भारतीय प्रतिभूति और विनिमय बोर्ड
Securities and Exchange Board of India

CONSULTATION PAPER ON

Environmental, Social and Governance (ESG) Rating Providers for Securities Markets

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1. Background of this Consultation

1.1. In recent years, climate change concerns and sustainable development have taken centre stage in global and national priorities. There has been a growing recognition of the significant financial and economic impacts of environmental, social and governance (ESG) risks across the globe, with many international bodies and financial regulators examining ESG-related issues including regulation and supervision.

1.2. The COVID-19 pandemic and unexpected climate changes around the world continue to demonstrate the fragility of traditional business approaches and highlight the importance of organizational resiliency. Investors are more aware of the financial implications of sustainability related risks and opportunities and factors the same in their investment decisions. This has led to increased investor interest and demand for ESG reporting, ESG ratings and ESG related products. Therefore, there is pressure on companies to focus on integrating ESG in their business practices and there is an increasing expectation that companies would transition towards environmentally, socially and economically sustainable business activities.

1.3. As regard, ESG related reporting by companies, various regulators and international bodies have been working on standardization of sustainability-related disclosures by listed entities. SEBI has issued a revised set of sustainability and social related reporting requirements (Business Responsibility and Sustainability Report (BRSR[1])) which shall replace the Business Responsibility Report (BRR). The filing of BRSR is mandatory from the financial year 2022-23, for the top 1000 listed companies by market capitalization. Other companies can also opt to disclose BRSR on voluntary basis.

1.4. The increasing legislative and regulatory focus on ESG is expected to expand the ESG related services industry world-wide. There is also an

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[1] SEBI circular numbered SEBI/HO/CFD/CMD-2/P/CIR/2021/562 dated May 10, 2021

increasing demand from the investors on evaluation and rating of ESG related parameters by ESG ratings providers (ERPs).

1.5. <u>The COP 26 mandate</u>: In the 2021 United Nations Climate Change Conference, more commonly referred to as COP26, held in Glasgow, Scotland, 197 Countries, including India, have made enhanced commitments towards mitigating climate change and promising more climate finance for developing countries to adapt to climate impacts. This means that sustainable finance will be the mainstay of world business, which in turn, will mean demand for more ESG products and consequently, ESG ratings demand in securities markets.

1.6. However, since the activities of ESG ratings providers(ERPs) are typically not subject to regulatory oversight at present, increasing reliance on such unregulated ESG rating providers in securities markets raises concerns about the potential risks it poses to investor protection, the transparency and efficiency of markets, risk pricing, and capital allocation, among others. Moreover, a lack of transparency in this area gives rise to the risk of greenwashing and misallocation of assets which could lead to infirmity in such ESG rating and a consequent lack of trust thereof. Therefore, there arises an imperative need, more than ever before, to ensure that the providers of such products operate in a transparent and regulated environment that balances the needs of all stakeholders.

1.7. In this context, SEBI, through this consultation paper, is seeking public comments on a proposed regulatory framework to regulate ERP and oversight there on, periodicity of such disclosure etc.

This consultation paper follows a series of discussions held with multiple stakeholders, including global and national ERPs, CRAs, mutual funds offering ESG schemes, and research/ audit firms.

2. **Need for regulation of ESG Ratings and other related products ecosystem in the securities market**

2.1. During discussion with various stakeholders, it is observed that most ERPs on an average rate hundreds of publicly listed companies based on public information on subscription basis. Primarily users of such ratings and research products are asset management companies and institutional investors in the securities market. The following issues are observed with the current ESG Ratings and other related products ecosystem:

2.1.1. Ambiguity about the wide range of products offered: A wide variety of ESG Ratings and other related products are offered to address the different needs of investors and companies. However, it is observed that there is lack of clear terminologies, definitions and objectives of the products due to non-disclosure or inadequate disclosure. The presence of large numbers of products in the ESG space also compounds the problem.

2.1.2. Inconsistency in disclosures and transparency of the methodology and rating process: In the absence of a regulatory framework around ERPs, there appear to be risks around transparency, verifiability and level playing field. Further, ESG ratings products offered by different ERPs may have same objective and definition, whereas, the underlying methodologies used may vary substantially across ERPs without adequate disclosures regarding the same, causing problems in interpretability of ratings.

2.1.3. Unregulated nature of market and potential conflict of interests: Given the unregulated nature of ESG Ratings and ERPs being in unregulated space globally, currently many ERPs provide services other than in ESG space, such as index solutions, advisory services related to ESG etc. which may cause potential conflict of interests. Further, due to lack of transparency around the manner of usage of ratings by investors as well as types of ESG ratings products of different ERPs, there is a risk of misallocation and greenwashing.

2.1.4. Lack of India specific ERPs: ERPs are in nascent stage world-over and insofar as India is concerned, it is learnt that large institutional investors primarily rely on in-house research. They supplement their due diligence with ESG rating or data products offered generally by global and unregulated providers of ESG ratings or data. Foreign ERPs provide ESG Rating only for companies which are typically included in an Index.

Indian companies are typically benchmarked to global and regional benchmarks with respect to ESG Rating and there is no differentiation in the performance of issuers within the domestic space. Therefore, a need has been felt not only by users of ESG Ratings (typically mutual funds, alternative investment funds etc.) but also by corporates and index providers (focussed on constructing Index in Indian Market) for a proper rating framework.

2.2. The International Organization of Securities Commissions (IOSCO)'s Sustainable Task Force's Working Stream, in its final report[2] published on November 23,2021 on 'ESG Ratings and Data Product Providers' (hereinafter referred to as the "IOSCO Report") has opined that while the market of ERPs does not typically fall within the remit of securities regulators, **regulators could consider focusing greater attention on the use of ESG ratings and other related products and activities of ERPs in their jurisdictions.** This could help to increase trust in ESG ratings going forward.

2.3. The IOSCO report further points out that 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. 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.

2.4. Thus, in line with this global thinking, it is felt that regulation of ERPs covering, inter-alia, the disclosure of rating methodologies for carrying out ESG ratings and other procedures followed may help in improving the reliability, comparability and interpretability of the ESG Ratings and other related products.

3. **Scope of Regulation/accreditation of ERPs**

3.1. **Global landscape of ERPs**: The IOSCO report identifies that the global market is concentrated around a small number of providers with global presence along-with a larger number of providers with a more regional focus. The landscape has also seen consolidations by larger and more established players. The IOSCO report states that the ERPs are diverse and range from data providers, analytical and evaluative service providers to credit rating agencies.

3.2. **Regulation of ERPs**: While the IOSCO report has called for regulation of ERPs, the manner of regulation has not been clearly spelt out. Further, various regulators have done public consultations over the form and manner of regulatory framework primarily focusing on:

[2] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf

- Registration and Supervision [3]; or
- Guidance to firms on use of third-party ESG Data and Ratings or Best Practice Code for ESG data and rating providers or Regulation of ESG data and rating providers[4]; or
- Authorisation and supervision of providers of ESG data, analysis and services[5].

3.2.1. ESMA has opined that a legal entity whose occupation includes the issuing of these ESG ratings and assessments should be required to be registered and supervised by a public authority. This would ensure that these gatekeepers of ESG ratings and assessments are subject to a common core of organisational, conflict of interest and transparency requirement.

However, ESMA in its letter to European Commission has highlighted that estimating the number of firms in the market for ESG ratings is challenging and the industry is experiencing significant consolidation. It stated that any actions in this area need to be carefully calibrated to capture the broad spectrum of existing product offerings, while at the same time ensuring that future innovations do not fall out of scope. Likewise, any regulatory action needs to be proportionate to accommodate both large multi-national providers which may be subject to existing regulatory frameworks, as well as those smaller entities that have no such experience of regulatory compliance but have a valuable role to play in the further development of this industry.

3.2.2. SEC Thailand [6] has opined that a balanced regulatory ecosystem that prevents greenwashing and yet supports sufficient innovations from providers that allow growth and more competitive market, financial support from the regulator to local service provider should be considered. Further, World Business Council[7] has raised questions on whether regulation will effectively resolve market challenges and whether Regulators can effectively regulate ESG ratings providers. A number of public commentators on the IOSCO report have represented for industry led standards and codes of conduct.

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[3] https://www.esma.europa.eu/sites/default/files/library/esma30-379-423_esma_letter_to_ec_on_esg_ratings.pdf

[4] https://www.fca.org.uk/publication/consultation/cp21-18.pdf

[5] https://www.amf-france.org/sites/default/files/private/2020-12/amf-afm-position-paper-call-for-a-european-regulation-for-providers-of-esg-data-ratings-and-related-services.pdf

[6] https://www.iosco.org/library/pubdocs/690/pdf/SEC%20Thailand.pdf

[7] https://www.iosco.org/library/pubdocs/690/pdf/World%20Business%20Council%20for%20Sustainable%20Development.pdf

3.3. The IOSCO Report concludes that the norms on Regulation of ERPs, if at all, may be broad and principle-based, where a Regulator may not generally assess the appropriateness of the ESG-rating assigned by the ERPs. However, Regulators may mandate certain measures related to governance, transparency, prevention of conflict of interest, and due diligence to be conducted by ERPs during the ESG-rating process.

3.4. **Indian landscape**: In India, the major ERPs may be broadly clubbed into the following categories:

- Global entities viz. foreign ESG rating providers
- Domestic ESG rating providers, including subsidiaries / parent entities of credit rating agencies, research analyst firms etc.

3.5. **Proposed scope of regulation/accreditation**

3.5.1. Given the above, it is felt that any regulatory framework designed for ERPs **for Securities Market** needs to be balanced i.e., goal of regulatory supervision should be designed in such a manner to enable the ESG Rating Provider to respond to new developments in this space including new products without being too prescriptive. Any framework also needs to give a level playing field to domestic unregulated entities offering ESG Rating as well as allowing well established players. To achieve these twin objectives, **SEBI proposes to accredit ERPs for the purpose of assigning ESG ratings to listed entities and listed securities.**

3.5.2. The proposed scope of accreditation of ERPs is as follows:

a. A listed entity who intends to avail an ESG rating, shall obtain the same from only a SEBI Accredited ERP.

Further, if entities other than the top 1,000 listed by market capitalisation wish to avail services of SEBI accredited ERPs, such entities shall make public disclosures in line with those prescribed in BRSR on mandatory basis prior to engaging with SEBI accredited ERPs. Such ERPs shall provide ESG Rating, subject to disclosures related to BRSR being available in the public domain. Further once a listed entity makes such BRSR disclosures, it shall continue making such disclosures to avoid information asymmetry.

b. SEBI-registered entities engaged in fund-based investment activities such as mutual funds or alternative investment funds, desirous of using third-party ESG ratings as part of their decision-making process for investing in Indian securities, shall avail services of SEBI-accredited ERPs. Further, any passive funds launched by these entities shall be based on ESG related indices which use ratings of SEBI-accredited ERPs only.

c. Further, to ensure uniformity, where an index-provider uses ESG ratings for formulation of index/indices on Indian securities, it shall use services of only SEBI-accredited ERPs for formulation of such index.

3.6. **Views/ comments sought on:**

a) *Whether there is a need to regulate/accredit ERPs in securities market?*

b) If ESG ratings are to be regulated, is the regulatory scope mentioned above adequate? If not, please suggest requisite modifications.

4. **Entity eligible to be accredited as ERP**

4.1. Each intermediary registered with SEBI undertakes a distinct activity and has specific requirements relating to skill set according to the activity it performs. While accrediting ERPs, regulatory comfort would lie with a set of established intermediaries who are already performing similar functions as ESG Ratings, even though certain skill sets could be slightly different. The following regulated entities may be considered as eligible entities for being accredited as ERPs for reasons given herein under:

4.1.1. **Credit Rating Agencies (CRAs)**: It has been contended in various papers that ESG ratings are very qualitative in nature and subject to diverse interpretation. However, ESMA, in a letter dated January 28, 2021, to the European Commission[8], had noted that ESMA's proposals for ESG ratings and assessments have largely been inspired by the requirements under ESMA's CRA Regulation, as there are clear parallels between the process of ESG and CRA rating providers and the objective pursued by that Regulation.

Globally, even though CRAs have a minor share in ESG ratings, they are not barred from offering this product. Currently, CRAs in the US, EU and Japan are providing ESG ratings. CRAs have been sharpening skills for

[8] https://www.esma.europa.eu/sites/default/files/library/esma30-379-423_esma_letter_to_ec_on_esg_ratings.pdf

assigning ESG ratings through acquisitions of established players. CRAs follow a well-defined process that ensures committee-based transparent evaluation, making them appropriate entities to be accredited as ERPs.

4.1.2. **Research Analysts (RAs)**: Existing ERPs provide ESG ratings based on publicly available disclosures, like filings, annual reports, sustainability reports etc. Further these ERPs collect thousands of data points and track several news and media sources daily. Thus, assignment of ERP rating is also an intensive data analysis (quantitative) exercise which is in line with the current activity carried out by Research Analyst(s), albeit on varying scales. Most of these ERPs also carry out consistent monitoring in addition to yearly reviews. It is felt that ERPs provide analytical or evaluative services which are akin to the services provided by RAs.

4.2. **Proposed eligible entities:** In view of above, SEBI-registered Credit Rating Agencies and SEBI-registered Research Analysts are proposed to be considered eligible to be accredited by SEBI as ERPs, subject to fulfilment of accreditation criteria.

4.3. **Views/ comments sought on**:

a) *Should only CRAs and RAs be considered to accredit as ERPs?*

b) *Could any additional category of entities be specified as an entity eligible for accreditation as an ERPs along-with rational for the same?*

5. **Conditions for accreditation:**

5.1. While designing any regulatory framework around regulation/accreditation of ERP, it is felt that accreditation criteria should be a combination of various factors viz. an ERP should have adequate infrastructure to provide such ESG ratings which would indicate its seriousness of intent in setting up the business and also inspire confidence. Given that investing entity would be relying on ERPs to make investment decisions, and to ensure continuity and provide reassurance to investors that the entity is fully equipped to meet the requirements of growth in operations, it is felt that ERPs need to be adequately capitalized in addition to other infrastructure requirements.

5.2. **Net worth**: It is felt that the minimum net worth should be prescribed in such a manner that it is not so prohibitively high that it would deter serious players or be anti-competitive. However, it is desirable to have a minimum net worth which would ensure capital adequacy commensurate with the required scale of operations and infrastructure and future growth projections.

ESG ratings require skilled manpower and adequate infrastructure to conduct necessary due diligence for assigning and reviewing ESG ratings. Hence, a SEBI-accredited ERP needs to be adequately capitalized. Therefore, it is proposed that CRAs/RAs with a minimum net worth of Rs. **10 crores**, as per the latest audited financial statements, may be eligible to apply to be a SEBI-accredited ERP. This net worth requirement would be in addition to the applicable minimum net worth requirement for the entity as CRA/RA.

5.3. **Infrastructure**: The IOSCO Standard for Market Intermediaries require that intermediaries should comply with standards for internal organisation and operational conduct that aim to protect the interest of clients, ensure proper management of risk and under which management of the intermediary accepts primary responsibility for these matters.

ESG Rating is a knowledge driven exercise wherein each ERP shall have infrastructure and technical know-how to undertake ESG rating mandates.

Therefore, it is proposed that an ERP must have adequate infrastructure to undertake necessary due diligence for assigning ESG ratings to listed entities in accordance with the provisions of SEBI Act, 1992 and regulations made thereunder. This shall include, but not be limited to, appropriate database collection and management systems, and analysis/ filtering tools (either in-house or outsourced).

5.4. **Manpower**: Since ESG Rating is a knowledge and technical know-how driven exercise, certain minimum standards would be required to be specified in relation to manpower employed by ERPs, especially employees performing "core" functions which would be crucial to manage ERPs and carry out its operations in an appropriate manner. Therefore, it is proposed that ERPs shall have at least one specialist each in the following areas on a continuous basis:

i. data analytics,
ii. sustainability,
iii. finance
iv. information technology, and
v. law

5.5. **Other criteria**: It is proposed that the applicant should be a 'fit and proper person' as stated in Schedule II of SEBI (Intermediaries) Regulations, 2008.

5.6. The accreditation shall be granted subject to review by SEBI every two years. However, the accreditation may be revoked at any time in case of material non-compliances by ERPs or in case of non-maintenance of the minimum net worth.

5.7. **Views/ comments sought on**:

a) *Whether the above accreditation criteria, including net worth, are appropriate?*

b) *Please offer comments on whether any additional conditions/requirements need to be specified, if any?*

6. **ESG Rating Products under purview of proposed SEBI's Accreditation Framework:**

6.1. ERPs currently operate in an unregulated environment. There is no standardized or regulatory-prescribed definition of what an ESG rating is, or what an ESG rating measure means. The IOSCO report states that a wide variety of ESG ratings and data products have emerged in response to investor needs. Further, the ecosystem of products offered in the ESG space is constantly evolving as per the emerging areas of interest of investors and corporates.

6.2. It is noted that the type of products offered, the objective of the product, and the methodologies vary significantly across ERPs and are denoted by different terminologies. However, the most common type of ESG Ratings and related research products currently provided by the ERP (s) are summarised as under:

6.2.1. **ESG "Risk" Ratings:** It is an assessment of a company's resilience to ESG related risks. This product assesses impact of social or environmental issues on the company's enterprise value. It does not take into account the company's impact on the environment or the society.

6.2.2. **ESG "Impact" Ratings**: It is an assessment of the positive and negative impact of companies on the environment and society, along with an assessment of their corporate governance profiles. Such ratings would, therefore, incorporate factors such as greenhouse gas emissions by a company, or its corporate social responsibilities measures, etc.

irrespective of the fact whether such factors have any impact on the company's enterprise value or not.

6.2.3. **Other ratings/benchmarking related products:** Apart from full-fledged products offering which covers the entire environmental, social and governance aspects of a company, ERPs also provide a wide range of products focussing on individual components or key issues. Some of the products are carbon risk rating, ESG disclosure ratings, corporate transition risk scores etc.

6.2.4. Apart from different types of ESG ratings, ERPs also provide research related products which may not necessarily include ranking or benchmarking but provide useful information on the ESG aspects of companies, industry etc, like screening tools, controversy alerts, ESG Index solutions, corporate governance research tools etc.

6.3. Given the context of urgency of action on climate and sustainability-related matters, ESG impact ratings are being provided by ERPs which are defined in terms of opinions on impact of companies' externalities on environment and society rather than measuring the impact of exposure to ESG risks on the company's finances. However, it may be noted that ESG impact ratings are not the mainstream ESG rating product currently offered by most providers. It has also been indicated that there may be difficulty in assigning a rating to environmental or social impact by a company, especially since such impact may be harder to calculate and integrate in investment analysis given that it may not have bearing on the company's financial performance; in many cases it could also be subjective.

6.4. Recently, institutional investors have become signatories to 'impact principles' with an aim to invest into companies and organizations with the intent to contribute to measurable positive social or environmental impact alongside financial returns. Certain institutional investors have adopted goals such as net zero carbon emissions of their investment portfolios by 2050. Hence, ESG impact ratings may provide useful insights to such investors who want to align their investment decisions with their environmental and societal goals.

6.5. While government organizations, institutional investors and non-governmental organizations may find ESG impact ratings more useful from perspective of sustainable development, ESG 'Risk' ratings have an important role to play among corporates for managing their financial risks more efficiently and prudently. It may be noted that the main users of ESG

'Risk' ratings are institutional investors managing clients' money (mutual funds, alternative investment funds, etc.) in a fiduciary capacity Similarly, other products viz. ESG fund ratings, carbon risk ratings etc. are used by investors and asset managers.

6.6. **Proposal on ESG Rating products to fall under SEBI accreditation framework**

6.6.1. As illustrated above, the aforementioned products have different objectives and cater to different set of stakeholders. However, it is observed that ESG Impact Rating and ESG Risk Ratings are marketed as ESG Ratings.

As there is a need to ensure clear and consistent use of terminology in ESG ratings, it is proposed that ESG rating products may be referred to as 'ESG Corporate Risk Ratings' or 'ESG Financial Risk Ratings', so as to distinguish them from ESG impact ratings. As regards other incidental products, it is proposed that ERPs shall specifically mention the domain to which the product is related. E.g. Carbon risk ratings shall not be referred as ESG ratings as the products assess the environmental aspect only.

6.6.2. As it is considered necessary that the framework for accreditation of ERPs, should provide flexibility to ERPs to offer any of ESG products, it is proposed that ERPs intending to get accredited with SEBI shall offer at least one of the following ratings products:

a) ESG Impact Ratings
b) ESG Corporate Risk Ratings or ESG Financial Risk Ratings
c) Any other ESG related rating products, which may be appropriately labelled.

In order to avoid any confusion among stakeholders, it is proposed that ERPs should always use proper terminologies for the products offered by them.

6.7. **Views/ comments sought on**:

a) *Whether the above proposal on classification of ESG ratings and other related products is appropriate?*

7. **Standardization of Symbols and Scales for ESG Ratings**:

7.1. As seen above, given the myriad products that may be offered under the umbrella of ESG rating either in form of ESG Scores, rating symbols etc, it may be challenging, at this stage, to formulate a standardized rating scale for a market that is so varied, dynamic and evolving.

7.2. A parallel may be drawn to credit rating agencies in India, for which SEBI regulations were put in place in 1999, but the rating symbols and their definitions were standardized only in 2011. A similar approach may be sensible for ESG rating scales, given the dynamics of the industry. Thus, it is proposed that, to begin with, SEBI may not standardize rating scales (i.e., rating/ scoring symbols and their definitions) at this stage.

7.3. However, the ERP shall prominently disclose on its website and in the ESG rating reports, the rating scale (symbols and their definitions) used by the ERP. Additionally, an ERP shall ensure consistency in the application of its ESG rating scale.

7.4. Where a CRA is also acting as an ERP, it shall ensure that the rating scale is such that it does not create any confusion among the general public between the CRA's assigned credit ratings and its ESG ratings. Similarly, where a research analyst is also a SEBI-accredited ERP, it shall ensure that it does not create any confusion among the general public between its ESG ratings and other offerings.

7.5. **Views/ comments sought on**:

a) Whether the proposal on not having standardized ESG rating scales (i.e., standardized symbols and their definitions) initially is appropriate?

8. **Transparency:**

8.1. An ERP shall prominently display on its website and in ESG rating reports the type of ESG rating product (whether impact-based, or risk-based, or otherwise).

8.2. An ERP shall disclose its rating methodology for all its products on their websites, while maintaining a balance with respect to proprietary or confidential aspects of the methodologies.

8.3. ERP shall disclose sectoral classification standard it is following, and other relevant disclosures up to at least two levels of sector classification.

8.4. The ESG rating methodology of an ERP shall include whether and how it defines the individual components, Environmental, Social, Governance of "ESG", including the specific issues being assessed, the Key Performance Indicators (KPIs) used weightage of each KPI and how to deal with incomplete and unreliable data inputs.

8.5. ERP shall publish on an annual basis, an evaluation of their ESG-rating methodologies against the outputs which they have been used to produce.

8.6. Any in rating methodology shall be disclosed and archives of earlier rating methodologies shall be maintained and disclosed on the website by the ERP.

8.7. The data and information sources that the ERP relies on, such as BRSR, shall be publicly disclosed, including the use of industry averages, estimations or other methodologies when actual data is not available or not publicly disclosed.

8.8. While an ERP shall necessarily disclose high level ESG rating on their websites for public access, a detailed ESG-rating report may be made available on a subscription-basis, which shall have detailed analysis of rating arrived at, specific KPIs used methodology applied for the rating and shall provide a reference/ hyperlink to the methodology placed on website.

8.9. An ESG rating may be provided at a sector-agnostic level, to facilitate comparison of ESG ratings of one company from other companies within the same industry as well as companies operating in other industries.

8.10. Where an index-provider is using ESG ratings in formulation of its index/indices, it shall cross reference the ESG rating methodology.

8.11. An ERP shall prominently display on its website and rating reports that ESG rating is not a recommendation to buy, sell or hold any security or financial instrument.

9. ESG Rating Process

9.1. An ERP shall follow a proper rating process and ensure consistency in application of its methodology for the same product (as publicly disclosed) across ESG ratings assigned by it.

9.2. An ERP shall have a reasonable and adequate basis for performing rating evaluations, with the support of appropriate and in-depth rating research. It shall also maintain records to support its decisions.

9.3. An ERP shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.

9.4. Every ERP shall be staffed by analysts qualified to carry out a rating assignment.

9.5. Every ERP shall have professional rating committees, comprising members who are adequately qualified and knowledgeable to assign a rating.

9.6. All ESG rating decisions, including the decisions regarding changes in rating, shall be taken by the rating committee.

9.7. Every ERP shall inform the Board about new rating product/instrument or symbols introduced by it.

9.8. The ERP shall have written policies, procedures and/or internal controls designed to ensure the processes and methodologies are rigorous, systematic, and applied consistently. Further, rating methodologies shall be reviewed and updated periodically.

9.9. An ERP shall have efficient systems to keep track of material ESG related developments so as to ensure timely and accurate ratings.

9.10. An ESG rating shall be subject to continuous surveillance by an ERP (except if it is a one-time rating) and shall be promptly reviewed after any ESG-material event, such as any controversy or publication of the BRSR.

9.11. An ERP shall formulate an Operations Manual/ Internal governing document, which shall inter-alia, cover operating guidelines, criteria, policies and procedures related to the ESG rating process.

9.12. The contents of the Operations Manual/ Internal governing document, as well as any changes to the same, shall be communicated to employees promptly, and training of employees on the same shall be conducted at regular intervals.

9.13. The following shall be specified in the Operations Manual/ Internal document governing ERP:

a) Detailed ESG rating process

b) Basic Minimum information required for conducting the Rating Exercise
c) Questionnaires / Communication with the rated entity
d) Policy regarding internal approvals and timelines at each step of the Rating Exercise
e) Policy regarding monitoring and review of ratings, including the timelines within which such review is to be completed

10. **Governance and prevention of conflict of Interest:**

10.1. Each ERP shall formulate detailed policy on managing conflict of interest. Such policy shall be prominently disclosed on its website.

10.2. An ERP shall not provide ESG ratings to its related entities or securities issued by them or the ERP.

10.3. The corporate governance organisational and operational structures of the ERP shall be sufficient to identify, manage and mitigate any potential conflicts of interest.

10.4. An ERP shall ensure that the personnel in the activity of ESG ratings are separate from those involved in other activities of the ERP.

10.5. An ERP shall take steps to help ensure the ESG ratings would not be affected by the existence of or potential for a business relationship between the ERP (or their affiliates) and any entity or any other party for which it provides ESG ratings.

10.6. An ERP shall structure reporting lines for their staff and their compensation arrangements to eliminate or appropriately manage actual and potential conflicts of interest related to their ESG ratings.

10.7. An ERP shall identify, disclose and, to the extent possible, mitigate potential conflict of interest that may arise between ESG Rating offering and other relationship with the covered entities such as ESG consulting etc.

10.8. The analysts involved in ESG rating assessments shall disclose any conflicts of interest involving a company / issuer to the ERP and shall not be allowed to rate such companies.

10.9. **Views/ comments sought on section 8, 9 & 10**:

a) *Whether the proposed norms relating to transparency, governance and conflict-of-interest issues in the ESG rating process are appropriate?*

b) *Whether ERPs should be free to assign ESG ratings on a sector-specific or sector-agnostic basis, subject to adequate disclosures on the same?*

11. **Business Model**:

11.1. Any discussion on proposed regulatory framework for regulating ERP must take into account existing business model which is 'subscriber pay' since there is no regulatory mandate to avail ESG ratings. This is in contrast to credit ratings, wherein since a rating is prerequisite for issuance and listing of a debenture (before investors are known) and therefore, 'issuer-pay' model is the dominant business model.

11.2. Thus, for establishing a regulatory framework for regulating ERP, a business model needs to be clearly established since that determines the disclosures and transparency requirements.

11.3. While the 'issuer pay' model ensures widespread availability of ratings to all investors at no monetary cost to the investors, there are inherent conflict of interest issues since ERP derives revenue from issuer and, may, therefore be inclined towards assigning and maintaining higher ESG ratings. On the other hand, quality of ratings may be higher since issuer is contractually bound to provide the ERP access to information and there are regular management interactions, though the same may also lead to greater reliance on issuer's management.

11.4. On the other side in 'subscriber pay' model, while ratings may be publicly available to all, the detailed rating rationale and report detailing as to why a listed entity was assigned the said ESG rating may be accessible only to those who pay for it. At the same time, since revenue may not necessarily come from the issuer, this model has lesse potential issues on the conflict of interest in comparison to 'issuer-pay' model. This model may also ensure greater responsiveness to investor concerns and furtherance of investor protection agenda. An investor paying for a specific rating could demand customised analysis, attuned to their goals/organizational requirements, from the ERP. However, it may also put smaller investors at a disadvantage, as their ability to subscribe to multiple product packages will likely be constrained by financial cost.

Further, since there is no contractual agreement between the ERPs and the issuer, unlike in a 'issuer-pay' model, an issuer may not be contractually bound to provide information to the ERPs. This may lead to data gaps due to inadequate information or clarification about the issuer's ESG credentials. In this context, the ERP may have to resort to sending questionnaires to the issuer, who may choose to prioritize responding to the ERP that may be likely to provide a higher ESG rating to the issuer, essentially engaging in 'rating shopping'.

11.5. However, while there may be merit to the issue of 'data gaps in 'subscriber-pay' model, it may be noted that the issues of data gaps may be plugged to some extent by extension of sustainability-related disclosures by issuers and standardization of practices around ERPs sending questionnaires to the issuer during the rating process, as also recommended by the IOSCO.

11.6. Finally, as there are no mandates around ESG Rating unlike credit rating, the business model for ERPs seems to be tilted towards subscriber pay model.

11.7. Globally, it is seen that 'subscriber-pay' is the predominant business model followed by most ERPs.

11.8. **Proposal on Business Model:** In view of the above, it is proposed that ERPs may be mandated to follow a 'subscriber-pay' business model. It may be noted that while investors may be the primary source of revenue in a 'subscriber-pay' model, a subscriber may include an issuer as well.

11.9. **Views/ comments sought on**:

a) *Whether you agree with the recommendation that the payment model should be subscriber pay in the current Indian context?*

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भारतीय प्रतिभूति और विनिमय बोर्ड
Securities and Exchange Board of India

Public Comments on this Consultation Paper

1. Considering the implications of the said matter on the market participants, public comments are invited on the proposal. The comments/ suggestions may be provided as per the format given below:

Name of the person/entity proposing comments:				
Name of the organization (if applicable):				
Contact details:				
Category: whether market intermediary/ participant (mention type/ category) or public (investor, academician etc.)				
Sr. No.	Extract from Consultation Paper	Issues (with page/para nos., if applicable)	Proposals/ Suggestions	Rationale

2. Kindly mention the subject of the communication as, ***"Comments on Consultation Paper on ESG Rating Providers"***.

3. Comments as per aforesaid format may be sent to the following, latest by March 10,2022, in any of the following manner:

    a. Preferably by email to: richag@sebi.gov.in ; rohan@sebi.gov.in ; and mneeraj@sebi.gov.in; or

    b. By post to:

    Richa Agarwal,
    General Manager,
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    Securities and Exchange Board of India,
    SEBI Bhavan, C4-A, G-Block,
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(End of Consultation Paper)