

## THE EU ESG RATINGS REGULATION - TEN QUESTIONS

### 1. What is the ESG Ratings Regulation? What is the background, current status and who falls within scope?

The European Union ("EU") has adopted a regulation aimed at enhancing the transparency and integrity of environmental, social and governance ("ESG") rating activities (herein referred to as the "Regulation").

The Regulation was initially proposed in June 2023, a compromise text was published on 14 February 2024 and the European Parliament formally adopted the Regulation on 25 April 2024. The Regulation is set to be published in the Official Journal of the EU shortly and will enter into force on the twentieth day following such publication. The Regulation will then apply 18 months from its entry into force, meaning it is expected to apply from late 2025/early 2026.

The trigger for falling within scope of the Regulation is the provision of an ESG rating by an ESG rating provider operating in the EU (regardless of whether such provider is established inside or outside the EU).

The broad definition of "ESG ratings" could include any sort of ESG scoring system. As such, any fund or asset manager that uses a proprietary methodology to generate ESG scores could fall within the definition of an "ESG rating provider". Certain exemptions (as discussed below under question 5) mean that not all ESG rating providers are subject to substantive obligations.

### 2. What are ESG ratings used for?

ESG ratings provide an opinion on a company's or financial instrument's sustainability profile, by assessing its exposure to sustainability risks. Similar to the role credit ratings play in relation to credit risk, ESG ratings should improve the operation of capital markets and investor trust in sustainable products. The current limitation of ESG ratings is the lack of transparency in the applied methodologies and lack of clarity on what the ratings represent, the consequence being that ratings offered by different providers for different products are difficult to compare.

Reliable ESG ratings, combined with other European regulatory initiatives (for example the Sustainable Finance Disclosure Regulation ("SFDR"), the Corporate

Sustainability Reporting Directive ("CSRD") and the EU Taxonomy Regulation) should, in theory, support the EU's transition goal to a net zero energy system by 2050 by rendering sustainable investments easier to assess, reducing the burden and cost on investors undertaking detailed due diligence and ultimately encouraging investment in sustainable products that have a clear, positive impact.

### 3. What specific requirements are imposed by the Regulation?

ESG rating providers established in the EU need to be authorized by the European Securities and Markets Authority ("ESMA") in order to provide ESG ratings. ESMA will be required to publish a list of ESG ratings providers, including their total market share in the EU, on an annual basis.

Non-EU established ESG rating providers that wish to operate in the EU will need to obtain an endorsement of their ratings by an EU authorised ESG rating provider, a recognition based on a quantitative criterion. Alternatively, they can be included in the EU registry of ESG rating providers based on an equivalence decision in relation to the country of its origin and following a dialogue held between ESMA and the relevant third-country competent authority.

In addition, the Regulation imposes the following requirements on ESG ratings providers:

- **Methodology principles:** to ensure the quality and reliability of ESG ratings, ESG rating providers should use rating methodologies that are rigorous, systematic, independent, continuous, and capable of justification. The methodologies will be reviewed on an on-going basis and at least annually.
- **Transparency:** linked to the above, ESG rating providers will be required to disclose information to the public on the methodologies, models, and key ratings assumptions, including the limitations of the analysis. They should explicitly disclose which dimension of the double materiality principle the rating addresses (i.e. whether the rating addresses both material financial risk to the rated entity and the material impact of the rated entity on the environment and society, or whether

it takes into account only one of these considerations). This will enable users to perform their own due diligence when assessing whether to rely on those ESG ratings.

- **Governance requirements:** ESG ratings providers will have to adhere to certain general organisational requirements, such as implementing internal due diligence policies and procedures, maintaining an oversight function and employing staff that are appropriately trained and have knowledge and expertise to perform their assigned duties etc. ESG ratings providers must also separate the ratings business from certain other activities, which they are prohibited from providing (for example, consulting activities to investors or firms). Some activities are nevertheless allowed, provided specific measures are taken to manage conflicts of interest (i.e. activities of credit institutions, investment services or activities) and in some cases also upon authorisation of ESMA (i.e. developing benchmarks). ESMA will develop regulatory technical standards to specify the measures and safeguards.
- **Separate E, S and G ratings:** separate E, S and G ratings should be provided, rather than a single ESG metric that aggregates E, S and G factors. Where an aggregate ESG rating is issued the provider should disclose the weighting of the three overarching ESG factor categories.
- **Marketing communications:** firms that disclose use of ESG ratings as part of their marketing communications will have to include information on the methodologies used on their websites. This rule applies to both fund managers subject to SFDR that disclose firm-level or product-level ESG ratings and other fund managers not in scope. The website should include the same detailed disclosures as an authorised ESG ratings provider is required to produce in accordance with Section 1 of Annex III of the Regulation. At a high level, this includes:
  - an overview of the rating methodologies used;
  - the industry classification used;
  - an overview of data sources, whether sources are public or non-public and an overview of data processes;
  - the ownership structure of the ESG rating provider;
  - information on whether and how the methodologies are based on scientific evidence;
  - information on the ratings' clearly defined objective, whether the rating is assessing risks, impacts, or both and in the case of double materiality the proportion of the risk and impact materiality;

- the rating's scope – i.e., whether it covers an individual factor (E, S, or G) or whether it is an aggregated rating (aggregating E and S and G factor), or whether it covers specific issues (e.g., transition risks);
- in the case of an aggregated ESG rating, weighting of the three overarching ESG factors categories and the explanation of the weighting method, including weight per individual E, S and G factors;
- within the E, S or G factors, specification of the topics covered by the ESG rating/score, and whether they correspond to the topics from the sustainability reporting standards developed pursuant to the EU Accounting Directive;
- information on whether the rating is expressed in absolute or relative values;
- where applicable, reference to the use of artificial intelligence ("AI") in the data collection or rating/scoring process including information about current limitations or risks of using AI;
- general information on criteria used for establishing fees to clients, specifying the various elements taken into consideration, and general information on the business/payment model;
- any limitation in data sources and methodologies used for the construction of ESG ratings;
- the main risks of conflicts of interest and the steps taken to mitigate them;
- if an ESG rating of a rated item covers the E factor, information on whether that rating takes into account the targets and objectives of the Paris Agreement or any other relevant international agreements;
- if an ESG rating of an entity covers the S and G factors, information on whether that rating takes into account any relevant international agreements; and
- any limitation on the information available to ESG rating providers.

#### 4. What is the Regulation's extra-territorial nexus and how will it impact UK and US clients?

As mentioned above, the trigger for falling within scope of the Regulation is the provision of an ESG rating by an ESG rating provider operating in the EU. The adopted text clarified the concept of "operating in the Union" as including:

- ESG rating providers in the EU that publish ratings on websites or by other means; and
- entities issuing and distributing ratings through

subscription or contractual relationships to regulated financial services firms in the EU and entities within scope of the EU Accounting Directive or EU Transparency Directive.

This clarification should limit the scope of the Regulation by excluding third-country ESG ratings providers that make their ratings publicly available, but do not actively distribute their ESG ratings into the EU.

## 5. What are the exemptions from the scope of the Regulation?

Certain exemptions will apply, including but not limited to:

- private ESG ratings produced pursuant to an individual order, provided exclusively to the person who placed the order, and which are not intended for public disclosure or distribution by subscription or other means;
- ESG ratings that are used exclusively for internal purposes or for providing in-house or intra group financial services or products;
- ESG ratings incorporated in a product or service already regulated under EU law (e.g. under SFDR, AIFMD etc.) and are disclosed to a third party (however, if this disclosure is included in marketing communications, the disclosure obligations set out at section 3 under the heading "marketing communications " above will still apply);
- ESG ratings provided in the context of SFDR disclosures and EU Taxonomy disclosures;
- the publication or distribution of data on environmental, social and human rights, and governance factors;
- products or services that incorporate an element of an ESG rating, including investment research as laid down in MiFID II;
- ESG labelling activities when granted to entities, financial instruments, or products (provided the label does not involve the disclosure of an ESG rating);
- the issuance of an ESG rating by a third-country ESG ratings provider to an EU user on a single use basis and which is subsequently distributed at the own exclusive initiative of the user established in the EU without any prior contact, solicitation, promotion, advertisement, or any other initiative by the ESG ratings provider, or by any third party on behalf of the provider; noting that the third-country ESG ratings provider could be brought back into scope if it:
  - develops a substantial market share in the EU; or
  - has a website in at least one of the official languages of the EU; and

- no substitute is offered by an ESG ratings provider authorised under the Regulation.

## 6. How will the Regulation be enforced?

The Regulation will establish a supervisory regime giving ESMA, as supervisor, the power to request information, conduct investigations and inspections. In case of violations, ESMA will be able to impose administrative sanctions and other measures, including fines and periodic penalty payments.

## 7. Where does the Regulation sit within the framework of the wider ESG regulatory landscape?

The Regulation is one of many measures to implement the European Commission's "Financing Sustainable Growth" action plan of March 2018. It ties in with international efforts aimed at addressing the lack of widely accepted market standards for assessing companies' sustainability performance. In terms of content, the Regulation is largely inspired by existing regulatory regimes (including the EU Credit Rating Agencies Regulation and EU Benchmark-Regulation.) In particular, ESMA has been given a preeminent supervisory role for regulating ESG rating providers in the EU, in line with the role it has for supervising Credit Rating Agencies and Benchmark Administrators.

## 8. Will the Regulation affect other methodologies and scores used by asset managers?

As above, the broad definition of ESG ratings could include any sort of ESG scoring system, subject to the applicable exemptions.

## 9. Is there a UK equivalent to the Regulation?

On March 6th 2024, the UK government confirmed that ESG ratings providers will be brought into the regulatory perimeter of the UK's Financial Conduct Authority. A consultation paper on the scope of such a regime (with proposals broadly similar to the Regulation) opened on 30 March 2023 and closed on 30 June 2023. A full consultation response and legislative steps have not yet been published but are expected later this year.

## 10. Next Steps

See question 1 on implementation timing. Firms should consider whether they fall within scope of the Regulation in order to ensure compliance ahead of its entry into force.

## For More Information

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