

## EU Reaches Provisional Agreement on ESG Ratings Regulation

*The European Parliament and the Council of the EU have made some significant changes to the European Commission's proposal.*

### Key Points:

- The agreed text includes important clarifications on the scope of the regime and additional exemptions, amongst other changes.
- The amendments will have notable impacts on global ESG ratings providers, the companies using their services, and financial institutions that embed ESG ratings within their products and services.

On 5 February 2024, the European Parliament and Council of the EU [announced](#) that they had reached a provisional political agreement on the text of the ESG Ratings Regulation (the Regulation). The [agreed text](#) was subsequently published on 14 February 2024. The Regulation was initially proposed by the Commission in June 2023, and seeks to introduce a new regulatory regime for ESG ratings providers “operating in the Union” (see below under “Scope”). Refer to this Latham [blog post](#) for previous commentary on the proposal.

The Regulation is an important piece of the EU's sustainability landscape, as it aims to strengthen the quality and reliability of ESG ratings, which are being relied upon more and more as the market for sustainability-related financial products develops.

The Regulation was subject to detailed consideration by the Parliament and the Council, and they have made some significant changes to the Commission's initial proposal. We outline some of the key outcomes below.

### Scope

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 key terms relating to scope are defined as follows:

- **ESG rating:** an opinion, a score, or a combination of both, regarding a rated item’s profile or characteristics with regard to environmental, social and human rights, or governance factors, or exposure to risks, or the impact on environmental, social and human rights, or governance factors, that are based on both:
  - an established methodology; and
  - a defined ranking system of rating categories,
 irrespective of whether such ESG rating is explicitly labelled as “ESG rating”, “ESG opinion,” or “ESG score”
- **ESG opinion:** an ESG assessment that is based on a rules-based methodology and defined ranking system of rating categories, involving directly a rating analyst in the rating process or systems process
- **ESG score:** an ESG measure derived from data, using a rule-based methodology, and based only on a pre-established statistical or algorithmic system or model, without any additional substantial analytical input from an analyst

A new recital to the Regulation clarifies that the assignment of an item in a category or a scale that is either positive or negative, based on an established methodology with regard to environmental, social and human rights, or governance factors, or exposure to risks, should be considered as a ranking system under the Regulation.

- **Rated item:** a legal person, a financial instrument, a financial product, or a public authority or a body governed by public law which is explicitly or implicitly rated in the ESG rating, irrespective of whether such rating has been requested for and irrespective of whether the legal person has provided information for that ESG rating
- **ESG rating provider:** a legal person whose occupation includes the issuance and publication or distribution of ESG ratings on a professional basis
- **Operating in the Union:** The concept of “operating in the Union” has been clarified as follows:

“Operating in the Union” covers:	Relevant to ESG ratings providers established in the EU?	Relevant to third-country ESG ratings providers?
1. Issuing and publishing ratings on the provider’s website or through other means	✓	✗
2. Issuing and distributing ratings through subscription or other contractual relationships to: <ul style="list-style-type: none"> <li>a. regulated financial services firms in the EU;</li> </ul>	✓	✓

“Operating in the Union” covers:	Relevant to ESG ratings providers established in the EU?	Relevant to third-country ESG ratings providers?
b. entities within scope of the EU Accounting Directive or EU Transparency Directive; or  c. certain EU bodies, or public authorities in an EU Member State		

## Exemptions

Following a period of active dialogue with stakeholders, the Parliament and the Council have made substantial changes to the originally proposed exemptions:

Exemption	Description	Changes
<b>1. Private ESG ratings</b>	Private ESG ratings produced pursuant to an individual order, and provided exclusively to the person who placed the order, and which are not intended for public disclosure or distribution by subscription or other means.	Scope clarified in the recitals
<b>2. ESG ratings for internal purposes</b>	ESG ratings issued by regulated financial undertakings that are used exclusively for internal purposes or for providing in-house or intra group financial services or products.	Wording clarified
<b>3. ESG ratings issued by regulated financial undertakings in the EU</b>	ESG ratings issued by regulated financial undertakings in the EU that: <ol style="list-style-type: none"> <li>1. Are incorporated in a product or a service, where such products or services are already regulated under EU law, including under:               <ul style="list-style-type: none"> <li>– SFDR (2019/2088);</li> <li>– CRD (2013/36);</li> <li>– MiFID II (2014/65);</li> <li>– Solvency II (2009/138);</li> <li>– the UCITS Directive (2009/65);</li> <li>– AIFMD (2011/61);</li> <li>– the Crowdfunding Regulation (2020/1503);</li> <li>– MiCA (2023/1114);</li> </ul> </li> </ol>	New exemption

	<p>– the Benchmark Regulation (2016/1011); and</p> <p>2. Are disclosed to a third party.</p>	
<b>4. EU SFDR disclosures</b>	Mandatory disclosures pursuant to Articles 6, 8, 9, 10, 11, and 13 of SFDR. Third-country firms issuing SFDR disclosures to EU-based investors therefore will not be considered to be providing ESG ratings.	New exemption
<b>5. EU Taxonomy disclosures</b>	Disclosures pursuant to Articles 5, 6, and 8 of the EU Taxonomy Regulation (2020/852).	New exemption
<b>6. ESG data</b>	The publication or distribution of data on environmental, social and human rights, and governance factors.	Wording clarified
<b>7. Credit ratings</b>	Credit ratings issued pursuant to the EU Credit Rating Agencies Regulation (1060/2009), any ESG-related scores or assessments that are produced or published as part of the methodologies for credit ratings or as an input or output of the creditworthiness assessment.	Wording clarified
<b>8. Products and services that incorporate an element of ESG ratings (including investment research)</b>	Products or services that incorporate an element of an ESG rating, including investment research as laid down in MiFID II (2014/65).	Wording clarified
<b>9. Sustainable finance activities</b>	<p>External reviews of European Green Bonds and second-party opinions on green bonds, bonds marketed as environmentally sustainable, sustainability-linked bonds, loans, and other types of debt instruments, to the extent that such external reviews and second-party opinions do not contain ESG ratings produced by the reviewer or the second-party opinion provider.</p> <p>External reviews include pre-issuance reports, such as those of financing frameworks, post-issuance reviews, such as allocation reports, and impact reports.</p>	Wording clarified
<b>10. ESG ratings produced by EU or Member States' public authorities; or European System of Central Banks</b>	ESG ratings produced by EU or Member States' public authorities, or members of the European System of Central Banks, when they are not published or distributed for commercial purposes.	Wording clarified

<b>11. Ratings developed exclusively for accreditation or certification processes</b>	ESG ratings developed exclusively for accreditation or certification processes and which do not target investment and financial analysis or decision-making.	New exemption
<b>12. ESG labels</b>	ESG labelling activities when granted to entities, financial instruments, or products (provided the label does not involve the disclosure of an ESG rating).	New exemption
<b>13. Non-profits</b>	Non-profit organisations that issue ESG ratings for non-commercial purposes and that publish those ratings free of charge, are not deemed to fall within the scope of the Regulation. However, they should endeavour to integrate the transparency requirements laid down in the Regulation where applicable. Non-profit organisations will be in scope if they charge rated items to report data or get rated through their platform, or they charge users to access any information on the ESG ratings.	New exemption
<b>14. Unsolicited EU distribution by a third-country ESG ratings provider</b>	<p>Issuance of an ESG rating by a third-country ESG ratings provider to an EU user on a single use basis and:</p> <ul style="list-style-type: none"> <li>• 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: <ul style="list-style-type: none"> <li>– develops a substantial market share in the EU; or</li> <li>– has a website in at least one of the official languages of the EU (and which is not customary in the sphere of international finance); and</li> </ul> </li> <li>• no substitute is offered by an ESG ratings provider authorised under the Regulation.</li> </ul>	New exemption

## Extraterritorial Considerations

The helpful clarification of the concept of “operating in the Union” (see under “Scope”, above) should limit the scope of the Regulation by excluding third-country ESG ratings providers that make their ratings publicly available on their website or otherwise, but do not actively distribute their ESG ratings into the EU. This limitation adds important clarity to the initial proposal, which had raised concerns about its broad extraterritorial reach.

Nevertheless, there will be certain circumstances where third-country ESG ratings providers will need to be mindful of the potential extraterritorial impact of the Regulation, notwithstanding a decision to restrict access to their ratings by EU-based institutions:

1. **Non-EU users subject to EU disclosure rules:** The ratings of third-country ESG ratings providers could fall within scope of the Regulation if they are issued to entities within scope of the EU Accounting Directive (2013/34) or the EU Transparency Directive (2004/109), which themselves have extraterritorial effect on third-country issuers (e.g., those with securities admitted to trading on EU regulated markets, but otherwise headquartered outside the EU). Therefore, even third-country ESG ratings providers with no contractual nexus to EU-based issuers will need to establish whether to (or to continue to) provide ESG ratings to third-country headquartered issuers, if that company has a relevant EU nexus.
2. **Single use and restricted EU distribution:** ESG ratings produced pursuant to an individual order and provided exclusively to the EU person requesting the rating would not be in scope of the Regulation. In this context, third-country ESG ratings providers should ensure that their license agreements clearly prohibit subsequent public disclosure or distribution by subscription (or other means) in the EU.
3. **Single use and unsolicited EU distribution:** As detailed at number 14 in the table above, the Regulation contains a reverse solicitation exemption for third-country ESG ratings providers. Such providers will need to consider the current inventory of EU use cases for their indices and, where necessary, seek undertakings from EU users on their distribution responsibilities in order to align with the above exemption, or otherwise qualify for use in the EU via one of the routes detailed in the section below.

## Authorisation Requirements

Any person that wishes to operate as an ESG ratings provider in the EU will require approval via one of the following routes:

### EU Established Entities

**An authorisation issued by ESMA (Article 5):** Entities seeking authorisation as an ESG ratings provider will need to apply to ESMA for authorisation, with ESMA then becoming the direct day-to-day supervisor of the regulated firm. ESMA will set out regulatory technical standards (RTS) on how to apply for authorisation. However, the timing of publication of these RTS will complicate the timeline for the approval process before the entry into force of the Regulation. Therefore, we expect ESG ratings providers looking to pursue this route to seek early engagement with ESMA on its expectations.

### Third-Country Established Entities

**Equivalence (Article 9):** This route would apply if the third-country ESG ratings provider is authorised or registered as an ESG ratings provider in the third country concerned, is subject to supervision in that third country, the European Commission has adopted an equivalence decision in relation to the relevant third-country regime, and relevant regulatory cooperation agreements are in operation between ESMA and the relevant third-country supervisor.

**Endorsement (Article 10):** An ESG ratings provider established and authorised in the EU may endorse ESG ratings provided by an ESG ratings provider established outside the EU and belonging to the same group, provided that certain conditions are met, which effectively create an EU liability profile for the third-country and EU-based ratings provider(s), under ESMA's supervision.

**Recognition (Article 11):** Pending an equivalence decision under Article 9 above, or in the event of a repealed equivalence decision, third-country ESG ratings providers with a consolidated annual net turnover below €10 million for the last three consecutive years may operate in the EU, provided ESMA has recognised that ESG ratings provider. This route necessitates the third-country ESG ratings provider appointing an EU-based legal representative who will be accountable to ESMA on its behalf.

### Small ESG Ratings Providers

The amendments have also introduced a temporary light-touch regime for small ESG ratings providers (which fit the criteria for a small undertaking under the Accounting Directive). This regime will run for three years once the Regulation is in force, and allow both existing and new small providers to benefit from a more proportionate application of the regime, and reduced supervisory fees. ESMA will also be granted the power to provide ongoing exemptions from some of the requirements for small providers when it considers this appropriate.

### Transparency

There is a new requirement for ESMA to publish a list of ESG ratings providers, including their total market share in the EU, on an annual basis.

### Organisational Requirements

As planned, all ESG ratings providers operating in the EU will need to comply with organisational requirements which govern the integrity and reliability of ESG rating activities. This includes the maintenance of a permanent, independent, and effective oversight function to ensure oversight of all aspects of the provision of their ESG ratings.

The Regulation maintains the restriction on ESG ratings providers performing activities which could conflict with the delivery of ESG ratings, including audit, assurance, and consultancy services; and the provision of credit ratings.

However, in a marked change from the original proposal, the amendments allow the possibility of providing investment, banking, or insurance activities from the same legal entity, subject to implementing certain measures to avoid conflicts of interest.

Any benchmark administrator wishing to also provide ESG ratings will need to make a specific request to ESMA. ESMA will then assess if the measures proposed are appropriate or sufficient regarding the potential risks of conflict of interest, taking into account whether the benchmark administrator offers benchmarks that pursue sustainability objectives.

## Disclosure Requirements

The Regulation now clarifies that ESG ratings encompass environmental, social and human rights, or governance factors. The agreed text also specifies that, as a rule, separate environmental (E), social (S), and governance (G) ratings will need to be provided, rather than a single ESG metric that aggregates E, S, and G factors. ESG ratings providers will need to disclose whether E, S, or G factors are taken into account (or an aggregation of these factors), the rating given to each relevant factor, and the weighting each of these factors is given in the aggregation. This will need to be presented in a manner that ensures comparability in order to ensure that each E, S, and G category can be compared with the other ones.

ESG ratings providers will also need to provide information on whether the rating considers, among other things, alignment with the objectives set in the Paris Agreement for the E factor, the compliance with International Labour Organisation core conventions on Right to Organise and Collective Bargaining for the S factor, and the alignment with international standards on tax evasion and avoidance for the G factor.

The amendments also add provisions to support double materiality reporting. Ratings will be required to explicitly disclose whether the delivered 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.

Further, ESG ratings providers will need to disclose details of the limitations of the information available to them, including information about engagement with the various stakeholders of a rated entity and how contradictory, incomplete, or subjective information is handled. ESG ratings providers will also need to disclose to the public information about the limitations of the methodology used, such as when they assess only one of the two dimensions of the double materiality principle, or when the ESG rating is expressed in relative or absolute value.

## EU-Regulated Firms / Interplay With EU SFDR

The agreed text also includes an amendment to the EU SFDR (in the form of new Article 13(3)) which requires a financial market participant or financial adviser to include information about the methodologies used in ESG ratings on its website if it discloses enterprise- or product-level ESG ratings as part of its marketing communications.

In the Regulation itself, a similar disclosure obligation has been added in relation to other regulated financial services firms not in scope of the SFDR that disclose an ESG rating as part of their marketing communications. This means that ESG ratings issued by regulated financial undertakings in the EU which are incorporated in a product or a service must be provided alongside a link to the firm's website. The website must include the same detailed disclosures as an authorised ESG ratings provider is required to produce in accordance with the first section of Annex III to the Regulation (replicated below, for ease of reference).

This is a material consideration for EU firms that include ESG ratings within their financial products, given the associated greenwashing risk exposure.



## Next Steps

The Parliament and the Council now need to formally approve the text before it goes through the final steps of the legislative process. The Regulation is expected to be finalised prior to the European Parliament elections at the beginning of June 2024. The revised timescale for application is 18 months after entry into force (the Commission's proposal included a six-month implementation period), so the Regulation is expected to apply from late 2025.

Meanwhile, similar proposals in the UK (see this Latham [blog post](#)) are also expected to progress this year, with HM Treasury likely to set out the next steps following its 2023 consultation on regulating ESG ratings providers in the coming months.

## Annex III of the ESG Ratings Regulation<sup>1</sup>

### Disclosure requirements

#### 1. Minimum disclosures to the public

In accordance with Article 21 of the Regulation, ESG rating providers shall, at the minimum, disclose to the public on their website and through the European Single Access Point (ESAP) the following:

- (a) overview of the rating methodologies used (and changes thereto), including whether analysis is backward-looking or forward-looking and the time horizon covered;
  - (aa) the industry classification used;
- (b) overview of data sources including whether data is sourced from sustainability statements required under Directive 2013/34/EU [Accounting Directive] or from information disclosed under Regulation (EU) 2019/2088 [SFDR] and whether sources are public or non-public and an overview of data processes, estimation of input data in case of unavailability and frequency of data updates;
  - (ba) the ownership structure of the ESG rating provider;
- (c) information on whether and how the methodologies are based on scientific evidence;
- (d) information on the ratings' clearly defined objective and marking whether the rating is assessing risks, impacts, or both, according to the double materiality principle, or any other dimensions, and in the case of double materiality the proportion of the risk and impact materiality;
- (e) 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);
- (f) in the case of an aggregated ESG rating, weighting of the three overarching ESG factors categories (e.g., 33% Environment, 33% Social, 33% Governance), and the explanation of the weighting method, including weight per individual E, S and G factors;
- (g) 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 Article 29b of Directive 2013/34/EU [Accounting Directive];
- (h) information on whether the rating is expressed in absolute or relative values,
- (i) 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;
- (j) 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;
- (k) any limitation in data sources and methodologies used for the construction of ESG ratings.
  - (ka) the main risks of conflicts of interest and the steps taken to mitigate them;

(kb) if an ESG rating of a rated item covers the E factor, information on whether that rating take into account the targets and objectives of the Paris Agreement or any other relevant international agreements;

(kc) 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;

(ke) any limitation on the information available to ESG rating providers.

## **2. Additional disclosures to users of ESG ratings and rated undertakings in scope of Directive 2013/34/EU [Accounting Directive]**

In accordance with Article 22 and in addition to the minimum disclosure to the public referred to in point 1 of this Annex, ESG rating providers shall make available the following information to users and rated item and issuers of the rated item, if applicable, that are the subject of such rating:

(a) a more granular overview of the rating methodologies used (and changes thereto), including:

(1) where applicable, scientific evidence and assumptions on which the ratings are based,

(4) the relevant KPIs per E, S and G factor, and weighting method,

(4a) in the case of an aggregated ESG rating, the result of the assessment for each ESG factor category, presented in a manner that ensures comparability of the E, S and G category,

(5) any potential shortcomings of methodologies, and the measures taken to address those shortcomings,

(6) policies for the revision of methodologies,

(6a) when an ESG rating has been upgraded or downgraded, due to any material changes to rating methodologies, models, key rating assumptions or data sources (including estimates), the reasons for these changes and their implications on the given rating,

(7) last date of the revision;

(7) where the ESG rating covers the E factor, whether and to what extent the ESG rating is correlated with the percentage of taxonomy-alignment under Regulation (EU) 2020/852 [Taxonomy Regulation], or aligned with other international agreements, together with an explanation of any significant deviations therefrom.

(b) a more granular overview of data processes, including:

(1) a more detailed explanation of data sources used – including whether public or non-public, whether subject to assurance engagement, mentioning whether derived from the sustainability reporting standards developed pursuant to Articles 19 and 29b of Directive 2013/34/EU [Accounting Directive] concerning sustainable economic activities and disclosure of information pursuant to Regulation (EU) 2020/852 [Taxonomy Regulation] and Regulation (EU) 2019/2088 [SFDR], including whether and how information on companies' transition plans derived from such sustainability reporting standards is used;

(2) where applicable the use of estimation and industry average and explanation of the underlying methodology,

- (3) the policies for updating data and revising historical data, date of last updates of data,
  - (4) data quality controls, their frequency and the remediation process if issues arise;
  - (5) any steps taken to address limitations in data sources, where applicable;
- (c) where applicable, information about engagement with rated entities, including whether on-site reviews or visits have been performed by the ESG rating provider and at what frequency;
- (cb) where an ESG rating provider issues an unsolicited rating, a prominent statement to that effect in the rating, including information on whether the entity or a related third party has been informed that it would be rated, whether it participated in the rating process and whether the ESG rating provider had access to the management and other relevant internal documents for the rated entity or a related third party;
- (d) where applicable, an explanation of any AI methodology used in the data collection or rating process;
- (e) in case of a major new information on a rated item that has the possibility to affect the result of an ESG rating, ESG rating providers shall inform how they have taken that information into account and whether they have amended the corresponding ESG rating.
- (e) Where applicable, the information referred to in point 2 of this Annex shall be specific to each ESG rating distributed.

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**Endnotes**

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<sup>1</sup> Note that the numbering in this Annex does not run sequentially, as the agreed text is a mark-up of the original Commission proposal.