SEBI REFORM ON ESG RATING PROVIDERS

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Abstract

Recently, after public consultation, SEBI introduced a framework on providers of rating on Environmental, Social and Governance (ESG) parameters. This article attempts to explain the SEBI reforms pertaining to ESG ratings.

What are ESG ratings?

ESG ratings are grading a company's performance on environmental, social, and governance (ESG) parameters on the basis of some standards. They include what a company has been doping to take care of ESG relates issues as well as its focus on risks relating to ESG. The past few years have seen many ESG rating providers mushrooming around the world as well as ESG ratings being accorded to companies. Since these ratings have become important to stakeholders including investors, companies have begun to solicit ESG ratings.

ESG ratings play an important role in reporting and compliance by companies. While there is no uniformity on policies, procedures, and standards to reduce conflicts of interest and increase confidence in the quality of ESG ratings, SEBI is perhaps the first regulator in the world to attempt reform in this space.

Issues with ESG ratings:

The following are the concerns as regards ESG ratings internationally:

- Rating agencies use their own system to rate companies which comprise of own, unique metrics, methodologies and terminologies
- Most of the ESG ratings rely on reporting of information from companies for rating
- Significant topics like labour issues, supply chain related matters are not considered in ESG ratings by rating agencies
- There is no uniformity as regards what is *"Green"* and it differs from agency to agency
- Disclosures tend to vary; not standardized for comparison
- The system is opaque, jargon filled and incomprehensible at times – few agencies have their methodology made transparent on their websites
- Rating upgrades can be managed just by tweaks technically without any real change on the ground.

A couple of international examples:

Bloomberg.com, published a pertinent investigative article, *'The ESG Mirage'*[1] on the state of ESG ratings in America today. The article highlights the dichotomous nature of ESG ratings in America today. For example, in the case of one company, the rating agency designed that the ESG rating in such a way that carbon emissions as a factor in the rating was removed – thus, the revised score was greater since packaging material and waste were given credit, thus boosting the ESG score. In another case, the water stress score did not take into account company's impact on water supplies, but whether communities have enough water to sustain their factories, thus giving a higher rating and thus misleading the investors. In fact, all the pitfalls that have been highlighted earlier in this article are seen to be universally prevalent in ESG ratings.

SEBI reform on and ESG ratings

SEBI consulted on ESG ratings twice – once in January 2022 and again in February 2023. The first consultation paper came in the backdrop of SEBI's revised set of sustainability and social related reporting requirements (Business Responsibility and Sustainability Report (BRSR)) which replaced the Business Responsibility Report (BRR) - the filing of BRSR was made mandatory from the financial year 2022-23, for the top 1000 listed companies by market capitalization. SEBI in its consultation paper[2] stated that:

"…..*since the activities of ESG ratings providers(ERPs)*

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[1] *https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/*

[2] *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*

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….."

The SEBI consultation paper of January 2022, *inter-alia,* sought comments on the eligibility of entities to be ESG Rating Providers (ERPs) to provide ESG ratings stated that:

- *Opportunities for streamlining abound as far as ESG ratings are concerned;*
- *The need for confidence and expanding the scope of disclosures beyond the stand-alone listed entity are critical requirements in this field of ESG disclosures;*
- *ESG Rating providers must consider the local/ domestic context when assigning ESG ratings;*
- *ESG Investing must ensure the robustness of disclosures and take measures to mitigate the potential risk of green-washing and mis-selling.*

SEBI, in May 2022 had constituted an ESG Advisory Committee to recommend regulatory framework for ESG disclosures, ratings and investing. The Committee gave its recommendations on the following areas:

- ESG disclosures
- ESG ratings and
- ESG investing.

Based on the recommendations of the EAC and other internal deliberations, on 20 February 2023, SEBI issued a 'Consultation Paper on ESG disclosures, ratings and investing. The February 2023 consultation paper of SEBI was exclusively focused on ESG Rating providers[3].

SEBI is of the view *that environmental, social and corporate governance issues –including risk and opportunities –can affect the long-term performance of companies and therefore should be given appropriate consideration in investment decisions."* In the consultation paper, SEBI attempted to follow a *principles-based* approach, while balancing SEBI's mandate of protection of interest of investors in the securities market, given the nascent stage of ESG rating regulation. Further, SEBI was of the view that the regulations on ERPs were necessitated in order to enhance transparency in ESG ratings and mitigate conflict of interests in ERPs.

[3] *https://www.sebi.gov.in/reports-and-statistics/reports/feb-2023/consultation-paper-on-regulatory-framework-for-esg-rating-providers-erps-in-securities-market_68337.html*

SEBI also stated in its consultation paper, stated that different jurisdictions have different NDCs (Nationally Determined Contributions) and have adopted varied transition paths and have diverse operational realities, sustainability related risks, opportunities and impact may vary across geographies.

For example, in its NDCs, India has pledged to:

- *Improve the emissions intensity of its GDP by 33 to 35 per cent by 2030 below 2005 levels.*
- *Increase the share of non-fossil fuels-based electricity to 40 per cent by 2030.*
- *Agreed to enhance its forest cover which will absorb 2.5 to 3 billion tonnes of carbon dioxide (CO_2, the main gas responsible for global warming) by 2030.*

In its February 2023 consultation paper, SEBI was also of the view that:

- *"there is a need for ESG Rating providers to factor in the local / domestic context while assigning ESG ratings;*
- *in the area of ESG Investing, there is a need to ensure robustness of disclosures and undertake measures to mitigate the potential risk of green-washing and mis-selling."*

After the consultation, SEBI has in July 2023, brought about reforms on ESG ratings[4]. SEBI's initiative is perhaps the of the first globally and concentrates on many issues relating to ESG ratings, including rating providers. To facilitate a balanced approach to ESG and considering that Emerging Markets have a different set of environmental & social challenges, SEBI has stated that:

- ESG Rating Providers (ERPs) shall be required to consider India / Emerging Market parameters while issuing ESG Ratings.
- There would be no constraints on their issuing other / additional ratings as required by their clients.
- In order to facilitate the credibility of ESG Ratings, ERPs shall offer a separate category of ESG Rating called as '*Core ESG Rating*', which shall be based on the assured parameters under BRSR Core.

Salient features of the SEBI stipulations on ESG Rating providers:

Applicability of the requirements for ESG Rating Providers (ERPs):

The SEBI regulations shall apply to both domestic and foreign ERPs if their ratings are utilised by users in India. However, regulations do not apply to foreign ERPs offering ratings exclusively on global asset classes for Indian investors.

[4] *https://www.sebi.gov.in/legal/master-circulars/jul-2023/master-circular-for-esg-rating-providers-erps-_73856.html*

Date of applicability

The provisions of came into effect on July 12, 2023

What are ESG Ratings:

ESG ratings defined as products providing an opinion on the ESG profile or characteristics of an issuer or security, including exposure to ESG risks, in line with International Organization of Securities Commissions (IOSCO) recommendations. ERPs are limited to activities such as rating listed issuers and securities, as well as additional activities as may be specified by SEBI or other regulators. Consulting in ESG-related areas prohibited to prevent any conflict of interests.

Categories of ERPs:

Category I ERP –

- An entity applying under this category shall be a subsidiary of an intermediary already registered with the board and shall have a minimum experience of five years in ESG Rating.
- Its promoters should be regulated by SEBI, IRDAI, or PFRDA, or they must be ESG Rating providers from a Foreign Action Task Force compliant country.
- It shall have a minimum liquid liquid net worth of Rs 10 crore at the time of application and shall maintain Rs 5 crore at all times.
- An entity applying under this category shall be a subsidiary of an intermediary already registered with the board and shall have a minimum experience of five years in ESG Rating.
- Once a certificate of registration is granted, a Category I ERP shall not engage only on the activity of ESG rating.

Category II ERP

- An entity applying in this category, needs an amount of Rs 20 lakh to register with SEBI.
- This entity shall maintain a net worth of Rs 10 lakh at all times.
- It shall have two key personnel specialising in governance, social responsibility, sustainability, and data analytics.
- Once a certificate of registration is granted, a Category II ERP shall not engage only on the activity of ESG rating.
- Category II ERPs cannot certify green debt securities.

Thus SEBI has specified two categories of ERPs Category I (big) and Category II (small), each with different requirements for net worth, promoter qualifications, manpower, remote work, etc.

Business Model

SEBI has said that ERPs shall follow either of the following two business models:

"Subscriber-pays" business model, where the ERP derives its revenues from ESG ratings from subscribers that may include banks, insurance companies, pension funds, or the rated entity itself.

"Issuer-pays" business model, where the ERP derives its revenues from ESG ratings from the rated entity, in terms of a written contractual agreement between such entity and the ERP, which may contain such provisions as may be specified by SEBI.

Business plans

During registration, ERPs have to submit business plans and targets for revenue, clients, breakeven, and projected losses.

Disclosures by ERPs

ERPs must disclose the methodologies of ratings, changes in rating, compensation arrangements, type of ESG rating (impact, risk, or otherwise), individual scores on E/S/G, extent to which a change in rating methodology resulted in a change in ESG rating, and whether ESG ratings assigned were solicited/unsolicited.

Measures - Governance

ERPs shall ensure governance measures with focus on managing conflicts of interest, and ensuring independence. They should avoid advisory roles related to ESG. They should also ensure that they maintain the quality and accuracy of ratings by:

- adequate internal resources,
- systematic review processes,
- timely information etc.

Monitoring of ERPs by SEBI

SEBI shall subject ERPs to inspections and periodic reports. ERPs to undertake continuous monitoring of ratings.

ERPs and Risk Management

ERPs shall ensure that they follow procedures to prevent insider trading, fraudulent practices, and protect non-public ESG rating information.

Conclusion:

SEBI's reforms on ERPs are path breaking, inasmuch that they are perhaps the first regulatory attempt made in the world to provide a framework for ESG Rating providers. This is expected to address issues like capability of ESG Rating Providers as well as matters plaguing ESG ratings like perceived lack of transparency, opacity of methodologies and arbitrariness in ratings. Moreover, the use of a 'principles-based' approach by SEBI would also go a long way in ensuring the growth of the that the industry. MA