

31 AUGUST 2023

CONSULTATION RESPONSE - EC PROPOSAL FOR A REGULATION ON THE TRANSPARENCY AND INTEGRITY OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) RATING ACTIVITIES

The Danish Institute for Human Rights (the DIHR) welcomes the opportunity to provide feedback to the European Commission (EC) on its proposal for a regulation on the transparency and integrity of Environmental, Social and Governance rating activities (the ESG proposal).

Numerous studies and analyses have clearly demonstrated the need for scrutiny over the ESG rating industry. The key concerns raised in respect to the industry include lack of transparency over methodological approaches, significant divergence in what gets measured/assessed across providers, failure to identify risk to people and environment and direct investors towards truly sustainable investments, and the existence of conflicts of interest that undermine the credibility of ESG scores/ratings.¹ The Institute supports the objective of the ESG proposal to address such concerns by proposing a regulatory framework that can curb green and social washing and improve the credibility of the ESG rating providers.

The DIHR response draws from the expertise of its Human Rights and Business Department, which has worked for 20 years with companies, states and civil society to promote and build capacity for the implementation of business and human rights standards such as the UN Guiding Principles on Business and Human Rights.

The DIHR stresses the need for regulation of the content of ESG ratings, an option which was regrettably discarded early in the legislative process for the ESG Proposal.² ESG remains a loosely defined concept whose lack of analytical rigor has so far undermined investors' efforts to channel finance towards

¹ See, for example, F. Berg et al, *Aggregate Confusion: The Divergence of ESG Ratings*, in *Review of Finance*, 26 (6), November 2022
IOSCO, *Environmental, Social and Governance Ratings and Data Products Providers – Final Report*, November 2021
SustainAbility, *Rate the Raters 2019: Expert Views on ESG Ratings*, February 2019
Timothy M Doyle, *Ratings that Don't rate: The Subjective World of ESG Ratings Agencies*, in *Harvard School Forum on Corporate Governance and Financial Regulation*, 7 August 2018

² Commission staff working document, [Impact Assessment report](#), 2023, p. 33.

sustainable investments. Refraining from regulating the substantive content of ESG ratings would be a missed opportunity to anchor the ESG concept in agreed standards on responsible business conduct. In the absence of a common normative framework, the ESG Proposal may fail in its objective of improving the quality of ESG practices, notably in respect to those ESG ratings/scores that measure ‘impact to people and environment’.

1.1 THE NEED TO BUILD UPON INTERNATIONAL STANDARDS

The DIHR is concerned that although the use of ESG ratings have become a preferred method for financial market participants to demonstrate their commitment to responsible investment, the concept of ESG has no clear anchorage in key international responsible business conduct standards. Although the growth in ESG practices took place concurrently with the standard-setting processes on responsible business conduct within multilateral fora such as the UN and OECD, there was little dialogue between these parallel developments. In 2011, the UN endorsed the UN Guiding Principles on Business and Human Rights (UNGPs) which clarified that all businesses, including financial market participants, have a responsibility to respect human rights that should be implemented through a process of human rights due diligence. This standard of due diligence has been integrated in the OECD Guidelines for Multinational Enterprises (OECD Guidelines) which expand its application to other responsible business conduct areas such as environment, anti-bribery, and consumer protection. The UNGPs and OECD Guidelines have gained wide legitimacy and are referenced in EU regulations underpinning the sustainable finance agenda such as the Sustainable Finance Disclosure Regulation³, the Taxonomy Regulation⁴ and the Corporate Sustainability Reporting Directive.⁵ They also represent the normative foundation for the proposal for a Corporate Sustainability Due Diligence Directive which is under negotiation at the time of writing. It is therefore surprising that the ESG proposal, which is intended to complement these regulations, doesn’t include any reference to these two key international standards (or any other international standard for that matter).

³ See Annex 1 in the regulatory technical standards in Commission Delegated Regulation 2022/1288. Note that the Annex 1 has been the subject of a public consultation by the European Supervisory Authorities has suggested changes to the indicators in Table 1 to ensure closer alignment with international standards.

⁴ See art 18 on minimum safeguards.

⁵ See para (31), (45) in recitals of EU Directive 2022/2464

The only provision in the ESG proposal that alludes to the expectation in these standards is the transparency requirement listed in Annex III (g) whereby ESG rating providers should disclose information on *“the topics covered by the ESG rating/score, and whether they correspond to the topics from the sustainability reporting standards developed pursuant to Art 29b of Directive 2013/34/EU.”* However, a transparency provision is not sufficient to ensure that what gets assessed and measured by ESG ratings is what is necessary to demonstrate respect human rights by the rated entities.

The DIHR recommends that the ESG proposal should reference the key international standards including the UNGPs and OECD Guidelines and set minimum requirements on ESG rating providers to follow these standards when constructing ESG scores/ratings with the intended objective to measure ‘impact to people/society/environment’. To measure the ‘social’ factor, the providers should be required to assess the extent to which the rated entity respects human rights in accordance with the UNGPs and OECD Guidelines. Respect for human rights should be interpreted as both a procedural requirement, i.e. whether rated entities have in place adequate human rights due diligence processes to prevent, mitigate and remediate harm, and an outcome/performance requirement, i.e. whether those processes are effective and result in actual avoidance of harm.⁶

Introducing a minimum set of requirements for the content of ESG ratings/scores will bring much needed normative clarity and analytical rigor in the industry. Equally important, such an approach would support policy coherence in the EU and ensure compatibility with other regulatory initiatives in force and under development which regulate the impacts of financial and real economy companies on human rights and the environment. This would provide a strong signal that financial and non-financial companies are expected to align their practices with the UNGPs and OECD Guidelines.⁷

Concerns by the EC that such a regulatory approach might potentially hinder innovation in the industry seem misguided. ESG companies play an outsized role in the allocation of capital towards sustainable investment. It is critical that their offerings build on agreed international definitions of environmental and social sustainability, rather than unnecessarily picking and choosing standards under the guise of innovation. Regulating ESG content would

⁶ See the EU Platform on Sustainable Finance [report on minimum safeguards](#) (Oct 2022) which makes similar recommendations.

⁷ See, for example, [Statement by the UN Working Group on Business and Human Rights](#) on Financial Sector and the EU Corporate Sustainability Due Diligence Directive, 12 July 2023

actually incentivise the industry to orient their efforts towards what truly requires innovative solutions, including, finding solutions to pressing ESG data challenges such as limited data availability on company performance as opposed to company policies and processes; limited integration of the perspectives of affected stakeholders; lack of methodologies to track allegations of adverse impacts and courts cases over time and across different geographies/jurisdictions; and limited predictive value of ESG ratings in terms of expected ESG impacts.

1.2. THE NEED TO ELIMINATE MISLEADING PRACTICES

In addition to regulating content through clear references to international standards, the **DIHR recommends:**

- **that the ESG proposal sets a requirement whereby aggregated ESG ratings should equally weigh the E, S, G factors;**
- **that the ESG proposal prohibits the aggregation in a single rating of data that measures both sustainability risks to the company and impacts on people and the environment.**

The first recommendation seeks to ensure that the ESG ratings/score provide a holistic perspective that captures in a balanced manner all impact areas of a rated entity. This would reduce incentives to artificially inflate the ESG ratings of certain industries/companies by using weighting methodologies that favour those E, S, G factors where the rated entities are likely to perform better.

The DIHR welcomes the transparency requirements in the ESG proposal (see Annex III, 1(e)) which require providers to specify whether the ESG score/ratings measure risks, impacts or some other dimension. From a human rights and responsible business conduct perspective, this is a critical provision. However, we believe that the proposal should go further and require that separate ESG ratings be provided for impact and financial risk, respectively. In other words, it shouldn't be possible for ESG rating providers to combine both impact (to people and environment) and risk (financial risk to company) related data in one single metric. We believe that such an approach would reduce the complexity of ESG offerings, enable the overall comprehensibility of ESG ratings and ensure that users can adequately interpret those metrics.