

NON-PAPER

Competitive disadvantage for new entrants from the EU

The ESG rating providers' market comprises of a limited number of very large non-EU entities and a large number of significantly smaller entities. The major providers are all currently headquartered in North America or the United Kingdom, except for ISS. Furthermore, recent years have witnessed consolidation, predominantly with major players acquiring smaller and specialised targets. The leading providers all sell products to EU-headquartered investors and include EU companies in their coverage.

In our view, new entrants from within the EU face a significant competitive disadvantage from US and UK ESG rating providers. The start-up phase is crucial: "smaller providers need to invest in development and research in order to attract new users and to establish their reputation, and additional costs may be detrimental to them"¹. The Commission proposal will lead to significant upfront costs and long application deadlines for EU entities, whereas new ESG rating providers based outside of the EU are better able to grow their business in the start-up phase.

In the long term, if EU-based ESG rating providers continually face these competitive challenges, the EU might not house any major ESG rating entities. This scenario means a significant part of sustainable investment decisions might be based on data compiled outside the EU's jurisdiction, thereby having an important effect on the investment decisions themselves.

We propose to include a growth model. Small EU companies providing ESG-ratings that are new entrants to the ESG-rating market should be able to focus on developing their product and user-base. In order to achieve this, we suggest to include a light regime for companies below a certain (group-level) revenue threshold for a limited number of years. This ensures that new (small) EU rating providers don't have to first set up their entire organisation (including all upfront costs) and then wait for (possibly) eight months before they can start issuing ESG ratings and get revenue.

What is the competitive disadvantage for new entrants from within the EU?

As mentioned, the Commission proposal leads to high initial costs and long application deadlines for new entrants. Stakeholders point to the 'high impact of costs related to compliance, authorisation, and supervision for smaller providers and new entrants.'² The impact assessment provides an indication of the time and costs new entrants from the EU will face:

- The authorisation period may take up to 170 working days³ (or eight months) during which the provider has to pay for all expenses and is not allowed to make revenue. Before applying for authorisation the new entrant will have to comply with all regulatory requirements, which will also takes up time. Furthermore the one-off costs stemming from authorisation amount to EUR 68.000⁴ for smaller entities. Article 48(3) does allow SMEs 12 months between notifying ESMA and having to apply for the Regulation.
- The annual supervisory fees are in the range of EUR 61.000 to 82.000⁵ for smaller ESG providers.

¹ Impact assessment, p. 89

² Impact assessment, p. 89

³ max. 30 working days between receipt of the application and notification by ESMA (art. 6.1); max. 120 working days between notification and decision to authorise or refuse (art. 6.3); max. 20 days in addition where SME applicant applies for governance exemption (art. 6.4)

⁴ Impact assessment, p. 90

⁵ Impact assessment, p. 90

- The one-off compliance costs for transparency are expected to be EUR 7.500 to 15.000. The ongoing costs are between EUR 13.000 and 29.000⁶. The other (organisational) requirements will lead to additional compliance costs.

New entrants outside the EU do not face additional regulatory costs, as the EU is currently the only jurisdiction working on legislation for ESG rating providers. Non-EU entities that start an ESG rating provider will only have to adhere to a Code of Conduct or no regulation at all, which allows them to use their available funds and capacity for development and research, attracting clients and to develop their reputation. EU entities will have a much higher hurdle to jump over. Furthermore, non-EU SMEs are able to make use of the transition period to keep offering their services inside the EU.

We support the Commission's effort to develop a proportionate regime, however it doesn't sufficiently address the problem for new entrants. The proposal includes mitigating measures to reduce the burden for SMEs:

#	Proportionality provisions	Analysis of provision for new entrants
1.	Proportionality in supervisory fees	Crucial, yet the costs of the authorisation are still expected to be EUR 68.000. In addition, the ongoing supervision costs <u>for smaller providers</u> are estimated at EUR 61.000 – 82.000 annually. These costs are disproportional for SMEs.
2.	Transitional regime	Supports only existing SMEs, not new entrants
3.	Exemptions for organisational requirements	Will benefit new entrants, however they will be unsure whether they can make use of this provision and they still have to adhere to all other organisational requirements before applying. In addition they have to wait for max. 170 working before a decision is made
4	And as a general principle risk-based supervision by ESMA	Will support new entrants.

The growth model can be based on the Alternative Investment Fund Manager Directive (AIFMD):

#	Provision	Based on AIFMD or new?	Explanation
1	Include a general exemption for smaller ESG rating providers	AIFMD	Easy to understand for smaller entities which requirements they must adhere to.
2	Set a group-level revenue and personnel threshold	New	Prevents misuse by large entities setting up new ESG rating providers to circumvent the regulation and large ESG rating providers issuing ratings publicly for free.
3	Limit time that companies can make use of light regime	New	Ensures that only new entrants can make use of this light regime.
4	Registration for smaller ESG rating providers	AIFMD	Entities are known to ESMA. Furthermore, registration expectedly leads "to result in negligible or low one-off compliance costs to ESG rating providers, stemming from the registration process". ⁷
5	Supervisor has supervisory powers regarding registered entities	AIFMD	Ensures that registered entities are supervised on the limited number of requirements laid down in the new article 3a, specifically paragraph 2 (the proposed new article is on the next page).

⁶ Impact assessment, p. 46 (average number, so costs for smaller providers will be lower)

⁷ P.38 impact assessment

6	Notify ESMA when they no longer meet the criteria	AIFMD	Ensures entity will adhere to full Regulation when mature enough.
7	Opt-in for smaller entities to get authorisation	AIFMD	Make it possible for smaller providers to obtain authorisation by ESMA if desired (so called 'opt-in'). For example when users require authorisation to make use of the provider's ratings.
8	Possibly set additional high-level requirements	New	Additional requirements to ensure adherence to crucial provisions. For example: (i) ensure independence of ratings, (ii) high-level public transparency requirements.

Proposed new article:

Article 3a

Exemptions

1. Without prejudice to the application of Article 30 – 32 [powers conferred to ESMA], only paragraphs 2 to 5 of this Article shall apply to the following ESG rating providers:

ESG rating providers which do not exceed the threshold of EUR [x] in annual revenue from ESG ratings.

2. ESG rating providers referred to in paragraph 1:

(a) are subject to registration with ESMA;

(b) identify themselves and the ESG ratings that they distribute to ESMA at the time of registration;

(c) notify EMSA in the event that they no longer meet the conditions referred to in paragraph 1.

Where the condition set out in paragraph 1 is no longer met, or five years after first providing ESG ratings in the Union, the ESG rating provider applies for authorisation within [x] calendar days in accordance with the relevant procedures laid down in this Regulation.

3. ESG rating providers referred to in paragraph 1 can choose to opt in under this Regulation. Where ESG rating providers opt in, this Regulation shall become applicable in its entirety.
4. The Commission shall adopt implementing acts with a view to specifying the procedures for ESG rating providers which choose to opt in under this Regulation in accordance with paragraph 3. Those implementing acts shall be adopted in accordance with the examination procedure referred to in Article [x].
5. The Commission shall adopt, by means of delegated acts in accordance with Article [x] and subject to the conditions of Article [x], measures specifying:
 - (a) how the thresholds referred to in paragraph 1 are to be calculated and the treatment of ESG rating providers that occasionally exceed and/or fall below the relevant threshold in the same calendar year;
 - (b) the obligation to notify competent authorities as set out in paragraph 3.