

First Notes



SEBI proposes framework for Environmental, Social and Governance (ESG) rating providers

3 March 2022

First Notes on
Financial reporting
Corporate law updates
Regulatory and other information
Disclosures
Sector
All
Banking and insurance
Information, communication, entertainment
Consumer and industrial markets
Infrastructure and government
Relevant to
All
Audit committee
CFO
Others
Transition
Immediately
Within the next three months
Post three months but within six months
Post six months
Forthcoming requirement

The Securities and Exchange Board of India (SEBI) issued a consultation paper 'Environmental, Social and Governance (ESG) Rating Providers for Securities Markets' to propose framework to regulate ESG rating providers. The consultation paper aims to streamline and standardise the ESG ratings for companies and also proposes to allow credit rating agencies and research analysts to provide such services.



Background

Recently, climate change and sustainable development concerns have become a priority at global and national level. There has been an increase in the interest of international bodies and financial regulators in examining ESG-related issues. SEBI is one of the regulator on the forefront of ESG and hence, it has mandated the top 1,000 listed companies by market capitalisation to report Business Responsibility and Sustainability Report (BRSR) from the financial year 2022-23.

Investors factor financial implications of sustainability related risks and opportunities and these are impacting their investment decisions. This has led to an increase in the investor interest and demand for ESG reporting. However, the activities of ESG Ratings Providers (ERPs) are not subject to regulatory oversight at present. Reliance on such unregulated ERPs in securities markets has raised concerns about the potential risks to investor protection, the transparency and efficiency of markets, risk pricing, and capital allocation, etc. Additionally, 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, SEBI has issued a consultation paper which describes the proposed regulatory framework to regulate ERPs and oversight thereon, periodicity of such disclosure, etc.

This issue of First Notes aims to provide an overview of the proposed framework issued by SEBI.

The consultation paper is open for comments upto 11 March 2022.

Overview of the proposed framework

Following are some of the key proposals:

1. **Proposed scope of regulation/accreditation:** SEBI proposes to accredit ERPs for the purpose of assigning ESG ratings to listed entities and listed securities. The consultation paper highlights following conditions for listed entities to avail ESG rating:
 - **Accredited ERP:** A listed entity that intends to avail an ESG rating, would obtain the same from only a SEBI accredited ERP.
 - **Mandatory BRSR reporting to avail services of accredited ERPs:** If entities other than the top 1,000 listed by market capitalisation wish to avail services of SEBI accredited ERPs, then such entities would be required to make public disclosures in line with those prescribed in BRSR on a mandatory basis prior to engaging with SEBI accredited ERPs. Also, ERPs would provide ESG rating, basis the publicly available disclosures as per BRSR reporting. Additionally, the consultation paper provides that to avoid information asymmetry, listed entities seeking rating would continue to provide BRSR disclosures.
 - **Mutual funds/alternative investment funds investment decisions:** 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, would be required to avail services of SEBI accredited ERPs.
 - **Index providers:** Index providers using ESG ratings for formulation of index/indices on Indian securities, would use services of only SEBI accredited ERPs for formulation of such an index.

Response sought by SEBI on:

- Whether there is a need to regulate/accredit ERPs in securities market.
- Whether the proposed regulatory framework are adequate, if not, suggestions to modify the requirements?



2. **Entity eligible to be accredited as ERP:** The consultation paper specifies that only following regulated entities may be considered as eligible entities for being accredited as ERPs subject to fulfilment of accreditation criteria:
 - Credit Rating Agencies (CRAs)
 - Research Analysts (RAs).

Response sought by SEBI on:

- Entities that should be considered to accredit as ERPs along with the rationale.



3. **Conditions for accreditation:** The proposed accreditation conditions for ERPs to include following criteria:
 - Minimum net worth of INR10 crore
 - Adequate infrastructure to undertake necessary due diligence for assigning ESG ratings
 - Manpower consisting of specialist in specified areas
 - The accreditation should be granted subject to review by SEBI every two years.

Response sought by SEBI on:

- Appropriateness of proposed accreditation criteria and if any additional criteria should be included.



4. **ESG rating products under purview of proposed SEBI's accreditation framework:** The consultation paper proposes that ERPs intending to get accredited with SEBI would offer at least one of the following ratings products:
 - ESG Impact Ratings
 - ESG Corporate Risk Ratings or ESG Financial Risk Ratings
 - Any other ESG related rating products, which may be appropriately labelled.

Additionally, it provides that in order to avoid any confusion among stakeholders that ERPs should always use proper terminologies for the products offered by them.

Response sought by SEBI on:

- Appropriateness of proposed classification of ESG ratings and other related products.



Overview of the proposed framework (cont..)

- 6. Standardisation of Symbols and Scales for ESG Ratings:** SEBI proposes to not standardise rating scales (i.e., rating/scoring symbols and their definitions). However, ERPs should prominently disclose on their website and in the ESG rating reports, the rating scale (symbols and their definitions) used by them. Additionally, an ERP should also ensure consistency in the application of its ESG rating scale.

Response sought by SEBI on:

- Whether the proposal to not to standardised ESG rating scales is appropriate.



- 6. Transparency:** ERPs are expected to maintain transparency and ensure the following:

- **Type of ESG product and rating methodology on website and reports:** Prominently display on their website and in ESG rating reports the type of ESG rating product (whether impact-based, or risk-based, or otherwise) and rating methodology for all its products. Also maintain archives of earlier rating methodologies on the website.
- **Sectoral classification:** Disclose sectoral classification standard being followed, and other relevant disclosures up to at least two levels of sector classification
- **Publish evaluation:** Publish, on an annual basis, an evaluation of their ESG-rating methodologies against the outputs which have been used to produce
- **Resources used to be disclosed:** Disclose the data and information sources, such as BRSR, including the use of industry averages, estimations or other methodologies when actual data is not available or not publicly disclosed.
- **Rating to be sector-agnostic:** 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.
- **Cross-reference:** Where an index-provider is using ESG ratings in formulation of its index/indices, it should be cross referenced to the ESG rating methodology
- **Caution statement:** Prominently display on their website and rating reports that ESG rating is not a recommendation to buy, sell or hold any security or financial instrument.

Response sought by SEBI on:

- Appropriateness of proposed norms relating to transparency.
- Whether ERPs should be free to assign ESG ratings on a sector specific or sector-agnostic basis, subject to adequate disclosures?.



- 7. ESG Rating Process to be consistent:** An ERP should 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.

- 8. Governance and prevention of conflict of interest:** The consultation paper emphasises that ERPs ensure prevention of conflict of interest. The following are the proposals:

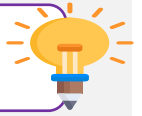
- **Policy on conflict of interest:** Formulate detailed policy on managing conflict of interest and provide prominent disclosure on its website.
- **Related entities:** ESG providers should not provide ratings to its related entities or securities
- **Adequate corporate governance structures:** The corporate governance organisational and operational structures should be sufficient to identify, manage and mitigate any potential conflicts of interest.
- **Independence:** Ensure that the personnel in the activity of ESG ratings are separate from those involved in other activities of the ERP. Take steps to help ensure that 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. 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.
- **Manage conflict of interest:** 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.

Overview of the proposed framework (cont..)

- **Require disclosure of conflict of interest:** Analysts involved in ESG rating assessments should disclose any conflicts of interest involving a company/issuer to the ERP and should not be allowed to rate such companies.

Response sought by SEBI on:

- Appropriateness of proposed norms relating to conflict of interest.



9. **Business model:** It is proposed that ERPs would follow a 'subscriber-pay' business model. While investors may be the primary source of revenue; a subscriber may include an issuer as well.

The consultation paper points out that the 'issuer pay' model is the dominant business model for credit rating companies. It also highlights that 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. In the subscriber pay model revenue may not necessarily come from the issuer, therefore this model has fewer potential issues on the conflict of interest in comparison to 'issuer-pay' model.

Response sought by SEBI on:

- Appropriateness of application of subscribe pay as payment model in India.



Our comments



The SEBI undertook discussion with various stakeholders like global and national ERPs, CRAs, mutual funds offering ESG schemes and research/audit firms. The discussion brought to the notice of the regulator that many of the ERPs are rating publicly listed companies based on public information on a subscription basis.

The consultation paper highlights the challenges surrounding the ESG ratings and other products ecosystem. This is due to ambiguity of the wide range of ratings products offered along with inconsistency in disclosures and transparency of the methodology and rating process. In some cases, the purpose and definition of ESG rating products offered by different ERPs may be the same, however, the underlying methodologies utilised are likely to differ significantly between ERPs without sufficient disclosures.

Further, currently many ERPs offer services other than ESG ratings such as index solutions, advisory services related to ESG, etc. which may cause potential conflict of interests. Additionally, 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 significant risk of misallocation and greenwashing¹.

As the activities of ERPs are not subject to any regulatory oversight at present, it could give rise to potential risk to investor protection, the transparency and efficiency of markets, risk pricing, and capital allocation, etc. Therefore, with an aim to regulate the ERPs, SEBI has issued a consultation paper.

What's happening internationally

Internationally, the International Organization of Securities Commissions (IOSCO)'s Sustainable Task Force's Working Stream, published its report on 'ESG Ratings and Data Product Providers' in November 2021. The report highlighted that while the market of ERPs does not typically fall within the remit of securities regulators, regulators could consider focussing greater attention on the use of ESG ratings and other related products and activities of ERPs in their jurisdictions. SEBI has also considered the report issued by IOSCO and its recommendations while drafting its consultation paper.

Other regulators around the world have also considered the recommendation issued by the IOSCO. For example, on 3 February 2022, the European Securities and Markets Authority (ESMA), the EU's securities markets regulator issued its consultation paper that seeks information on the market structure for ESG rating providers in the European Union (EU). The paper describes the concerns regarding lack of standards and oversight for ESG ratings.

The US Securities and Exchange Commission (SEC) has also highlighted the risks associated with the ESG ratings by the rating firms in its report Staff Report on National recognised statistical rating organizations issued in January 2022. The report states that by adding ESG factors, ratings firms may deviate from their methodologies, policies or procedures which may not be properly disclosed to investors. This would create certain potential risks for the ratings agencies, such as failing to follow ratings methodologies and failure to manage conflicts of interest.

¹ IOSCO report defines greenwashing as the practice by asset managers of misrepresenting their own sustainability-related practices or the sustainability-related features of their investment products'

Our comments (contd.)



Considerations relevant for the companies

The IOSCO report discussed that the term 'ESG ratings' can be referred to the broad spectrum of rating products in sustainable finance and include ESG scorings and ESG rankings. ESG ratings, rankings and scorings serve the same objective, namely the assessment to ESG risks and/or opportunities with regard to an entity, an instrument or an issuer.

ESG ratings and data products providers rely on data inputs to support their analysis for ESG ratings and data products. The availability of reliable and high-quality data inputs is a critical component of ESG ratings and data products. Therefore, companies are expected to provide the information which is accurate and reliable and also consistency of this information is an important consideration.

Considering that the activities of ESG ratings are currently not subject to regulatory oversight, the lack of standards in this area may present the risk of greenwashing or misallocation of assets and could lead to a lack of trust in ESG ratings or in the data. Therefore, the companies are expected to establish good governance practices in this area to ensure effective and efficient policies and procedures around the ESG structure. The companies should also ensure that the data provided to the agencies is in compliance with the rating criteria used by the ERPs.

Another consideration for the companies is the business model used by the ERPs. The consultation paper proposes that ERPs should follow a 'subscriber-pay' business model. Many credit rating companies use 'issuer pay' model. The consultation paper describes both the models and their inherent pitfalls. This is an important area to deliberate, and companies should evaluate these models and provide their inputs to SEBI on this topic.

The bottom line

ESG considerations have become significant aspect for investors while taking investment decisions. This has led to regulators across the world to focus on ERPs and ratings.

Companies in India are dealing with both international and domestic investors as some of the companies have listed their securities in the overseas markets as well.

While the SEBI framework will be relevant for India, companies should keep an eye on this topic as it is evolving internationally too and be prepared to respond to regulatory developments in this area. The new international regulations could impact changes in the methodologies and processes and consequent impact on the process of getting ESG ratings.

Therefore, companies should watch out for the developments in this sphere both in India and internationally.



KPMG in India offices

Ahmedabad

Commerce House V, 9th Floor,
902, Near Vodafone House,
Corporate Road,
Prahlad Nagar,
Ahmedabad – 380 051
Tel: +91 79 4040 2200

Bengaluru

Embassy Golf Links Business
Park, Pebble Beach, 'B' Block,
1st & 2nd Floor,
Off Intermediate Ring Road,
Bengaluru – 560071
Tel: +91 80 6833 5000

Chandigarh

SCO 22-23 (1st Floor)
Sector 8C, Madhya Marg
Chandigarh – 160 009
Tel: +91 172 664 4000

Chennai

KRM Towers, Ground Floor,
1, 2 & 3 Floor, Harrington Road
Chetpet, Chennai – 600 031
Tel: +91 44 3914 5000

Gurugram

Building No.10, 8th Floor
DLF Cyber City, Phase II
Gurugram, Haryana – 122 002
Tel: +91 124 307 4000

Hyderabad

Salarpuria Knowledge City, 6th
Floor, Unit 3, Phase III, Sy No.
83/1, Plot No 2, Serilingampally
Mandal,
Ranga Reddy District,
Hyderabad – 500 081
Tel: +91 40 6111 6000

Jaipur

Regus Radiant Centre Pvt Ltd.,
Level 6, Jaipur Centre Mall,
B2 Bypass Tonk Road
Jaipur – 302 018.
Tel: +91 141 - 7103224

Kochi

Syama Business Centre
3rd Floor, NH By Pass Road,
Vytilla, Kochi – 682 019
Tel: +91 484 302 5600

Kolkata

Unit No. 604,
6th Floor, Tower – 1,
Godrej Waterside,
Sector – V, Salt Lake,
Kolkata – 700 091
Tel: +91 33 4403 4000

Mumbai

1st Floor, Lodha Excelus,
Apollo Mills
N. M. Joshi Marg,
Mahalaxmi, Mumbai – 400 011
Tel: +91 22 3989 6000

Noida

Unit No. 501, 5th Floor,
Advant Navis Business Park
Tower-A, Plot# 7, Sector 142,
Expressway Noida,
Gautam Budh Nagar,
Noida – 201 305
Tel: +91 0120 386 8000

Pune

9th floor, Business Plaza,
Westin Hotel Campus, 36/3-B,
Koregaon Park Annex, Mundhwa
Road, Ghorpadi, Pune – 411 001
Tel: +91 20 6747 7000

Vadodara

Ocean Building, 303, 3rd Floor,
Beside Center Square Mall,
Opp. Vadodara Central Mall,
Dr. Vikram Sarabhai Marg,
Vadodara – 390 023
Tel: +91 265 619 4200

Vijayawada

Door No. 54-15-18E, Sai Odyssey,
Gurunanak Nagar Road, NH 5,
Opp. Executive Club, Vijayawada,
Krishna District ,
Andhra Pradesh - 520008
Contact: 0866-6691000

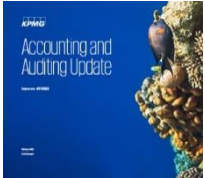
KPMG in India's IFRS institute



Visit KPMG in India's IFRS institute - a web-based platform, which seeks to act as a wide-ranging site for information and updates on IFRS implementation in India.

The website provides information and resources to help board and audit committee members, executives, management, stakeholders and government representatives gain insight and access to thought leadership publications that are based on the evolving global financial reporting framework.

Missed an issue of Accounting and Auditing Update or First Notes?



Issue no. 67 – February 2022

The topics covered in this issue are:

- The Foreign Contribution (Regulation) Act, 2010 – impact on Not for Profit Organizations
- ESMA identified its priorities in sustainable finance road map 2022-2024
- Regulatory updates



SEBI notified amendments to related party transactions

24 December 2021

On 9 November 2021, the SEBI notified amendments to Listing Regulations with respect to Related Parties Transactions (RPTs). These amendments will be applicable in a phased manner, with certain amendments coming into effect from 1 April 2023 and remaining amendments will come into effect from 1 April 2022.

Subsequently, on 22 November 2021, SEBI issued a circular specifying the disclosure obligations of listed entities in relation to RPTs (i.e. information to be placed before the audit committee and the shareholders for consideration of RPTs, and the format for disclosure of RPTs to stock exchanges on a six-monthly basis has also been provided). This circular is effective from 1 April 2022.

In this issue of First Notes, we aim to provide an overview of the key amendments made by SEBI in the Listing Regulations relating to related parties and RPTs.

Voices on Reporting



VOR quarterly publication for the quarter ended 31 December 2021

Quarterly updates publication (for the quarter ended 31 December 2021) provides a summary of key updates from the Securities and Exchange Board of India (SEBI), the Ministry of Corporate Affairs (MCA), the Institute of Chartered Accountants of India (ICAI) and the Reserve Bank of India (RBI). To access the publication, please click [here](#).

Feedback/queries can be sent to aaupdate@kpmg.com

Previous editions are available to download from: home.kpmg/in

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

KPMG Assurance and Consulting Services LLP, Lodha Excelus, Apollo Mills Compound, NM Joshi Marg, Mahalaxmi, Mumbai - 400 011 Phone: +91 22 3989 6000, Fax: +91 22 3983 6000.

© 2022 KPMG Assurance and Consulting Services LLP, an Indian Limited Liability Partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

This document is for e-communication only.