of all stakeholders, and especially those impacted by corporate operations, should be taken into account when proposing and deciding on standards and regulations for the ESG industry.

Specific comments related to IOSCO's recommendations

While we understand IOSCO's mandate leads it to focus on financial risks, SOMO believes that IOSCO needs to assess how it can take meaningful account of the wider social, governance and environmental impacts on a broad range of stakeholders, of its initiative towards the ESG data and rating industry. As the comments below suggest, IOSCO should consider whether other financial market regulators and authorities are fully equipped to propose, implement and enforce high qualitative and robust standards and regulatory requirements to address all aspects of the ESG industry.

Response to recommendation 1

- As regards the **use of sustainability related and ESG rating and data product terminology**: IOSCO should clearly identify and promote clarification from ESG data and rating providers, whether they are providing information that allows investors to assess financial ESG-related *risks* based on material financial risks from the company's performance, or whether the information identifies wider ESG *impacts* on the environment (e.g. biodiversity loss), people (e.g. human rights abuses) or governance (e.g. legal aggressive tax planning), which have an impact on society but not necessarily (in the short term) on the company and return to investors.

- When the data are about material financial ESG-related ***risks*** to the company and the investor, they should be integrated into the assessments of material risks by credit rating agencies (CRAs) when they are rating companies, something that CRAs are not doing sufficiently at present.
- A **conflict of interest** that has not yet been identified is how the ESG rating and data provider companies are themselves performing on various environmental, social and governance issues. As companies themselves their own approach to critical ESG issues may have an impact on how they define key performance indicators and assess other companies.
- ESG data and ratings that focus on financial risks also exacerbate the risks of conflict-of-interests. ESG data and rating providers that have been acquired by the large CRAs or investment product providers have tended to focus on ESG risks rather than wider ESG impacts.
- IOSCO's approach is also narrowly framed by its supervisory mandate, to prevent abusive information practices that have effects on financial markets. However, the ESG ratings are often assumed to assess the ESG ***impacts*** (on, variously, climate, the environment, human and labour rights, communities, and society). From an integrity and transparency perspective, it is critical that the distinction between risk to investors and ESG impacts on wider society is made clear. This is also important because ESG data and ratings are used to inform various investor strategies and financial products (such as the EU's Sustainable Financial Disclosures Regulation, which requires transparency about integration of ESG risks or ESG/sustainable impact and transparency about adverse sustainability impacts at entity level).
- IOSCO should advise on regulatory measures and codes to increase transparency and integrity of the methodology and information, as proposed.

Recommendation 2:

- As regards ESG ratings and data products they issue are based on a **fair and thorough analysis** of **all relevant information available to them**, and **transparency around the sources** of data used in determining their ESG ratings and data products:
  It is important that transparency is provided in how far non-company information that is publicly available has been seen, assessed, verified, and whether it was used or not, and the reasons for not using certain information (e.g. the company denied certain actions or allegations). It should be made clear whether, and to what extent, company stakeholders (workers, consumers, communities in which companies operate) and information published by them or about their situation or concerns, has been integrated to any data product, assessment or rating. The ESG data and rating providers should provide information about how they dealt with any conflicting information, particularly where the company being assessed denies claims made by others about the company's actions and impact. Affording the assessed company the opportunity to review and seek alteration of the assessment, while reasonable as a means of identifying genuine errors, is also open to manipulation, and the ESG ratings and data providers should make clear how they prevent abuse of the process. The use of "ongoing dialogue" between the ESG rating agency or data provider and the assessed entity carries high risks of conflict of interests, and such practice should be discouraged, and at least be disclosed

- As regards **transparency around the sources of data** used: There should be robust transparency on if, and how, company information has been verified (e.g. on the ground where the company is operating), and by whom (independent verifiers, accountants, independent observers or institutions, trade unions, etc.).

- The issue of sufficient resources to carry out high-quality ESG-related assessments, including **sufficient highly qualified and trained personnel** and technological capabilities is important. The ESG data and rating providers should provide information on the expertise of ESG data and rating staff, as well as the investments made in the training and quality checks, up to the highest management unit.

Recommendation 3 and 4:

- Supervisors, regulators and legislators should, as appropriate within their mandate, provide best practices guidelines, requirements and legal standards that apply the suggested improvements, with clear mandates to supervisors.
- The ESG industry requires substantial improvement if the problems identified above. Given the potentially wide-ranging negative consequence of misleading information, not only for investors but for a wide range of stakeholders, voluntary measures are insufficient. Such measures will not address the challenges swiftly enough, nor will they instill confidence in the products and providers.
- We recommend that IOSCO assesses how different authorities, supervisors and regulators should be involved in regulating the ESG industry, given that a financial risk approach by financial supervisors does not cover the full scope of regulatory needs around ESG data, assessments and ratings.

Recommendation 5:

- The measurement objective of the ESG rating or data product should clarify whether the data or rating is assessing ESG risks for the company and/or the investor, or whether it is about ESG impacts, including on stakeholders, the environment and society.
- There should be sufficient transparency by ESG rating and data providers to allow other stakeholders to evaluate whether the ESG rating or data product company has considered a balanced mix of ESG factors or whether the KPIs and data on social and governance factors have been well developed.

Recommendation 6:

There should be transparency about how the non-public information has been obtained, what weight it has been given in the ESG assessment methodology, and whether there was a conflict between the non-pubic information and (non-company) public information and if so, how that conflict was resolved.

Recommendation 7:

The due diligence of ESG data product users should include not only how ESG data and ratings are informing their risks but also the wider and longer-term ESG impacts. The users' due diligence should assess how the stakeholders impacted by ESG factors have been consulted, and their public material has been used and integrated. In addition, users' should be able to assess how conflicting information has been handled and reflected in the data and ratings.

ESG data and rating providers and their users should also verify whether a company has taken action to avoid negative ESG information being made public, particularly action that could be viewed as repressing legitimate disclosure of public interest information by affected groups or civil society actors. ESG rating and data users should be aware that companies react to negative ESG ratings and related investor behavior, and such reactions can include more aggressive efforts to prevent criticism being made public.

Recommendation 9:

Any possibility by the assessed company to correct information should be accompanied by the highest standards of integrity at the ESG rating or data product agency. This should include robust procedures for verification and allowing affected third parties to also provide input. Simply removing from consideration any information a company denies is accurate (as one ESG provider interviewed for the IOSCO report stated was their policy) would render any subsequent assessment or rating highly questionable. Again, full transparency around the methodologies and data sources used by ESG rating and data product providers is vital to avoid data manipulation or unintentionally partial assessments emerging. ESG data and ratings providers should assess integrity and whistleblower procedures policies at companies. Whistle blower procedures should be present at the ESG data and rating providers.

Recommendation 10

When requiring **entities subject to assessment by ESG ratings and data products providers to streamline their ESG related information** it is important that these entities :

- Use the existing and upcoming sustainability accounting and reporting requirements (whether legal or guidelines), provided by authorities (such as EU, IFRS, national laws, etc.), and in case lacking, best voluntary sustainable corporate reporting standards;
- Have integrity standards in place to ensure that those responsible for data disclosure within the rated entities are not manipulating data disclosure to improve ESG ratings. This can include codes of conduct about conflict of interests, whistleblower procedures, brand management separated from sustainability officers, etc.);
- Clarify how these data have been verified;
- Clarify how much human and financial resources are dedicated to such reporting;
- Are transparent on how stakeholders are involved in provided the ESG data, and what stakeholder complaints there have been and how they have been dealt with.