Regulation of ESG Rating Providers in India

COVID-19 pandemic has uncovered the fragility of traditional business set-ups and financial implications of unsustainable business activities are being realized and acknowledged by various stakeholders. With the growing awareness regarding Environmental, Social and Governance ("**ESG**") standards and increasing focus on sustainable development goals, sophisticated investors across the globe have diverted their attention towards environmentally conscious and socially responsible investments. This is evident from the global proliferation of ESG related funds, that are expected to represent USD 50 trillion out of USD 140 trillion total global assets under management, by year 2025. While growth of ESG funds is in its nascent stage, there has been an increased demand of ESG related products, which in turn has resulted in need for evaluation and rating of ESG related parameters by ESG rating providers ("**ERPs**").

ESG ratings and third-party data products have played an important role in the ESG ecosystem so far, especially in the absence of consistent and comparable issuer disclosures. Even though investors are increasingly relying on the ESG ratings to determine a company's performance on ESG issues and to gauge the ESG related risks, the current rating systems have low reliability due to the lack of transparency and inconsistency in rating methodologies. To address these deficiencies, the International Organization of Securities Commissions ("**IOSCO**") tabled a report on ESG Ratings and Data Products Providers ("**IOSCO Report**"), encouraging individual jurisdictions to adopt a global reporting baseline for investor oriented ESG rating system.[1]

[1] Final Report on '*Environmental, Social and Governance (ESG) Ratings and Data Products Providers*' published by the Board of the IOSCO, dated November 2021; as available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf

The Prime Minister of India, during a Virtual Global Investor Roundtable held on November 5, 2020 expressed that investors are moving towards companies which have a high ESG score and that India believes in following the path of growth with equal focus on ESG.[2] The regulatory landscape for ESG in India has developed at a measured but regular pace in the last decade.[3] However, there is no legal regime governing the ESG ratings and the ERPs providing ESG ratings to Indian entities are not under any regulatory supervision as yet. As a result, a constant need was being felt to introduce a well-balanced regulatory framework that enables the ERPs to respond to new developments in the ESG space without being too prescriptive. With this objective in mind, the Securities and Exchange Board of India ("**SEBI**") released a consultation paper dated January 24, 2022, on ESG Rating Providers for Securities Markets ("**Consultation Paper**")[4] taking into account the recommendations made to the regulators in the IOSCO Report.

This note aims at understanding the concept of ESG ratings and the need for their regulation in the rapidly evolving ESG ecosystem. This note further explains (i) the issues in the current system of ESG ratings being provided by ERPs as identified by SEBI in its Consultation Paper; and (ii) the framework being proposed in the Consultation Paper to develop a legal regime for regulation of ERPs in India.

ESG RATINGS AND THE NEED FOR REGULATION

The term 'ESG rating' is not defined under any legislation or global standards. IOSCO Report explains the term "ESG ratings" as the broad spectrum of rating products in sustainable finance and include ESG scorings and ESG rankings. It clarifies that ESG ratings, rankings and scorings serve the same objective, namely the assessment of an entity, an instrument or an issuer's exposure to ESG risks and/or opportunities. It further explains that ESG scores and ESG ratings differ in the resources and methodologies used as the ESG scores usually result from quantitative analysis whereas ESG ratings are produced using both quantitative models and qualitative analysis and are accompanied by analyst reports to explain the ratings. IOSCO Report

[2] Press release in respect of the Virtual Global Investor Roundtable; as available at: https://pib.gov.in/Pressreleaseshare.aspx?PRID=1670444

[3] To read our earlier article on Indian legal regime for ESG issues, please click here.

[4] Consultation Paper on '*Environmental, Social and Governance (ESG) Rating Providers for Securities Markets*' published by the SEBI, dated January 24, 2022; as available at https://www.sebi.gov.in/reports-and-statistics/reports/jan-2022/consultation-paper-on-environmental-social-and-governance-esg-rating-providers-for-securities-markets_55516.html

emphasizes the importance of ESG ratings by making a comparison with the credit ratings provided by credit rating agencies in the following terms:

"*Similar to how credit ratings by a CRA provide an objective opinion about credit-worthiness of an individual debt obligation of an issuer or the issuer's relative creditworthiness based on assessment of financial disclosures and other credit information, an ESG rating may also be a single output based on ESG disclosures by listed entities and any other due diligence undertaken by the ERPs to ascertain ESG characteristics of a company*."

In simple terms, ESG rating or score is a measure of a company's exposure to the long-term ESG risks. A superior ESG rating helps companies in developing a good reputation thereby attracting investors and consequently reducing financing costs. In the current times, asset owners and managers are using ESG ratings to supplement their financial analysis to understand a company's ability to better anticipate future risks and opportunities, and long-term value creation. ESG ratings are also utilized by various index providers to formulate indices or indexes on securities.

The European Securities and Market Authority (ESMA), in its letter[5] to the European Commission, acknowledged that the market for ESG ratings and assessments is complex and still developing. It further recommended regulatory supervision of ERPs on the ground that the gatekeepers of ESG ratings and assessments should be subject to a common core of organizational, conflict of interest and transparency requirements.

The IOSCO Report, *inter alia*, proposed that regulators could consider focusing greater attention on the use of ESG ratings and data products and the activities of ESG rating and data products providers in their jurisdictions and encouraged the regulators to examine their existing regulatory regimes and consider whether there is sufficient oversight of ESG ratings and data products providers.

SEBI has also acknowledged that there is an imperative need, more than ever before, to ensure that the ERPs operate in a transparent and regulated environment that balances the needs of all stakeholders.

SEBI'S CONSULTATION PAPER

The Consultation Paper tables the concerns around the current unregulated ERP industry and aims at creation of a more reliable, comparable and interpretable ESG

[5] Letter dated January 28, 2021 from ESMA to European Commission, as available at: https://www.esma.europa.eu/sites/default/files/library/esma30-379-423_esma_letter_to_ec_on_esg_ratings.pdf

rating system, in line with the emerging global practices. In brief, the Consultation Paper has identified the following issues in the current rating system:

- **Ambiguity:** There are a wide variety of ESG products that are offered to address the different needs of investors and companies but there is a lack of clear terminologies, definitions and objectives of these products due to non-disclosure or inadequate disclosure by ERPs.

- **Inconsistency:** Non-comparable and unreliable nature of the current rating system due to inconsistencies in the rating methodologies used causes problems in interpretability of ratings. There is also risk around transparency, verifiability and level playing field in the absence of a regulatory framework for ERPs.

- **Conflict of Interest:** There could be conflict of interests in the ratings provided by the ERPs since the ERPs are providing services other than in the ESG space such as advisory services, index solutions etc. There is also a potential risk of green washing and misallocation due to lack of transparency around the manner of usage of ratings by investors as well as types of ESG rating products of different ERPs.

- **Lack of India Specific ERPs:** The need for a proper rating framework has been felt not only by users of ESG ratings (typically mutual funds, alternative investment funds etc.) but also by corporates and index providers (focused on constructing indices in Indian market) as the Indian companies are typically benchmarked to global and regional benchmarks with respect to ESG ratings and there is no differentiation in the performance of issuers within the domestic space.

PROPOSED FRAMEWORK BY SEBI

- **Accreditation:** SEBI has proposed accreditation of ERPs in India for the purpose of assigning ESG ratings to listed entities and listed securities. Any listed entity who intends to avail an ESG rating as well as the SEBI-registered entities engaged in fund-based investment activities such as mutual funds or AIFs desirous of using third-party ESG ratings as part of their decision-making process for investing in Indian securities, must only use SEBI-accredited ERPs. In addition, where an index provider uses ESG ratings for formulation of index/indices on India securities, it must use services of only SEBI-accredited ERPs for formulation of such index. The Consultation Paper has also proposed certain eligibility requirements for obtaining accreditation as an ERP such as minimum net worth, skilled manpower and requisite infrastructure to undertake necessary due diligence, satisfaction of the ‘fit and proper person’ criteria under the SEBI (Intermediaries) Regulation, 2008. The

Consultation Paper has proposed SEBI registered credit rating agencies and research analysts to act as ERPs, subject to fulfillment of accreditation criteria.

- **Classification of ESG Rating Products:** In order to ensure clear and consistent use of terminology in ESG ratings, SEBI has proposed that the ERPs intending to get accredited with SEBI should offer at least one of the following rating products: (i) impact ratings (i.e. assessment of the positive and negative impact of companies on the environment and society along with an assessment of their corporate governance profiles), (ii) risk ratings related products (assessment of a company's resilience to ESG related risks and the impact of social or environmental issues on the company's enterprise value) - further bifurcated into and termed as either ESG corporate risk ratings or ESG financial risk ratings; and (iii) any other category of ESG related rating products that are appropriately labelled such as ESG fund ratings, carbon risk ratings etc.

- **Standardization:** Even though SEBI has not proposed standardized rating scales (i.e. rating/scoring symbols and their definition) at this stage, it has recommended that the accredited ERPs should apply their ESG rating scales consistently and disclose on their website the ESG rating reports and rating scales (symbols and their definitions) used by such ERPs. If the credit rating agencies and/or research analysts are also SEBI accredited ERPs, they should ensure that there is no confusion between ESG ratings and their other offerings such as credit ratings.

- **Transparency:** The proposed framework requires an ERP to, *inter alia*, disclose the type of ESG rating products, its rating methodology for all its products, the data and information sources (such as BRSR, industry averages, estimations or other methodologies) that the ERP relies on when the actual data is not available or not publicly disclosed, a statement to the effect that the ESG rating is not a recommendation to buy, sell or hold any security of financial instrument, sector classification standard followed by it and other relevant disclosures up to at least two levels of sector classification, policy on managing conflict of interest, annual evaluation of its ESG-rating methodologies against the output which they have been used to produce. It has also been recommended by SEBI that the ESG rating methodology of an ERP must include whether and how it defines the individual components of Environment, Social and Governance of "ESG", including the specific issues being assessed, the Key Performance Indicators ("**KPI**") and the weightage every KPI carries in the rating report and how to deal with incomplete and unreliable data inputs.

- **ESG Rating Process:** SEBI has proposed various steps to be followed by ERPs in order to ensure that a proper rating process is followed by them while undertaking their rating assessment. Such steps include, among others, ensuring consistency in the application of the methodology of its rating process for the same product across ESG ratings assigned by it, in-depth rating research to support their rating evaluations, exercising due diligence and independent professional judgment in order to achieve and maintain objectivity and independence in the rating process, efficient system to keep track of material ESG related developments to ensure timely and accurate ratings, continuous surveillance of an ESG rating by ERP and prompt review of such rating after any ESG-material event such as any controversy on the BRSR filed by the relevant entity. SEBI has also proposed requirements with respect to the personnel and specialist committee to be formed by ERPs to undertake the rating process. Additionally, the SEBI requires an ERP to formulate an operations manual or internal governing document which will act as a comprehensive guide for criteria, policies and procedures related to ESG rating process.

- **Governance Measures:** SEBI has proposed that the accredited ERPs will be obligated to create corporate governance organizational and operational structures to identify and mitigate conflict of interest. The analysts involved in ESG rating assessment must be under an obligation to disclose any conflict of interest involving a company/issuer to the ERP and should not be allowed to rate such companies. The ERPs have also been recommended to take steps to identity, disclose and, to the extent possible, mitigate any potential conflict of interest that may arise between any existing business relationship between the ERP and entities availing its ESG ratings.

- **'Subscriber Pay' Model:** In the current system, as the issuers pay for obtaining the ratings for themselves, these ratings are often marred with conflict of interest. The Consultation Paper recommends a 'subscriber pay' model as against the existing 'issuer pay' model where the investors should pay to obtain the rationale behind the ESG rating given to a company. SEBI believes that the proposed subscriber pay model may also ensure greater responsiveness to investor concerns and furtherance of investor protection agenda.

The Consultation Paper was released at the beginning of this year and the comments from various stakeholders were sought by March 10, 2022 (later extended to April 10, 2022). However, SEBI has yet to make an announcement regarding the tentative timelines by which it is planning to introduce and implement the regulatory regime for

ERPs in India. It is likely that SEBI is currently engaged in the mammoth task of balancing its wish-list set out in the Consultation Paper against the concerns received from various stakeholders.

Important stakeholders such as the foreign portfolio investors have publicly expressed their reservations to the proposed framework by SEBI since it is feared that if mandated to register with SEBI, the international ERPs would distance themselves from the Indian business houses. It is a well-known fact that Indian business houses heavily rely on the ratings provided by international rating agencies to invite global investments as these ratings are universally recognized and accepted, and, accordingly, any dissociation of international ERPs on account of regulatory framework by SEBI might have negative impact on Indian business houses.

Even though the Consultation Paper reflects that the securities market regulator has sufficient understanding of the flaws in the current rating system and the steps required to rectify such flaws, there is a long way to go before the Indian regulators manage to implement a well-balanced legal regime for ESG ratings and ERPs that not only fulfills the regulatory requirements but also satisfies needs of various stakeholders.

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