Regulating ESG Rating and Data Product Providers: Critically Examining EU Regulation through the Lens of Functional Regulatory Consistency

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Abstract

The expansion of EU regulatory governance in the financial sector since the end of the global financial crisis 2008 has given rise to the need to examine regulatory consistency in the volumes of financial regulation that may have cross-cutting implications. In this light, this article examines the effectiveness of the Regulation of ESG infomediaries through the lens of 'functional regulatory consistency' with other infomediary regulations, for credit rating agencies and stock market benchmarks. It argues that this lens most aptly reveals the three key weaknesses of the regulatory regime for ESG infomediaries. These relate to sub-optimal coverage of scope, over-inclusiveness in the application of regulatory standards and under-inclusiveness where appropriate governance is not provided. the sub-optimal coverage of scope raises the question of whether ESG stock market index providers should indeed be regulated as ESG infomediaries or as stock market benchmarks more generally falling within the Benchmarks Regulation 2016. Over-inclusiveness and under-inclusiveness in the regulatory provision reflects blindspots in applying functional regulatory consistency, where it is inappropriate due to distinguishing features in business models, market structures or market relations.

Keywords: ESG ratings, credit ratings, stock market indices, benchmarks

I. Introduction

The market for information, analytical and 'rating' or 'scoring' products related to 'environmental, social and governance' (ESG) risk management has grown since the early 2000s. These products relate mostly to evaluating how companies manage ESG risks that are material to them (the 'outside in' approach)[1] but could also offer evaluation of the impact of corporate activities on ESG risks more broadly (the 'inside-out' approach).[2] Of late, many products of this kind also evaluate collective investment

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[1] Term used in Matteo Gargantini and Michele Siri, 'Information Intermediaries and Sustainability: ESG Ratings and Benchmarks in the European Union' (ECMI Working Paper 2022). Nicole R Hovatter, 'Defending ESG: A New Standard of Review for Defensive Measures That Impact ESG Ratings' (2022) 171 University of Pennsylvania Law Review 204.

[2] Gargantini and Siri (2023).

funds that carry an ESG label (within a variety of meanings as to how ESG risks are integrated within a number of different possible investment strategies).[3]

The growth of the ESG information industry supports the rise in ESG-related investing, which has grown exponentially. From a niche product, socially responsible investing[4] or impact investing[5] have developed since the 2000s to become *thematic but mainstream* labels for collective investing strategies, including the terms 'ESG', 'green', 'climate' or 'sustainable'. This trend is underpinned by authoritative policy steers in the EU[6] and other governments in leading financial jurisdictions towards mobilising public and private finance to fund sustainable environmental and social goals. Financial product providers, observing the demand side's responsiveness towards hybrid financial and sustainable goals,[7] have dramatically increased financial product offerings, especially in terms of collective investment funds accessible to retail investors.

However, the risks of 'greenwashing' have risen with the growth of the hybrid financial market,[8] as investors remain unsure what investment fund labels mean, what information and methodologies justify such labels and whether the assets invested indeed accord with investors' preferences and objectives.[9] This development has attracted regulators to provide governance for investment product design and marketing.[10] Although, as will be discussed in Section II, many ESG information providers do not directly engage in 'greenwashing' to harm investors' interests, the credibility and integrity of their information signals feed into product providers' designs and distribution. Further, in the case of ESG information signals relating to investment fund evaluation, there is direct investor reliance on these signals.

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[3] Funds can be actively managed to select stocks, such as within a class, or actively managed to produce ESG impact as well as financial returns. Passive management means adherence to a selected ESG index of stocks.

[4] Generally, Benjamin J Richardson, *Socially Responsible Investment Law* (Oxford: OUP, 2008).

[5] Jess Daggers, Alex Nicholls, 'Academic Research into Social Investment and Impact Investing' in Othmar M Lehner (ed), *Routledge Handbook of Social and Sustainable Finance* (Oxford: Routledge, 2016).

[6] European Green Deal, https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal_en; also European policy support for the UN Agenda for Sustainable Development 2030.

[7] Charlotte Christiansen, Thomas Jansson, Malene Kallestrup-Lamb and Vicke Noren, 'Who are the Socially Responsible Mutual Fund Investors?' (2019) at http://ssrn.com/abstract=3128432.

[8] Christin Nitsche and Michael Schröder, 'Are SRI Funds Conventional Funds in Disguise Or Do They Live Up to Their Name?' in Sabri Boubaker, Douglas Cumming, and Duc Khuong Nguyen (eds), *Research Handbook of Investing in the Triple Bottom Line* (Cheltenham: Edward Elgar, 2018), ch19.

[9] E.g, investors need explanation as to how apparent anomalies could exist, such as the inclusion of oil majors in a sustainable-themed stock market index adopted by passively-managed investment fund, see Jason Halper, Duncan Grieve, Sara Bussiere, Timbre Shriver and Jayshree Balakrishnan, 'ESG Ratings: A Call for Greater Transparency and Precision' (2023) 31 Corporate Governance Advisor 1.

[10] The EU Sustainable Finance Disclosure Regulation 2019/2088; UK fund labelling regime, FCA Handbook ESG 4.1.

Policy-makers in the EU have decided to introduce regulation for ESG information, data product or rating providers (collectively called ESG informediaries in this article).[11] This article critically reflects on key shortcomings of the Regulation, crucially through the lens of functional regulatory consistency. Regulatory consistency is a key tenet in EU financial regulation, aimed at regulatory clarity and serving fundamental objectives such as achieving a level playing field (epitomised in the mantra of 'same activity, same risks, same rules),[12] and maintaining financial stability.[13] Hence, functionally equivalent activities giving rise to similar risks should be subject to consistent rules, which this article clarifies as 'functional regulatory consistency'. Functional regulatory consistency mitigates regulatory arbitrage and can provide regulatory certainty and credibility. Functional regulatory consistency also helps to streamline expectations for firms' implementations, so that efficient and consistent procedures across similar lines of business can be instituted for compliance.

In regulating ESG infomediaries, Section II argues that the major business models in ESG infomediation are unevenly captured within the Regulation's scope, leading to sub-optimally discrepant regulation or regulatory gaps. There is a failure to apply an optimal level of functional regulatory consistency that should cut across all the major business models that intermediate ESG information. Section II maps the three major business models in ESG infomediation, which are: ESG infomediaries working at issuer level, producing stock market benchmarks and rating investment funds. It highlights the under-inclusive weaknesses of the Regulation through the lens of functional regulatory consistency.

Functional regulatory consistency can further be pitched at a higher level, i.e. across all financial sector infomediaries as they broadly perform the role of information analysis in order to provide signals to guide market behaviour. Hence, the regulation of ESG infomediaries can be mapped against earlier regulation of infomediaries such as credit rating agencies[14] (CRAs) and financial benchmark providers.[15] This ensures that regulatory standards are well-thought and consistently applied, giving rise to more certain compliance and supervision expectations. The ESG infomediary regulation

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[11] Agreed text in February 2024, https://www.consilium.europa.eu/en/press/press-releases/2024/02/05/environmental-social-and-governance-esg-ratings-council-and-parliament-reach-agreement/#:~:text=Under%20the%20new%20rules%2C%20ESG,methodology%20and%20sources%20of%20information.

[12] especially articulated for digital finance, European Commission, *Digital Finance Strategy for the EU* (2020), https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX%3A52020DC0591#:~:text=The%20Commission%20will%20therefore%20pay,institutions%20and%20new%20market%20participants. It has wider implication, see

[13] Kian Navid, 'How Many Single Rulebooks? The EU's Patchwork Approach to Ensuring Regulatory Consistency in the Area of Investment Management' (2022) 23 European Business Organisations Law Review.

[14] Regulation of credit rating agencies 2009/1060 amended in 2011 and 2013.

[15] Regulation of benchmarks and indices 2016/1011.

draws on such functional regulatory consistency, but its application is fraught with challenges in relation to over and under-inclusion. In this manner, the substantive weaknesses in regulating the three major business models of ESG infomediaries can be interrogated through the lens of sub-optimal application of functional regulatory consistency.

Sections III and IV show that although functional regulatory consistency is useful to an extent, its lure can tempt regulators to adopt earlier regulatory templates wholesale, obscuring them from finer considerations concerning the precise business models, market structures or relations that give rise to market failures and regulatory needs for ESG infomediation business models. Finer distinctions from functional regulatory consistency need to be made to prevent the over-inclusive and under-inclusive weaknesses existing concurrently in the ESG infomediation regulation.

The article suggests adjustments for regulating ESG infomediaries, and these also highlight broader lessons for the pursuit of optimal functional regulatory consistency. In the quest for achieving coherence and clarity in the ever-increasing volume of European financial regulation, understanding how optimal functional regulatory consistency should be achieved will remain an important priority.

II. The ESG Infomediary Market and Three Major Business Models

The rise of ESG infomediaries supports the work of institutional investment management which increasingly takes into account of material non-financial risks, alongside conventional financial risks.[16] Despite controversies regarding whether non-financial risks are material or conflicting with financial interests,[17] such a holistic or 'enlightened' approach to investment management has become well-accepted in the EU and UK. Empirical research reports significant market effects for corporate fund-raising as the cost of capital is reduced[18] in connection with healthy ESG evaluations. Investors' perception of better financial performance,[19] and of corporations' quality of

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[16] UNEPFI, Fiduciary Responsibility: Legal and Practical Aspects of Integrating Environmental, Social And Governance Issues Into Institutional Investment (2009); PRI, UNEPFI and Generation Foundation, A Legal Framework for Impact: sustainability impact in investor decision-making (2021), https://www.unepfi.org/industries/investment/a-legal-framework-for-impact-sustainability-impact-in-investor-decision-making/.

[17] The issue raises sharp divides in the US, see Virginia Harper Ho, 'Sustainable Investment & Asset Management: From Resistance to Retooling' in Iris HY Chiu and Hans-Christoph Hirt (eds), *Investment Management, Stewardship and Sustainability* (Oxford: Hart Publishing, 2023).

[18] Gianfranco Gianfrate, Dirk Schoenmaker and Saara Wasama, 'Cost of Capital and Climate Risks'; Anant K Sundaram, 'ESG Investing' in Anant K. Sundaram and Robert G. Hansen (eds), *Elgar Handbook on Business and Climate Change* (Cheltenham: Edward Elgar, 2023), chs 21, 22.

[19] the subject of many studies, and meta-studies such as Gunnar Friede, Timo Busch & Alexander Bassen, 'ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies' (2015) 5 Journal of Sustainable Finance & Investment 210; Tensie Whelan, Ulrich Atz and Casey Clark, 'Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015 – 2020' (NYU Stern Center for Sustainable Business, 2022), https://sri360.com/wp-content/uploads/2022/10/NYU-

financial and non-financial reporting also improve, which build investor trust.[20] Further, commentators have found that corporations benefiting from good evaluations from ESG informediaries substantively improve their sustainable innovations.[21]

Since the early 2000s, specialist information and analytical providers such as Asset4, Refinitiv, Trucost have been established as market providers of ESG information goods, different from traditional analysis and research. The mainstreamisation of material non-financial risks in investment management has changed the investment management business model, and observations that inflows into ESG investment funds have swelled since 2020[22] may probably be better explained as the reframing and re-orientation of many conventional investment funds rather than necessarily the growth of a niche investment market. ESG-themed investment funds positively evaluated by trusted infomediaries, such as Morningstar, attract significant inflows.[23] ESG infomediaries exert notable influence upon financial allocation.

There are arguably three major business models in the ESG infomediary industry. One focuses on evaluating corporate issuers, the second focuses on corporate issuers in order to select stocks for inclusion into stock market benchmarks that can be adhered to by passively-managed funds, and the third focuses on rating investment funds. The EU regulation agreed in 2024 caters mainly for the first-mentioned industry. Stock market benchmarks fall within the overall EU Regulation of Benchmarks 2016, while the third seems neglected in the 2024 text. This Section argues that all three business models should be explicitly included within the Regulation's scope. They intermediate ESG information for user bases that are broadly similar for investment purposes and at similar levels of sophistication. Further, unincluded business models pose similar risks to users, perhaps even in increased intensity, highlighting the incongruence of their non-explicit treatment within the Regulation's scope. We first turn to survey the rationales for regulating the three major business models in ESG infomediation.

A. ESG Infomediaries Working at Issuer Level

ESG infomediaries working on corporate issuers supply their information products mainly to financial product providers. Analysis, data and ratings can be supplied to

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RAM_ESG-Paper_2021-2.pdf confirm a positive correlation between companies' ESG scores and financial performance (Sharpe ratio and return on equity measurements included).

[20] Dalit Gafni, Rimona Palas, Ido Baum, Dov Solomon, 'ESG Regulation and Financial Reporting Quality: Friends or Foes?' (2024) 61 Finance Research Letters 105017.

[21] Cheng Chen, Min Fan and Yaojun Fan, 'The Impact of ESG Ratings Under Market Soft Regulation on Corporate Green Innovation: An Empirical Study from Informal Environmental Governance' (2023) 11 Frontiers in Environmental Science 1278059, doi: 10.3389/fenvs.2023.1278059.

[22] A marked rise in ESG assets from 2020, 'ESG assets projected to swell to as much as $30tn by 2030' (FN London, 20 Dec 2021), https://www.fnlondon.com/articles/esg-assets-projected-to-swell-to-as-much-as-30tn-by-2030-20211202.

[23] Fabrizio Febriani, 'The Importance of Labels for Sustainable Investments: SFDR Versus Morningstar Globes' (2023) Applied Economics Letters, doi:10.1080/13504851.2023.2208326;

active investment managers who screen or pick stocks for portfolio curation; and to stock market benchmark developers who offer passive investment managers indices of included stocks that meet the criteria for certain investment themes. The user base for these ESG infomediaries' products is largely sophisticated in nature.

Active investment managers often apply or integrate relevant information products into their in-house frameworks and strategic decisions relevant to financial product design and marketing.[24] In this manner, ESG infomediaries contribute to an upstream stage of financial product generation, and users transform their input into their product designs and marketing agendas at the mid-stream before ultimate investment products are offered downstream to investors, whether professional or retail. Often, active investment managers subscribe to more than one ESG infomediary's products[25] in order to gain scope or benefit from different perspectives in infomediaries' methodologies. Users often attribute their multiple subscriptions to the problem of 'variance' in ESG information products, as there is relatively low correlation between ESG ratings compared to credit ratings from different agencies.[26]

Where the risks of greenwashing are concerned, investors are not necessarily directly 'harmed' by ESG infomediaries' outputs, which are invariably transformed by active investment managers into other product labels. Hence, the EU and UK have rightly taken steps to require investment fund managers to adhere to standards of credibility in offering ESG-related investment products and to explain how these standards are met.[27] The regulators also do not endorse mechanistic reliance by fund managers on ESG infomediaries, so as not to allow the former to 'pass the buck' of compliance. In this manner, users' exercise of choice and market discipline can be sufficient to ensure that the ESG information market meets their needs and keeps innovating. It is queried if regulation should be introduced for ESG infomediaries producing an essentially private market good for sophisticated users.

It may be argued that the new burdens of regulatory compliance now placed on investment fund managers to combat greenwashing need to be supported by the appropriate regulation of the market for ESG information, as fund managers source their inputs from this market even if they design and label investment fund products themselves. But it can equally be argued that users' diligence and discernment in the market for ESG information should be part and parcel of their compliance with investor protection duties. Nevertheless, work is underway to establish standards for corporate

[24] Quinn Curtis, Jill E Fisch and Adriana Z Robertson, 'Do ESG Mutual Funds Deliver on Their Promises?' (2021) 120 Michigan law Review 393.
[25] Sung Eun (Summer) Kim, 'The Duality of Variance Among ESG Assessments' 88 Mo. L. Rev. (2023) Available at: https://scholarship.law.missouri.edu/mlr/vol88/iss2/7.
[26] Halper et al (2023).
[27] note4.

reporting of non-financial material information in the EU[28] and UK.[29] These often form an important source of information for ESG infomediaries' work. Further, ESG infomediaries have often been criticised to be insufficiently transparent about their data sources, methodologies and weightings which make it difficult for users to determine the real quality of their information products.[30] Users arguably have a case that market discipline is insufficient.[31]

When compared to the case for regulating CRAs, it may be argued that the case is less clear for regulating ESG infomediaries working on corporate issuers.[32] CRAs benefit from regulatory endorsement or difficult substitutability,[33] and are often fully relied on by investors as a shorthand without further diligence on their part. Further, ESG infomediaries are paid by their subscribers or users, this revenue model being dominant despite some infomediaries' diversification of business into corporate issuers' consultancy. Hence they may not suffer as extensively from the issuer-pays influence that affect CRAs, which may result in ratings inflation.[34] That said, regulating ESG infomediaries may be justified. One, the market structures for ESG infomediaries have changed of late, as specialist providers have been merged with or acquired by large and influential firms such as stock exchanges, index providers and investment firms. Hence, self-regulation in this market may be affected by changes in bargaining power which now require regulatory scrutiny. Second, as many of these large and influential companies are subject to regulation in respect of their other business lines, such as the provision of credit ratings, benchmarks or investment firm business, there may be a gap which can be susceptible to regulatory arbitrage if the business of ESG infomediation is left unregulated. Finally, ESG infomediaries, like other infomediaries, suffer from conflicts of interests even if they are not exactly the same types, and regulation that secures the independent qualities of ratings may be warranted.

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[28] Corporate Sustainability Disclosure Regulation 2023.
[29] UK's imposition of TCFD reporting on listed companies, FCA Handbook LR 9.8.6.
[30] Ibid.
[31] 'ESMA identifies shortcomings in 'immature' ESG ratings market' (Global Investor, Euromoney, 27 June 2022).
[32] Harry McVea, 'Credit Rating Agencies, The Subprime Mortgage Debacle and Global Governance: The EU Strikes Back' (2010) 59 International and Comparative Law Quarterly 701, critically see Iris H-Y Chiu, "Regulatory Governance of Credit Rating Agencies in the EU: The Perils of Pursuing the Holy Grail of Rating Accuracy" (2013) European Journal of Risk and Regulation 199.
[33] Raquel Garcia Alcubilla and Javier Ruiz del Pozo, *Credit Rating Agencies on the Watch List: Analysis of European Regulation* (Oxford: Oxford University Press, 2012); Andreas Kruck, *Private Ratings, Public Regulations: Credit Rating Agencies and Global Financial Governance* (Basingstoke: Palgrave Macmillan 2011), ch5.
[34] Benjamin J Kormos, 'Quis Custodiet Ipsos Custodes? Revisiting Rating Agency Regulation' (2008) 4 International Business Law Journal 569; Andrew Johnston, 'Corporate Governance is the Problem, not the Solution: A Critical Appraisal of the European Regulation on Credit Rating Agencies' (2011) 11 Journal of Corporate Law Studies 395; Chester Spatt, 'Ratings Shopping and Asset Complexity: A Theory of Ratings Inflation' (2009) 56 Journal of Monetary Economics 696 on ratings shopping exacerbating the issuer-pays influence.

B. Stock market benchmarks as ESG infomediation?

Next, we turn to stock market benchmark developers who curate indices that include what they regard as 'ESG', sustainable or green stocks, so that investors who wish to invest passively according to said themes can basically follow the index strategy and curate portfolio holdings matching with the index selection. In this manner, stock market benchmark, or index providers, are a form of ESG infomediary, as they analyse and intermediate issuer information, although they may also subscribe to other ESG infomediaries' products. Stock market benchmarks are essential to the market for passive investing, which has grown exponentially as a global phenomenon.[35]

Passively tracking a diversified portfolio of stocks (selected by benchmark/index providers) that adhere to certain performance track records or upfront themes, is a popular and less expensive form of collective investing. In this manner, the ESG stock market benchmark/index developer is not only an ESG infomediary offering an infomediation product at the upstream to investment funds and asset managers.[36] Its influence is more pronounced on the investment sector than ESG infomediaries in the first business model discussed. Index adoption directly steers capital flows to issuers included in the benchmarks,[37] automating a form of user reliance on the benchmark developer's ESG assessment of issuers. Widespread adoption of a stock market index or benchmark produces significant market effects. However, stock market benchmark developers are regulated under the EU Benchmarks Regulation 2016.

Arguably, the inclusion of ESG stock market benchmarks in the Benchmarks regulation is not preferable to their inclusion in the ESG infomediary regulation. This argument is made with hindsight as the Benchmarks regulation predates the ESG infomediary regulation. However, the lack of good fit between stock market benchmarks generally and the Benchmarks regulation, which focuses on other financial benchmarks for contracts such as interest rate benchmarks, should re-open this question of regulatory categorisation. It may however be argued that, even if the migration of ESG stock market benchmarks to the ESG infomediary regulation takes place, other stock market benchmarks cannot be so caught. Hence, there is scope for the Benchmarks regulation to address its governance thinking for stock market benchmarks more generally, and the issue of regulatory categorisation may still be far from straight forward.

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[35] 'Global passive equity funds' assets eclipsed active in 2023 for first time' (Reuters, 1 Feb 2024), https://www.reuters.com/markets/us/global-markets-funds-passive-2024-02-01/#:~:text=The%20SPDR%20S%26P%20500%20ETF,billion%20and%20%2424.79%20billion%2C%20respectively.

[36] Stock market index providers are treated as part of the ESG data and information providers sector analysed in IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers* (Final Report, Nov 2021).

[37] Tom Nangle, 'The hidden power of index providers' (Financial Times, 9 April 2024), https://www.ft.com/content/badb4ac9-eafe-4963-8406-4ede5cfa878d.

In any case, the Benchmarks regulation caters primarily for interest rate benchmarks, after the interest rate benchmark manipulation scandals involving LIBOR and EURIBOR.[38] Many conduct rules for benchmark administrators were introduced to safeguard future credibility of the financial benchmarks that financial instruments would reference. In that manner, stock market benchmarks were included as an afterthought for conceptual comprehensiveness. Nevertheless, the case is not clear from the Preambles why their inclusion produces desirable functional regulatory consistency. Indeed the nature of affected financial benchmarks which underlie debt-based instruments can be distinguished from stock market benchmarks which serve the equity investment market.

Stock market benchmarks are relatively lightly regulated in the Benchmarks regulation. The regulation for conflict of interest management and rating methodologies match with the CRAs and ESG infomediary regulations[39] though less demanding in places.[40] Stock market benchmarks are not captured within the Regulation's most demanding provisions that apply to 'significant benchmarks'.[41]

Significant benchmarks are defined as being used as reference for financial instruments worth at least 50bn euros, with 'critical' benchmarks having a threshold of ten times that figure. These pertain more to interest rate benchmarks referenced by significant volumes of debt instruments. Many stock market indices are not referenced by such volumes of assets under management. For example the popular Blackrock ishares MSCI ESG screened fund references the MSCI ESG index, and has about USD$2bn in assets under management. Even if this MSCI index is referenced elsewhere, it is unlikely that a 50bn euros threshold may be reached in the EU. Hence, most stock market benchmarks would be exempt from a significant number of organisational and conduct obligations in the Regulation.

However, it seems incongruent ESG benchmark developers, whose indices/benchmarks can entail extensive user reliance and market allocation effects, should be subject to less demanding forms of organisational governance, control, and conflicts of interest management than that applying to ESG infomediaries supplying to active fund managers under the ESG infomediary regulation.

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[38] The London Inter-bank offered rate and European Inter-bank offered rate are aggregate interest rate benchmarks maintained as private goods, but are referenced by debt instruments where interest rates are variable. Scandals discussed in "LIBOR Manipulation: Done for you, Big Boy", Financial Times (27 June 2012); Martin Wheatley, The Wheatley Review of LIBOR (Sep 2012); 'Interest rate 'rigging' evidence 'covered up' by banks' (BBC News, 22 May 2023), https://www.bbc.co.uk/news/business-65635243; R Herrera, F Climent, A Momparler & P Carmona,' Can Euribor be Fixed?' 34 Economic Research-Ekonomska Istraživanja 2833–2852 (2021), https://doi.org/10.1080/1331677X.2020.1844029.
[39] Sections III and IV.
[40] ibid 3.
[41] Art 26.

It may be argued that the ESG infomediary regulation provides for mandatory separation of benchmark and ESG infomediation business,[42] therefore distinguishing the two and reconciling with the applications of two regulatory regimes to these businesses respectively. This is not a satisfactory position in view of functional regulatory consistency. The two business models perform similar issuer-level analytical processes, and serve the investment management sector although they feed into different dominant investment strategies offered by investment funds. Despite that difference, the similar nature of user reliance, coupled with the same problem users face regarding the opacity under which ESG infomediation is carried out, should warrant the same regulatory treatment relating to user risks. User reliance is more pronounced in relation to passive investment managers' adoption of certain stock market benchmarks. In that regard, a case can be made that not only should ESG stock market benchmark developers fall within the scope of ESG infomediation regulation but enhanced regulatory standards should indeed be considered for them to improve accountability to users.[43]

C. ESG Investment Fund Raters

The third business model in ESG infomediation is that of evaluation of investment funds. ESG, sustainably or green-themed investment funds can be rated, and fund ratings may be directly relied upon as shorthand guidance for institutional and retail investors considering their allocations.

The fund ratings industry has developed since the 1990s, with Morningstar being the most dominantly relied upon.[44] These fund ratings, such as provided by Morningstar, Lippers or Zacks, started out as being focused on historical financial performance[45] and provide useful shorthand information for investors considering their allocations, although past performance does not have necessarily have predictive power. Empirical research shows that fund ratings significantly affect inflows.[46] Fund rating services such as Morningstar and MSCI have now expanded into rating ESG-labelled funds, and ride upon their reputation in the marketplace for conventional fund ratings. Empirical

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[42] Art 15, unless special dispensation is obtained from ESMA the regulator.
[43] Gargantini and Siri (2022).
[44] Eg Morningstar, *The Morningstar Rating for Funds* (Aug 2021), mentioning the inception of the fund rating methodology based on past financial performance since 1985. The dominance of Morningstar ratings, see Andreas Oehler et al. "Do Mutual Fund Ratings Provide Valuable Information for Retail Investors?" (2018) 35 Studies in Economics and Finance 137-152. doi:https://doi.org/10.1108/SEF-05-2017-0120.
[45] Oehler et al (2018).
[46] W.J. Armstrong, E. Genc, M. Verbeek, 'Going for Gold: An Analysis of Morningstar Analyst Ratings' (2019) 65 Management Science 2310-2327; D. Del Guercio, P.A. Tkac, 'Star Power: The Effect of Morningstar Ratings on Mutual Fund Flow' (2008) 43 Journal of Financial and Quantitative Analysis 907-936; Dawei Fang, Martin Holmen, Taylan Mavruk, 'Meeting Dawei Fang, Martin Holmen, Taylan Mavruk, Meeting New Peers: The Effects f Morningstar Category Reassignment on Fund Flows and Star Ratings' (2021) 77 International Review of Financial Analysis 101842, https://doi.org/10.1016/j.irfa.2021.101842.

research shows that Morningstar sustainability ratings, for example, affect ESG fund inflows.[47] There seem high levels of market reliance on them, even if the financial performance of highly-rated ESG funds may not be statistically different from conventional funds.[48]

In this manner, fund ratings are more like credit ratings in relation to attracting investors' mechanistic reliance, although regulators do not endorse such reliance. The risks of financial misallocation relying on flawed ratings can be high. Fund ratings are awarded at the portfolio level, and as Morningstar puts it, are 'a straight-forward' roll up[49] of the ESG ratings and scores for portfolio companies (at issuer-level). There are arguably a number of hazards in relation to investor reliance on portfolio -level ESG ratings. First, portfolio-level ESG ratings are derived from underlying ESG ratings for corporate issuers, and they potentially obscure investors from interrogating the differences between these underlying ratings and other market choices. For example, Morningstar fund ratings are derived from Sustainalytics' ESG ratings for issuers, as Sustainanalytics has since been acquired by Morningstar. Investors who are inclined to rely at the meta-level on portfolio ratings would risk not applying their minds to compare Sustainalytics' products to other issuer ratings. Second, it is uncertain what a 'straight-forward' roll-up means as aggregations and trade-offs of portfolio companies' individual ratings must have taken place. Such methodology seems opaque and need explaining. Third, as empirical research has found that conventional funds rated with the same Morningstar gold medals in their peer category are not equally efficient,[50] it may be surmised that sustainability ratings could produce the same effect, i.e. portfolios rated with the same number of globes may not necessarily mean the same thing. Finally, investors cannot easily tell to what extent portfolio-level ratings are independent, as empirical research has found correlations between Morningstar fund ratings and external fund certifications,[51] as well as causal interdependences amongst different ESG fund ratings providers.[52]

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[47] Febriani (2023); S.M. Hartzmark, A.B. Sussman, 'Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows' (2019) 74 Journal of Finance 2789-2837.
[48] Marie Steen, Julian Taghawi Moussawi &Ole Gjolberg, 'Is There a Relationship Between Morningstar's ESG Ratings and Mutual Fund Performance?' (2020) 10 Journal of Sustainable Finance and Investment 349.
[49] Morningstar, 'Understanding Morningstar's Fund Ratings' (undated), https://www.morningstar.co.uk/static/UploadManager/Assets/Morningstar_Ratings_Infographic_2023.pdf.
[50] D. K. Malhotra, Rashmi Malhotra, Robert L. Nydick, 'Are All Gold Medal Mutual Funds Equally Efficient?' in KD Lawrence and DR Pai (Eds.), *Applications of Management Science* (Vol. 21, Emerald Publishing Limited, Leeds, 13-26), https://doi-org.libproxy.ucl.ac.uk/10.1108/S0276-897620220000021002.
[51] Sofia Brito-Ramos, Maria Céu Cortez, and Florinda Silva, 'Do Sustainability Signals Diverge? An Analysis of Labeling Schemes for Socially Responsible Investments' (2023) Business and Society 1-46.
[52] Pornanong Budsaratragoon, "Fund Ratings of Socially Responsible Investing (SRI) Funds: A Precautionary Note." (2021) 13 Sustainability 7548, doi:https://doi.org/10.3390/su13147548.

In this manner, ESG fund evaluaters perform similar analytical processes in relation to issuer level ESG information and apply aggregate methodologies at portfolio level. They also serve a similar user base to the other two business models discussed, and give rise to more pronounced user risks in terms of their opaque analytical and aggregation methodologies. The fact that users more mechanistically rely on shorthand fund rating information to allocate inflows heightens the governance need for this business model. Arguably, the ESG infomediary regulation includes ESG fund evaluaters as the definition of 'ESG rating' covers rating of financial instruments and products, not just issuers.[53] However, the regulatory provisions inadequately provide for ESG fund evaluaters, being more focused on ESG infomediaries working at issuer level. These are discussed in Section IV below. The failure to distinguish between the business models, market structures and market relations between these industries has led to an under-inclusive adoption of functional regulatory consistency.

In sum, the article argues that all three business models should be explicitly captured within the 2024 Regulation's scope, and finer distinctions for their governance can be further made, discussed in the Sections below. This would address the discrepant gaps in regulating stock market benchmark developers, and the lacunae in appropriate governance of ESG fund evaluaters.

III. Perils of Pursuing Functional Regulatory Consistency I- Regulating Infomediaries' Methodological Standards

Where infomediaries' outputs, as market goods, have suffered credibility damage, EU policy-makers have decided to address such failures by setting regulatory standards for infomediaries' methodologies. Regulating methodological quality can better underpin trust in infomediation products. Such restoration of trust can be seen as a basic condition to return markets to effective outworking and providing choice. In this manner, functional regulatory consistency underpins the regulation of all financial sector infomediaries, and the ESG infomediary regulation has drawn upon earlier regulation for CRAs and benchmarks.

ESG infomediaries are subject to two cross-cutting regulatory tenets in methodological regulation, derived from earlier antecedents.

A. Information Diligence

The first regulatory tenet deals with information diligence on the part of infomediaries, as a necessary condition to their performance.

The 2024 Regulation requires procedures to be set up in order to collate and analyse information effectively, ie 'to implement written policies and procedures to ensure that

[53] Art 3(2), (7).

they are able to engage in a thorough analysis of relevant information'[54] as well as to 'to implement internal due diligence policies and procedures in order to protect the independence and accuracy of their ratings.'[55] It is not explicitly stated what the due diligence means in this rather broad framing. It can relate to taking stock of all possible conflicts of interest situations that may taint the independence or accuracy of ratings. It can also mean undertaking due diligence of all potentially relevant sources of input for ESG ratings. This would support the requirement for ESG infomediaries to carry out thorough analysis of all relevant information. This diligence enumeration is broadly consistent with the regulation of CRAs. The functional regulatory consistency in adopting diligence governance for infomediaries is meaningful, as information richness, diversity and comprehensiveness underlie analytical credibility. In this regard, it is arguably unjustified for stock market benchmark/index developers not to be subject to the diligence tenet, not articulated for them in the Benchmarks regulation. Precise information governance in the Benchmarks regulation only relates to the input and information required for interest rate benchmarks to the neglect of stock market benchmarks.[56]

Next, the ESG infomediary regulation contains procedural regulation for information processing systems which, in light of modern developments in increasing sophistication of information processing systems, such as big data analytics and machine learning,[57] should be made consistent for the infomediation industry more broadly. Under the Regulation, ESG infomediaries need to implement 'sound administrative and accounting procedures, internal control mechanisms, and effective control and safeguard arrangements for information processing systems'.[58] It is uncertain what information processing systems mean, and this could refer to the body of frameworks involving both humans and machines in terms of collecting, filtering/selecting, analysing and making findings regarding information inputs. This provision is neither drawn from the CRAs or Benchmarks regulations, and may be a modernised take on the increasing sophistication of information processing systems. In light of changes across the infomediation industry in terms of new operational models for information processing, functional regulatory consistency can be usefully considered for antecedent legislation benefiting from newer governance insights.

The diligence provisions, as well as governance of information processing systems are open-textured in nature. They are in the vein of 'new governance' regulatory designs. 'New governance' regulatory designs refer to an umbrella of regulatory approaches

[54] Art 14(4).
[55] Art 14(11).
[56] Art 12(2); 16(1)(a) and Commission delegated Regulation 2018/1639.
[57] For example see Clarity.AI which prides its business model as based on machine learning analytics for ESG infomediation.
[58] Art 14(6).

including process-based or procedural regulation[59] and meta-regulation.[60] Procedural regulation[61] co-opts firms to design the appropriate procedures and systems for regulatory implementation, as would suit each firm's structures and capacity to meet regulatory outcomes. As regulators cannot micro-manage firms' implementation, new governance regulatory designs set out broad contours leaving flexibility for firms to carry out the necessary implementation, allowing firms and their managers to take responsibility to embed such compliance in the firm.[62] In this manner, open-textured forms of procedural regulation such as diligence and managing information processing systems are not precise in terms of how legal risk can be managed. Functional regulatory consistency across the infomediation industry helps firms to forge best practices consistently for and across their business lines. Functional regulatory consistency also directs regulators' supervision and enforcement towards clearer and consistent expectations for the industry.

B. Methodological Regulation

The second regulatory tenet underpinning infomediation credibility is the adherence to certain methodological standards to generate infomediation products. The methodological standards regulators have articulated for CRAs, benchmark developers and ESG infomediaries have attained some convergence but there are also differences. The plethora of methodological standards is unfortunately not well-explained nor supported by enforcement jurisprudence. This is an area where the substantive weaknesses of these standards[63] in the earliest CRAs regulation have been replicated due to suboptimal functional regulatory consistency, serving only to sharpen the incongruence of application across different infomediation businesses.

Amongst a plethora of open-textured adjectives applying to infomediaries' methodologies, the convergent methodological standards for CRAs,[64] benchmark administrators[65] and ESG infomediaries[66] are the qualities of being 'rigorous', 'systematic' and 'continuous'. These also reflect IOSCO's recommendations,[67] which have set similar international standards for CRAs.[68] These terms have attained a status of 'gold standard' for methodological quality.

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[59] Cary Coglianese and David Lazer, "Management-Based Regulation: Prescribing Private Management to Achieve Public Goals" (2003) 37 Law and Society Review 691.
[60] Sharon Gilad, "It Runs in the Family: Meta-regulation and its Siblings" (2010) 4 Regulation and Governance 485; Christine Parker, *The Open Corporation* (Cambridge: Cambridge University Press 2000).
[61] Note60.
[62] Orly Lobel, 'Setting the Agenda for New Governance Research' (2004) Minnesota Law Review 665.
[63] Chiu (2013).
[64] Art 8.
[65] Art 12.
[66] Art 14(4), (7), EU compromise text 2024.
[67] IOSCO (2021), Recommendation 1.
[68] IOSCO, Code of Conduct Fundamentals for Credit Rating Agencies (2014), para 1.1, Appendix A.

However, it remains unclear how the apparent consistency can be useful for the three types of ESG infomediaries discussed. The methodological standards required may be ill-fitting for the nature of ESG evaluations. Further, the methodological standards risk being inappropriate as they may not be able to accommodate 'good variances'[69] in ESG evaluation methodologies. Such regulation would not make it any clearer for the users of ESG infomediaries' products how to exercise their market choice.

First, the methodological standards of being 'rigorous', 'systematic' and continuous' are unpacked in the Commission delegated regulation for CRAs,[70] applying to the measurement of 'credit worthiness',[71] which is the probability of borrower default concerning a debt financial instrument. For example, rigour includes comprehensiveness in considering all 'driving factors' of credit worthiness; using reliable and relevant models for analysing these driving factors; ensuring the use of such models is sensitive to relevant risk factors; explainability in relation to each qualitative and quantitative factor considered and that the analytical framework is robustly controlled and approved within the credit rating agency.[72] The elements of 'rigour' are specific to the needs of measuring credit worthiness. For ESG infomediaries, we are unclear as to *what* is being measured in relation to issuers, as well as at portfolio level.

ESG infomediaries working at issuer level (including for the purposes of stock market benchmark inclusion or exclusion) and at portfolio level could be measuring single or double materiality. Single materiality refers to the importance of an E, S or G factor to corporations' financial risk. At portfolio-level, such single materiality measurements are 'rolled up' in order to assess how ESG risks are in aggregate accounted for by portfolio companies as a whole. Double materiality has become a leading policy in the EU,[73] and this is meant to measure how corporations' activities impact upon environment, society and good governance, a very different concept from single materiality.[74]

Within the scope of single materiality, each E, S or G evaluation is a composite of various possible indicators. These indicators may affect financial risk in contradictory ways. For example, how would a corporation with low GHG emissions but poor performance with water conservation for example, score in its E measurement in relation to single materiality? For double materiality, it is not just the composite nature

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[69] Kim (2023).
[70] Commission delegated regulation 447/2012.
[71] Art 3, ibid.
[72] Art 4, ibid.
[73] 'The Challenge of Double Materiality' (Deloitte, undated), https://www2.deloitte.com/cn/en/pages/hot-topics/topics/climate-and-sustainability/dcca/thought-leadership/the-challenge-of-double-materiality.html, referring to both corporate reporting and conceptions of investment in sustainable finance.
[74] Andreas Engbert, 'ESG Ratings: Guiding a Movement in Search of Itself' (2023), https://www.ecgi.global/sites/default/files/working_papers/documents/esg.pdf.

of E, S and G that makes it difficult to measure. There can be differences in terms of what level of abstraction we choose to measure double materiality. For example, measurements for S can be carried out in narrow or broad manners, such as the level of diverse representation on corporate Boards (i.e precise) to levels of employee 'happiness' or 'well-being' (ie abstract). Hence, even if the Regulation mandates that ESG infomediaries must separate E, S and G scores,[75] there is still a relative lack of precision as to what is being measured compared to the more specific evaluation of creditworthiness. At the aggregate level, which is the bundling of E, S and G indicators for an aggregate score, often offered by ESG infomediaries working at the issuer level, what is sought to be measured embeds opaque reconciliations and tradeoffs which may be subjective and difficult to standardise. Aggregate scores are also of fundamental importance for ESG infomediaries working at the portfolio level, as evaluations at portfolio level are derived from portfolio companies and an aggregated shorthand would be easier to work with than many separate granular scores.

In this manner, requiring there to be rigour in applying ESG methodologies may be an impossible regulatory expectation in terms of how 'all driving factors' and comprehensiveness can be achieved in essentially a selective form of conceptualisation for what E, S and G are, and what an aggregate of them means.[76] Arguably, the expectations of rigour can more clearly fasten on a subject whose evaluation is susceptible to well-accepted norms for measurement and analysis. The conceptualisation of ESG evaluation can be subjective and debatable. This is an area where users may benefit from ESG infomediaries' different offerings of conceptualisations and definitions. Regulation's role may be to make these market choices clearer. In time, best practices or optimal conceptualisations can emerge which can then be standardised in regulation, but the time seems not yet arrived.

Regulating ESG infomediaries' methodologies to conform to certain expectations of 'rigour' or being 'systematic' (see below) could be incompatible with or stifle 'good variance' in ESG infomediaries' output. The main complaint users have, in relation to ESG infomediaries' products for issuers, including different ESG-themed stock market benchmarks, is variance and low correlations.[77] Variance are as a result of E, S and G evaluations and aggregated measurements being carried out differently amongst different providers- due to the selectivity of indicators, plurality in terms of qualitative or quantitative evaluations, explained or unexplained reconciliations in weightings or

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[75] Art 21(1a), EU compromise text.
[76] Attila Jámbor and Anett Zanócz, 'The Diversity of Environmental, Social, and Governance Aspects in Sustainability: A Systematic Literature Review' (2023) 15 Sustainability 13958.
[77] Lucy Pérez, Vivian Hunt, Hamid Samandari,; Robin Nuttall and Krysta Biniek, 'Does ESG Really Matter and Why' (McKinsey Quarterly, 10 Aug 2022), https://www.mckinsey.com/business-functions/sustainability/our-insights/does-esgreally-matter-and-why.

aggregation. Kim[78] however argues that there is 'good' and 'bad' variance amongst ESG infomediaries' output. Good variance relates to deliberate differences made in the infomediary's methodological choices, which offer particular perspectives for certain market participants. These need not be standardised to be comparable, and are part of a market offering a menu of choices for investment analysis and research. These deliberate differences can cater for different investors' objectives.

Whether it is for single or double materiality, different E, S and G factors attract different quantitative or qualitative indicators whose measurement methods may not be comparable or internally consistent. Some indicators are susceptible to more quantitative than qualitative methods of measurement, and vice versa, or a hybrid of them may be needed.[79] Quantitative methodologies may depend on historical data and correlations, while qualitative methodologies may rely on social perceptions, reputation and may be more forward-looking. As ESG infomediaries may give different weights to different factors and indicators, and also balance and reconcile them in different ways, based on their values and conceptualisations, they offer investors different perspectives of corporate issuers. Investors can benefit from such good variances in a market for choice as long as differences are made clear and how these serve investors' objectives. It is not necessary that ESG evaluations be standardised by regulatory fiat, as dynamic perspectives and methodological measurements can be prematurely stifled. Clear signposting of 'good variances' is also crucially important for ESG infomediaries working at portfolio level so that investors can choose whether to rely on their portfolio-level outputs or indeed carry out more issuer-level investigations themselves.

In light of the value of good variances, what is the value-added to regulatory governance in applying the 'systematic' and 'continuous' standards to ESG rating methodologies? Although users of ESG ratings would like comparability between rankings, and methodological consistency arguably underpins credible comparisons, it is likely more important to require ESG rating providers to explain clearly what is being measured across a selected cohort, the purpose and criteria for their selection and the application of analyses and evaluations. In this manner investors can decide if those selections/groupings for comparison are meaningful for their portfolio or allocation decisions. The qualitative standards regarding being systematic and continuous assume that the categories of subjects to be evaluated are relatively clear and established, and this may be the case for credit ratings. But where such an assumption cannot be made, in the case of ESG ratings, what is important to investors is the rationalised and explained selection of a category or grouping of comparable issuers. The methodologies adopted must then be appropriate to the grouping selected. Such

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[78] Kim (2023).
[79] Halper et al (2023).

methodologies may also be innovative, developing and subject to adjustment, so their responsiveness to change must not be curtailed by the fears of legal risk regarding what 'systematic' or 'continuous' may mean. Hence, on balance, these terms may be more counterproductive than effective in regulating ESG infomediaries' methodological quality.

In sum, the apparently gold standards of cross-cutting methodological regulation are likely uncertain and unclear in what they mean. It seems undue to create and impose such unclear forms of legal risk on ESG infomediaries. These standards have also not been subject to substantive fleshing out by jurisprudence in enforcement actions for CRAs or benchmarks.

Where CRAs are concerned, ESMA the pan-European regulator has issued a number of enforcement actions against both large and smaller CRAs, but many of these enforcement actions focus on failures of internal governance and control in relation to conflicts of interest management that can affect rating integrity. ESMA fined Moody's in relation to the failure to disclose and manage potential conflicts of interest regarding a threshold shareholder in Moody's parent company and in companies rated by Moody's jurisdictional subsidiaries.[80] Further, Scope was fined in relation to failure to manage conflicts of interest in relation to multiple business lines and a key individual's relationship with the rated entity, Greensill, which has now become bankrupt.[81] Framing a regulatory enforcement case upon methodological failure is not easy except in the clearest of cases where errors are obvious. Where S&P had carelessly released ratings prematurely, before issuers' offer of securities, it was fined for a general failure in internal control and governance.[82] Regulators would likely establish more convincing cases on failures of procedures where evidence would be clear. The scope for debate regarding the interpretation of rigour, being systematic or continuous in methodology would likely make regulators' cases unclear and expensive to prosecute. In this way, these methodological standards are difficult to enforce, and may be seen as aspirational articulations, rhetorically reassuring but arguably lacking in substantive effect in terms of supervisory and enforcement governance.

The adoption of functional regulatory consistency can obscure what appropriate methodological regulation for ESG infomediaries should be. What is needed for the market is that distinctions amongst choice are made more clearly discernible to users,

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[80] ESMA, *Public Notice against Moody's* (23 March 2021), https://www.esma.europa.eu/sites/default/files/library/esma41-356-168_public_notices_moodys_uk_de_es_fr_it.pdf.
[81] ESMA, *Public Notice against Scope* (22 March 2024), https://www.esma.europa.eu/sites/default/files/2024-03/ESMA43-1868696574-745_Public_Notice_Scope_Ratings_fine.pdf.
[82] ESMA, *Public Notice against S&P Global Ratings* (22 March 2024), https://www.esma.europa.eu/sites/default/files/2023-03/ESMA43-475-60_Public_Notice_-_S%26P_Global_Ratings_Europe_Limited.pdf.

so that they can exercise market choice to suit their investment mandates and strategies.

C. *Proposal for Reform: Standard of Explainability in Methodological Regulation*

Gargantini and Siri support a more thorough disclosure-based regulation for ESG infomediaries[83] to support users' market for choice. Without supporting too much reliance on lengthy disclosure, which can make users suffer from information overload, this article argues that rating methodologies should be subject to a standard of explainability, and pre-contractual disclosure should be made to users to demonstrate how the standard is met, in a succinct and comprehensible manner.

The standard of explainability would require ESG infomediaries to make users informed of what key features there are, or what 'stands out as being different or unique' in relation to their methodologies. These can relate to whether they evaluate single or double materiality, and in relation to which E, S and G factors which can be drawn from internationally well-accepted lists such as the GRI's[84] or ISSB's.[85] These can also relate to their selection criteria for input sources and how inferences from information are made. Depending on the intensity of competition in the infomediation market, the explainability of an ESG infomediary's methodology can also relate to the key quantitative or qualitative analytical methods used, weighting and scoring methods, aggregation methods, sectoral approaches, time horizon of application and orientation, whether backward or forward-looking. ESG infomediaries should also clearly state whether they evaluate at issuer or portfolio levels and the extent of methodological similarity.

The proposal above would mitigate the overkill of methodological regulation in the 2024 text. It reflects the unique state of the ESG infomediation market, ultimately aimed at empowering sophisticated users to determine which ESG infomediaries' output may meet their investment needs.

Further, the above standard of explainability would mitigate the lack of clarity in existing methodological regulation for stock market benchmarks, which are subject to a plethora of different qualitative standards. The methodological requirements include 'robustness', 'reliability;, 'rigour', 'continuity', 'validation by back-testing', 'resilience', 'traceability', 'verifiability', and having clear rules where discretion is exercised.[86] These

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[83] (2023).

[84] The GRI Universal Standards identify salient E, S and G indicators for corporations to report against, and these are further refined by sector under the Sectoral Standards, see https://www.globalreporting.org/standards/.

[85] The ISSB's sustainability disclosure standards relate to lists of sustainability items and climate related items that affect issuers' financial risk, ie single materiality, IFRS S1 and IFRS S2, https://www.ifrs.org/projects/completed-projects/2023/general-sustainability-related-disclosures/.

[86] Art 12(1).

are not further unpacked in Commission delegated legislation, which also means that the CRA exposition of similar standards such as rigour or continuity cannot necessarily apply to benchmark developers. Further, there is no enforcement jurisprudence to clarify these terms. Benchmark developers are not supervised by ESMA but by relevant national regulators. The major national regulators for investment funds marketed in the EU, many of which may be referenced to stock market benchmarks, are the Irish and Luxembourg regulators. There is no known supervisory or enforcement action taken by these regulators against stock market index providers, whether the index is conventional or ESG-themed. Further, enforcement actions that allege the lack of methodological credibility of a stock market benchmark can implicate many investment funds and asset managers, causing disruptions in terms of reallocations or disruptions to investor confidence and sentiment. Given the needs of financial stability and national regulators' interest in maintaining confidence in their jurisdictions, there would be a lack of incentive to actually enforce these provisions.

The lack of clarity in the above qualitative terms does not clearly address how users' risks are governed in relation to ESG stock market benchmark developers. We argue that these are inferior to the standard of explainability as a cross-cutting methodological standard that could apply to stock market benchmark developers. As discussed, ESG stock market benchmark/index developers perform their own analytics to exercise discretion whether to include or exclude issuers from certain benchmarks/indices. Passive investors adhering to the benchmarks/indices would direct their allocations accordingly. Users' risk lie in misallocation, if trust in the qualities signalled by the benchmark is misplaced. As there is a market for choice in terms of selecting indices/benchmarks to adhere to, passive investment managers can decide whom to trust if the level of explainability for benchmark curation is optimal. The above standard of explainability can require benchmark providers to explain what makes their curation methodologies different, and how these methodologies deliver credibility to the label they use. Governing ESG stock market benchmark developers by the standard of explainability is more meaningful for users in exercising their market choice, than by the plethora of unexplained qualitative terms listed above.

IV. Perils of Pursuing Functional Regulatory Consistency II- Conflict of Interest Regulation

Another cross-cutting theme for regulating infomediaries is to provide market confidence in how infomediation products have been generated. As infomediaries' conflicts of interest may damage the veracity of their products, a regulatory approach across infomediaries is to address their conflict of interest management. CRAs' inflated ratings for structured finance products which contributed to the global financial crisis 2008 were attributed to CRAs' issuer-pays model and conflicts of interest with other

issuer-focused business lines.[87] Conflicts of interest also underpinned flawed interest rate data submitted to interest rate benchmark administrators, although such conflicts affected data submitters and not benchmark administrators as such.

In this manner, the CRAs Regulation sets the standard for infomediaries' outputs to be *independent,* as this quality, free from political or other economic interference, promotes market choice and confidence. To this end, regulation can adopt precise forms of organisational and personnel regulation in order to demonstrate achievement of rating *independence.* The CRAs regulation governs CRAs' conflicts of interest management in three internal aspects and an externally-facing aspect. The internal aspects relate to: business lines, organisational structures and individual incentives. The externally-facing aspect relates to CRAs' crucial relations with issuers who commission them. These regulatory designs now shape subsequent infomediary regulation. ESG infomediary regulation addresses similar internal and externally-facing aspects, but a lesser extent is observed in the Benchmarks regulation applying to ESG stock market benchmarks. Even if the condition of *independence* is an optimal form of governance that should be functionally consistent across infomediaries, the more granular details on how these aspects should be designed could differ amongst infomediaries due to differences in their business models, market structures or market relations.

A. Separation of Business Lines

Infomediaries generally have diverse business lines in analytical, consultancy, business, regulatory solutions etc. The Regulations for CRAs[88] and ESG infomediaries'[89] converge on requiring separation of business. The benchmarks regulation also requires separation of business for significant benchmark developers, but where the benchmark is not significant,[90] business separation is not required. This is arguably a regulatory gap missing the benefits of functional regulatory consistency. Even if ESG stock market benchmarks are not likely significant within the meaning of the Benchmarks regulation, the risk to users may be mitigated if benchmark developers are less likely affected by conflicts of interest which may emanate from the multiple lines of business that stock market benchmark developers engage in. Many ESG stock market benchmark developers are large firms/groups such as S & P, Moody's or MSCI, engaging in multiple lines of business and are larger and more powerful than independent or boutique ESG infomediaries.

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[87] Lynn Bai, 'On Regulating Conflicts of Interests in the Credit Rating Industry' (2010) 13 New York University Journal of Legislation and Public Policy 253; Johnston (2011).
[88] Provision 4, Section B, Annex I.
[89] Art 15, EU compromise text.
[90] Art 4(2) and 26, Regulation 2016/1011.

Further, the ESG infomediation regulation misses a trick in relation to separation of business between different ESG infomediation business models that may be carried out by the same firm or group, as the Regulation only focuses on separation of business from non-ESG infomediation business. There is arguably a case for separation of business between ESG infomediation businesses at issuer and portfolio levels. Where an ESG infomediary at portfolio level sources ESG infomediation output at issuer levels, such business relationships can be affected by conflicts of interest such as common ownership of both businesses. Morningstar's ESG fund evaluation business is closely related to Sustainalytics' ESG infomediation outputs at issuer level as the former has now acquired the latter. This gap is not identified in the 2024 Regulation due to the lack of differentiating between ESG infomediaries working at issuer and portfolio levels, which is a distinguishing feature in terms of market structure that seems to have eluded policy-makers.

B. Organisational and Personnel Regulation for Conflicts of Interest Management

There is significant convergence between the organisational regulation for ESG infomediaries and CRAs, reflecting the dividends of functional regulatory consistency. CRAs are regulated to establish internal control policies, independent appointments at the board level for corporate governance; an oversight/compliance function; and are subject to scrutiny in terms of threshold shareholding and the prohibition from rating such shareholders who may be corporate issuers themselves.[91] The ESG infomediary Regulation features useful similarities in terms of internal control policies, the oversight function as well as preventing cross-ownership from exerting undue influence upon the production of ESG infomediation outputs,[92] therefore protecting the independent quality of outputs.

On managing individual incentives where conflicts of interest are experienced by personnel, the convergence between the CRA and ESG infomediary regulation also reflects dividends from functional regulatory consistency. These similar rules[93] deal with staff's financial interest such as investment interest and remuneration incentives. Rating staff are also prohibited from participating in fee negotiations and gift acceptance, and disclosure or exchange of information with rated entities. Further, the risk of the revolving door between infomediary and rated entities affecting rating judgment is addressed.

However, stock market benchmark developers are inconsistently regulated for the same purposes of managing conflicts of interest. As argued earlier, many ESG stock market benchmarks would unlikely be treated as 'significant or critical', and they would enjoy

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[91] Annex I, Regulation 1060/2009.
[92] Arts 14(10), 23, EU compromise text.
[93] Art 7 and Annex 1, Regulation 1060/2009, and art 16, EU compromise text.

the disapplication of many organisational and control regulations[94] that apply to significant or critical benchmarks (many of which relate to financial contract prices). As a result, some of the detailed conflict of interest management regulations such as controls on personnel's interests, and detailed internal control regulation such as the roles of the oversight function do not apply to non-significant benchmarks.[95] This means that ESG stock market benchmark developers would not be subject to as stringent a regime compared to other ESG infomediaries. This is arguably an incongruent position. Many ESG stock market benchmark developers are in multiple lines of business, and could incur conflicts of interests amongst their business lines, and in relation to the different users of different business lines. They may also be involved in businesses relating to non-ESG benchmarks, investment management, credit ratings etc. Existing regulatory treatment in the benchmarks regulation would only subject them to high-level regulation in terms of identifying, managing and preventing conflicts of interest where possible.[96] This is an open-textured form of new governance design that can leave firms with much implementation freedom. Although the ESG infomediary and CRAs regulations require these businesses to be separated,[97] this could still mean that a corporate group with business lines in credit ratings and stock market benchmarks would implement differently demanding conflicts of interest management between these business lines. The discrepancy may not be justifiable as the types and intensity of conflicts of interest do not seem to be vastly dissimilar.

C. Externally-facing Relations

Infomediaries maintain a range of externally-facing relations with their clients, users (who may or may not be clients) and other stakeholders as their information goods can be used in different ways. The CRAs regulation focuses intensely on CRAs' relations with their issuer clients, as this paradigm has been criticised to give rise to compromised or inflated ratings, particularly in relation to structured finance products prior to the global financial crisis.[98] However, the lessons learnt for the CRAs regulation may not apply to other infomediation contexts. Seeking functional regulatory consistency may result in over-inclusive and under-inclusive regulatory tenets for ESG infomediaries.

CRAs maintain intense relations with their issuer clients, hence this aspect is heavily regulated. ESG infomediaries do not maintain similarly intense issuer relations, and their market relations extend to a wider range of business and stakeholder constituents. Stock market benchmark developers may maintain more intense user/investor relations than with issuers, and in the market for popular stock market benchmarks, the balance

[94] Art 26, Regulation 2016/1011.
[95] exemptions from the application of parts of Art 4-7 in Art 26, ibid.
[96] Arts 4(6), 7(b).
[97] Art 15.
[98] Johnston (2011).

of power between benchmark developers and their investor customers may be unequal. Applying functional regulatory consistency, especially with CRAs, may become inappropriate if over-inclusive regulation of issuer relations is unnecessary and/or under-inclusive regulation of other market relations occurs.

The ESG infomediary regulation is too issuer-focused, perhaps because it is overly-influenced by the CRA model. The regulatory approach to issuer relations is risk averse to the potential for undue influence,[99] and policy-makers do not prefer the IOSCO recommendation which encourages ESG infomediaries to engage with issuers.[100] It is queried if this risk aversion to issuer relations is excessive, reflected in the overly cautious approach to giving issuers a limited right and timeframe to review ratings. IOSCO takes a different view as issuers are viewed as a valuable source of ESG information. Further, ESG infomediation may deal with single and/or double materiality, and the latter would almost necessarily entail infomediaries' wider research and information diligence beyond relying on issuers. In this way, ESG infomediaries may not maintain relations as intensely as CRAs do with issuers. It is however acknowledged that there are some regulatory differences specific to CRAs on personnel regulation due to the heightened risks of more intense issuer relations. As CRAs work extensively with issuers, there is a greater risk of affinity or mindset-capture on the part of staff, therefore justifying mandatory analyst rotation.[101] CRAs also need to report their largest clients and most significant sources of revenue to enable scrutiny regarding the independence of output.[102] In this manner, it can be argued that there has been sufficient distinction made from functional regulatory consistency.

The ESG infomediary regulation however neglects to adequately address ESG infomediaries' relationships with other parties and sources of input, resulting in under-inclusive regulation of other market relations in the conflict of interest management framework. This is perhaps because there is a lack of functional regulatory consistency to draw upon. In this manner, functional regulatory consistency can shape regulatory designs sub-optimally where new matters are neglected due to their absence in previous regulation. ESG infomediaries are likely to work with a range of information sources such as publicly available reports, specialist third party reports/opinions as well as issuer-supplied information, whether in generating issuer ratings or stock market benchmark inclusion/exclusion decisions. Conflicts of interest can arise in many more ways with various sources of information input. EU regulation has not sufficiently conceptualised these webs of relationships, hence there is minimal conflict of interest governance for other relations besides issuer relations.[103] These relations require

[99] Art 14(11a), EU compromise text.
[100] Recommendation 8, IOSCO (2021).
[101] Art 7, Sect C, Annex 1, Regulation 1060/2009.
[102] Provision 2, Sect B and Section E (II), Annex 1, above.
[103] Art 16(5) on prohibition of gift acceptance, art 18a on stakeholders' reasoned concerns.

different provisioning in relation to conflict of interest management. A broader scope of conflict prevention or mitigation should be framed for ESG infomediaries' staff relations with a variety of third party information suppliers and stakeholders, in order to prevent undue influence from any source, where business or financial interest may not be strictly implicated. ESG infomediaries working at issuer level should also manage their conflicts of interest appropriately across business lines that are user-pays as well as issuer-pays. Clear disclosure should also be made of which rated entities benefit from corporate consultancy and solutions provided by ESG infomediaries' diverse business lines.

Further, there is a regulatory gap in relation to conflicts of interest management for ESG infomediaries working at portfolio level. Their crucial relationships are with ESG infomediaries working at issuer-level. Their implicit endorsements of certain issuer-level information providers may not be clear to users who rely on portfolio level ratings. In considering how these relations should be subject to regulatory governance, we have earlier argued that business, or at least operational separation of these two types of ESG infomediation in the same business group may be needed. In particular, such separation could extend to separation of personnel resources, limits to personnel transfer and the erection of Chinese walls between ESG infomediation businesses that are paid for by different constituents, where the interests among them would conflict.

Finally, there is a regulatory gap in relation to the externally-facing relations for stock market benchmark developers. As the Benchmarks regulation is predominantly focused on the interest rate benchmark manipulation scandals that preceded regulatory reform, regulatory governance is targeted at benchmark submitters' relationships with benchmark developers. High level principles on conflict of interest management that apply to benchmark developers generally, including ESG stock market benchmark developers, are not precise enough to address specific issues of market relations. ESG stock market benchmark developers licence their benchmarks to asset managers for use in designing passively managed investment funds. There is a need to ascertain if such licenses meet the needs of users[104] and whether regulation can promote more accountability for user scrutiny. For example, would users be able to critically scrutinise the quality of the data they receive in relation to the veracity of the benchmark? Is the apportionment or rights and responsibilities between benchmark developers and users optimal for users to exercise market choice and discipline? The Benchmarks regulation does not govern these issues. This creates discrepant levels of regulatory governance for infomediaries' market relations and may give rise to sub-optimal regulatory gaps that

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[104] For a useful template see https://www.nortonrosefulbright.com/en/knowledge/publications/2c1fc0da/contracting-for-indices#section2.

ultimately undermine the intention of regulatory governance to address user risks in relation to the credibility and integrity of ESG information goods.

This Section shows that functional regulatory consistency can offer a useful lens to critically interrogate the regulatory standards for ESG infomediaries. The broad need to ensure infomediary independence and appropriate conflicts of interest management opens the door to drawing upon functional regulatory consistencies. However, differences in business models, market structures or market relations can provide clear bases for departing meaningfully from functional regulatory consistency in order to provide for distinguished treatment in regulatory governance where appropriate. In this way, Sections III and IV show how a nuanced application of functional regulatory consistency can offer particular insights for optimising the regulation of ESG infomediaries.

V. Conclusion

The expansion of EU regulatory governance in the financial sector since the end of the global financial crisis 2008[105] has given rise to the need to examine regulatory consistency in the volumes of financial regulation that may have cross-cutting implications. In this light, this article examines the effectiveness of the Regulation of ESG infomediaries through the lens of functional regulatory consistency with other infomediary regulations, for credit rating agencies and stock market benchmarks. It argues that particular shortcomings of the ESG infomediary regulation can be aptly interrogated through this lens.

Dividends from functional regulatory consistency can be achieved where there are similar objectives for governing infomediaries' market roles. The need for regulatory governance to ensure infomediaries' diligence and the independence of their outputs commonly underpin convergence in appropriate cross-cutting regulatory standards. In this manner, the discussion on ESG stock market benchmarks also shows dividends missed from their contestible regulatory classification as financial benchmarks, rather than as ESG infomediaries.

There are however limits to applying functional regulatory consistency where infomediaries' business models, market structures and relations have significantly different features. These limits are explored in relation to methodological regulation of ESG infomediaries as well as certain aspects of conflicts of interest management. In this manner, well-articulated distinctions in business models, market structures or

[105] Which can be regarded as the beginning of a new 'regulatory era', ch1, Mads Andenas and Iris H-Y Chiu, *The Foundations and Future of Financial Regulation* (Oxford: Routledge 2014); Eilís Ferran, Niamh Moloney, Jennifer G Hill and John C Coffee Jnr, *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge: CUP 2012).

relations provide the required bases for distinguishing regulatory treatment, justifying departure from regulatory consistency with other infomediary regulations.

There is no straightforward guidance to applying functional regulatory consistency in informing regulatory designs. However, the critique applied to the ESG infomediary regulation, and to an extent, to the Benchmarks regulation, shows how a nuanced application can take place, avoiding inappropriate over-inclusive or under-inclusive regulation.