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IOSCO GOOD SUSTAINABLE FINANCE PRACTICES

For Financial Markets Voluntary Standard Setting Bodies and Industry Associations

CALL FOR ACTION

Madrid, 7 November 2022

I. PURPOSE

IOSCO is calling upon all voluntary standard setting bodies and industry associations operating in financial markets to promote good practices among their members to counter the risk of greenwashing[1] related to asset managers and ESG rating and data providers. As part of this Call for Action, IOSCO will engage with voluntary standard setting bodies and industry associations to promote the adoption and implementation of the good practices stemming from the IOSCO recommendations amongst their members, as a baseline to address greenwashing and related investor protection concerns within the context of their domestic regulatory frameworks.

II. BACKGROUND

IOSCO is committed to supporting the transition to a more sustainable economic model for capital markets. Notably, IOSCO has focused its efforts on addressing the growing risk of greenwashing in order to mitigate the investor protection concerns that greenwashing raises. These efforts are important since greenwashing has the potential to severely undermine investor confidence in sustainable finance and threaten efforts to combat climate change.

In November 2021, IOSCO published two reports addressing greenwashing in two areas of critical importance in sustainable finance. The **Report on Sustainability-related Practices, Policies, Procedures, and Disclosures in Asset Management industry**[2] lays down a series of recommendations for asset managers covering regulatory and supervisory expectations for asset managers; related disclosure both at the firm and product levels; terminology; and financial and investor education.

The **Report on Environmental, Social and Governance (ESG) Ratings and Data Products Providers**[3] explores the developments and challenges related to the use of ESG ratings and data products and seeks to better understand the implications of the increasingly important role of these products for financial markets. As most jurisdictions do not currently have regulatory oversight frameworks in place for such providers, the report recommends that regulators could consider focusing more attention on ESG ratings and data providers that may be subject to their jurisdiction and could consider whether there is sufficient oversight of ESG ratings and data products providers. Underpinning this high-level recommendation is a set of specific recommendations about the type of issues that

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1 In the report titled 'Recommendations on Sustainability Related Practices, Policies, Procedures and Disclosure in Asset Management', IOSCO defined "greenwashing" as "the practice of misrepresenting sustainability-related practices or the sustainability-related features of investment products." However, greenwashing can occur throughout the investment value chain and any market participant (issuers, asset managers, financial advisers, ESG rating agencies and data providers, etc.) can engage in this behaviour. For the purposes of the Call for Action, the term "greenwashing" should be understood within this broader context, rather than being restricted to only asset managers, such that it addresses the practice of misrepresenting sustainability-related information, practices or features throughout the investment value chain.

2 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD688.pdf

3 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf

regulators and ESG ratings and data providers could both consider in developing their regulatory frameworks and internal processes, respectively. These recommendations have a focus on the governance and processes implemented by ESG ratings and data providers and call for transparency surrounding the methodologies that underpin ratings.

Both sets of recommendations complement IOSCO's efforts towards improving sustainability-reporting for corporate issuers, including IOSCO's support of the ongoing work to establish third-party assurance of corporate sustainability-related disclosure and the efforts of the International Sustainability Standards Board (ISSB) to establish a global baseline for sustainability-related information[4]. Improving sustainability-related practices, policies, procedures, and disclosures in the asset management industry and ensuring transparency and good governance of ESG ratings and data providers would together provide investors with internationally consistent and comparable sustainability-related information, which would help prevent greenwashing and foster investor confidence in sustainable finance.

On the regulatory front, jurisdictions have started to establish or build upon existing regulatory frameworks for the regulation of asset managers and the use of ESG ratings and data in the context of sustainable finance. It is therefore critical that asset managers now push forward to improve sustainability-related practices, policies, procedures, and disclosure in their industry and that ESG ratings and data providers improve the reliability, comparability, and interpretability of their ESG ratings and data products.

III. THE IOSCO GOOD PRACTICES

Based on the aforementioned recommendations, IOSCO has prepared this **Good Sustainable Finance Practices Call for Action ('IOSCO Good Practices**') which covers both asset managers and ESG ratings and data providers. The IOSCO Good Practices are voluntary and are not intended to conflict with national or regional legal and regulatory frameworks.

The IOSCO Good Practices in Section 1 are addressed to asset managers, while Section 2 covers ESG rating and data providers who provide important services that are relied upon by market intermediaries, investment funds, issuers, pension funds, central banks, and others. Each section includes detailed guidance supporting the IOSCO Good Practices.

All relevant stakeholders should undertake that, at **no** time, will they or their members make use of reference to the IOSCO Good Practices in any promotional material regarding asset management or ESG ratings and data products relating to sustainable finance or in the promotion of their own organisation.

Section 1: Asset Managers

Voluntary standard setting bodies and industry associations should develop and promote guidance among their members for the following Good Practices (GP):

GP1: Clear expectations for asset managers regarding the: (a) development and implementation of practices, policies and procedures relating to material sustainability-related risks and opportunities; and (b) related disclosure.

GP2: Clear expectations regarding product-level disclosures to help investors better understand: (a) sustainability-related products; and (b) material sustainability-related risks and opportunities for all products.

4 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD713.pdf

GP3: Common sustainable finance-related terms and definitions, including those related to ESG approaches, to ensure consistency throughout the global asset management industry and comparability among sustainability related products.

GP4: Promoting or participating in financial and investor education initiatives relating to sustainability.

GP5: Clear expectations regarding due diligence and/or the gathering and reviewing of information on the ESG ratings and data products that asset managers use in their internal processes.

The following sections set out detailed guidance relating to each of the Good Practices and indicate that this guidance should be included in the initiatives undertaken by the voluntary standard setting bodies and industry associations in promoting the IOSCO Good Practices amongst their members.

GP1: Clear expectations regarding the: (a) development and implementation of practices, policies and procedures relating to material sustainability-related risks and opportunities; and (b) related disclosure.

Specifically, the practices, policies, and procedures relating to material sustainability-related risks and opportunities and the disclosure thereof should cover the following areas, as detailed by the Task Force on Climate-related Financial Disclosures (TCFD) and further elaborated by ISSB standards:

- Governance: The asset manager's governance around material sustainability-related risks and opportunities.
- Investment strategy: How material sustainability-related risks and opportunities are factored into the asset manager's investment strategies and investment process, including, where relevant, the data and methodologies used.
- Risk management: How the asset manager identifies, assesses, and manages material sustainability-related risks and opportunities.
- Metrics and targets: The metrics and targets used to assess and manage relevant material sustainability-related risks and opportunities where such information is material.

The disclosure may also cover any firm-level commitments to other international or regional sustainability-related initiatives and any relevant signatory reports, where appropriate.

GP2: Clear expectations regarding product-level disclosures to help investors better understand: (a) sustainability-related products; and (b) material sustainability-related risks and opportunities for all products.

Specifically, the product-level disclosure should cover the following areas:

- Naming: Parameters around the naming of sustainability-related products to help ensure that the name of the product accurately reflects the nature and extent of the product's sustainability focus, including promoting consistency with the product's name and its investment objectives, characteristics and/or strategies. This may include only referencing sustainability in the product name if the investment objectives refer to sustainability.
- Labelling and classification: Parameters around the use of sustainability-related labels and/or classification systems by sustainability-related products to help promote the consistent and correct use of labels and classification systems.
- Investment objectives disclosure: Practices regarding disclosure in product offering documents about sustainability-related products' investment objectives (including the fundamental nature or features of the products). This type of disclosure should include the nature and extent of a product's sustainability-related investment objectives , including which components of sustainability the product is focused on, and whether sustainability is a primary focus of the product).
- Investment strategies disclosure: Practices regarding disclosure in product offering documents about sustainability-related products' investment strategies (including, in particular, their sustainability-related investment strategies). This type of disclosure should include the investment

universe, investment selection process (including the types of ESG strategies used, as well as the use of indices and ESG scores or ratings, the extent of such use, and their methodologies, where applicable), sustainability criteria used, and the extent of the portfolio's focus on sustainability.

- Proxy voting and shareholder engagement disclosure: Practices regarding disclosure about proxy voting and shareholder engagement. This type of disclosure should address: (a) sustainability-related products' use of proxy voting and shareholder engagement, which should include disclosure about proxy voting and shareholder engagement policies (including where to access those policies); and (b) past proxy voting and shareholder engagement records (which should include disclosure about how the past proxy voting and shareholder engagements records align with and help advance the sustainability-related investment objectives or characteristics of the sustainability-related product).
- Risk disclosure: Practices regarding disclosure in product offering documents about: (a) material risks and opportunities by sustainability-related products, including any unique risks and opportunities that arise from a product's focus on sustainability; and (b) material sustainability-related risks by all products. Risk disclosure by sustainability-related products addresses the disclosure of all material risks and opportunities associated with investing in the specific sustainability-related product and enables investors to better understand the potential risks and opportunities associated with the product. This type of risk disclosure could include any unique risks that arise from a product's focus on sustainability, such as concentration in certain types of investments and reliance on third-party providers for sustainability-related ratings. Disclosure of material sustainability-related risks and opportunities by all types of products, including products that are not sustainability-related, assists investors with making informed investment decisions about how material sustainability-related issues can impact their investments. This type of risk disclosure could include any material risks and opportunities that arise from sustainability-related issues.
- Marketing materials and website disclosure: Practices regarding the content of marketing materials and communications, including websites, of sustainability-related products to promote disclosures that are fair, balanced and consistent with their regulatory filings.
- Monitoring of compliance and sustainability-related performance: Practices to assess, measure and monitor: (a) the sustainability-related product's compliance with its investment objectives and/or characteristics; (b) the sustainability impact of its portfolio[5] to the extent applicable to the portfolio's stated design; and (c) its sustainability-related performance.
- Periodic sustainability-related reporting: Practices regarding periodic sustainability-related reporting by sustainability-related products. This type of disclosure should include information about whether a sustainability-related product is meeting its sustainability-related investment objectives or characteristics, including the product's sustainability-related performance and holdings, during the applicable time period, and would include both quantitative information, where reasonably available, and qualitative information.

GP3: Common sustainable finance-related terms and definitions, including those relating to ESG approaches, to ensure consistency throughout the global asset management industry and comparability mong sustainability related products.

There is currently a lack of consistency around the use of sustainability-related terminology in the asset management industry, which increases the potential for investor confusion around sustainability-related products, contributing to greenwashing.

Market participants should consider coalescing around a set of globally consistent sustainability-related terms. The issue of terminology is distinct from the issue of labelling and classification, as terminology covers broader concepts beyond product types, such as ESG approaches (e.g., ESG integration, negative screening, best-in-class) and definitions of commonly used sustainability-related terms such as "green".

5 The *sustainability impact* of a sustainability-related product's portfolio refers to the effect of the product's portfolio holdings on environmental, social and/or governance issues.

While there are existing initiatives in different jurisdictions addressing the issue of what is "sustainable" or "green", for example, there is a particular need for the development of common terms and definitions for ESG approaches.

GP4: Promoting or participating in financial and investor education initiatives relating to sustainability.

Financial and investor education initiatives may include promoting sustainability-related risk awareness and improving investor comprehension about, and enhancing transparency of sustainability-related products, which would improve comparability and informed decision-making as well as prevent greenwashing. In emerging markets, such initiatives may also promote the importance of sustainable finance and expand the market for sustainability-related products.

Financial education initiatives may also address the professional and licensing obligations of industry participants, including financial advisors, to ensure that industry participants have the necessary knowledge and skills to provide advice and services relating to sustainable finance.

Financial and investor education initiatives could include tools, methodologies, guidelines and orientations that focus on retail investors as well as the larger public. These initiatives should seek to overcome barriers to access, mainly using the internet and, where applicable, could include partnerships with other institutions.

GP5: Clear expectations regarding due diligence and/or the gathering and reviewing of information on the ESG ratings and data products that asset managers use in their internal processes.

This due diligence or information-gathering and review should include an understanding of what is being rated or assessed by the product, how it is being rated or assessed and, limitations and the purposes for which the product is being used.

Asset managers should consider evaluating the published methodologies of any ESG ratings or data products that they refer to in their internal processes. This evaluation should cover:

- the sources of information used in the product, the timeliness of this information, whether any gaps in information are filled using estimates, and if so, the methods used for arriving at these estimates;
- an evaluation of the criteria utilised in the ESG assessment process, including if they are science-based, quantitative, verifiable, and aligned with existing standards and taxonomies, the relative weighting of these criteria in the process, the extent of qualitative judgement and whether the covered entity was involved in the assessment process; and
- a determination as to the internal processes of the financial market participant for which the product is suitable.

Section 2: ESG Rating and Data Providers

Voluntary standard setting bodies and industry associations should promote among their members the following Good Practices (GP):

GP1: Adopting and implementing written policies and procedures designed to help ensure the issuance of high quality ESG ratings and data products based on publicly disclosed data sources, where possible and other information sources where necessary, using transparent and defined methodologies[6]

[6] For the purpose of this Call for Action, the term methodologies could include inter alia, (i) attributes being assessed, (ii) indicators used to measure the attribute, and (iii) weighting of the relevance of each attribute to the final rating.

GP2: Adopting and implementing written policies and procedures designed to help ensure that their decisions are independent, free from political or economic interference, and appropriately address potential conflicts of interest.

GP3: Identifying, avoiding, or appropriately managing, mitigating, and disclosing potential conflicts of interest.

GP4: Making adequate levels of public disclosure and transparency a priority for their ESG ratings and data products, including their methodologies and processes.

GP5: Adopting and implementing written policies and procedures designed to address and protect all non-public information received related to their ESG ratings and data products.

GP6: Improving information gathering processes with entities covered by their products.

GP7: Responding to and addressing issues flagged by entities covered by their ESG ratings and data products while maintaining the objectivity of these products.

The following sections set out detailed guidance supporting the Good Practices, indicating the key points that initiatives by relevant voluntary standard setting bodies and industry associations should aim for in promoting the IOSCO Good Practices amongst their members.

GP1: Adopting and implementing written policies and procedures designed to help ensure the issuance of high quality ESG ratings and data products based on publicly disclosed data sources where possible and other information sources where necessary, using transparent and defined methodologies.

ESG ratings and data products providers should consider:

- adopting and implementing written policies and procedures designed to help ensure that the ESG ratings and data products they issue are based on a thorough analysis of all relevant information available to them;
- adopting, implementing and providing transparency around methodologies for their ESG ratings and data products that are rigorous, systematic, applied continuously while maintaining a balance with respect to proprietary or confidential aspects of the methodologies;
- for ESG ratings, publishing on a regular basis an evaluation of their methodologies against the outputs which they have been used to produce;
- subjecting these methodologies to regular review, with sufficient communication regarding changes made to the methodologies as well as potential impacts of these changes to the ESG ratings and data products;
- providing transparency, where reasonably possible, around the sources of data used in determining their ESG ratings and data products, including the use of any industry averages, estimations or other methodologies when actual data is not available. This may include transparency around whether the data used is up to date, and the time period that data is relevant to as well as whether the data is publicly sourced or proprietary in nature, including through approximations.;
- monitoring on an ongoing basis, and regularly updating, their ESG ratings and data products, except where specifically disclosed that the rating is a point in time rating;
- maintaining internal records to support their ESG ratings and data products;
- ensuring sufficient resources to carry out high-quality ESG-related assessments, including sufficient personnel and technological capabilities, to seek out information they need in order to make an assessment, analyse all the information relevant to their decision-making processes, and provide quality assurance;
- ensuring personnel involved in the deliberation of ESG ratings and data products are professional, competent, and of high integrity; and
- offering ESG ratings and data products to clients in a machine-readable format.

GP2: Adopting and implementing written policies and procedures designed to help ensure that their decisions are independent, free from political or economic interference, and appropriately address potential conflicts of interest.

GP3: Identifying, avoiding, or appropriately managing, mitigating, and disclosing potential conflicts of interest.

ESG ratings and data products providers should consider:

- adopting written internal policies and procedures and mechanisms designed to (1) identify, and (2) eliminate, or manage, mitigate and disclose, as appropriate, any actual or potential conflicts of interest related to their ESG ratings or data products that may influence the opinions and analyses ESG ratings and data products providers make or the judgment and analyses of the individuals they employ who have an influence on their ESG ratings or data product decisions;
- disclosing such conflict avoidance and management measures;
- taking steps to help ensure the ESG ratings and data products would not be affected by the existence of or potential for a business relationship between the ESG ratings and data products providers (or their affiliates) and any entity or any other party for which it provides ESG ratings or data products;
- putting in place measures to help ensure their staff members refrain from any securities or derivatives trading presenting inherent conflicts of interest with the ESG ratings and data products;
- structuring 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 and data products;
- not compensating or evaluating staff on the basis of the amount of revenue that an ESG rating and data products provider derives from an entity that staff provides ESG ratings and data products for, or with which staff regularly interacts regarding such ESG ratings and data products;and
- where consistent with confidentiality, contractual and other business, legal and regulatory requirements, disclosing the nature of the compensation arrangement or any other business or financial relationships that exist with an entity for which the ESG ratings and data products provider provides ESG ratings or data products.

GP4: Making adequate levels of public disclosure and transparency a priority for their ESG ratings and data products, including their methodologies and processes.

ESG ratings and data products providers should consider:

- making public disclosure and transparency a priority for their ESG ratings and data product offerings, subject to commercial sensitivity considerations;
- clearly labeling their ESG ratings and data products to enable the user to understand the ESG rating's or ESG data product's intended purpose including its measurement objective;
- publicly disclosing the data and information sources they rely on in offering ESG ratings and data products, including the use of industry averages, estimations or other methodologies when actual data is not available; and
- publishing sufficient information about the procedures and methodologies underlying their ESG ratings and data products to enable the users of these products to understand how their outputs were determined.

Information regarding methodologies that ESG ratings and data products providers should consider publishing include, but is not limited to the:

- measurement objective of the ESG rating or data product;
- criteria used to assess the entity or company;
- key performance indicators used to assess the entity against each criterion
- relative weighting of these criteria to that assessment;
- scope of business activities and group entities included in the assessment;

- principal sources of qualitative and quantitative information used in the assessment as well as information on how the absence of information was treated;
- time horizon of the assessment; and
- meaning of each assessment category (where applicable).

GP5: Adopting and implementing written policies and procedures designed to address and protect all non-public information received related to their ESG ratings and data products**.**

ESG ratings and data products providers should consider:

- adopting and implementing written policies and procedures and mechanisms related to their ESG ratings and data products designed to address and protect the non-public nature of information shared with them by entities under the terms of a confidentiality agreement or otherwise under a mutual understanding that the information is shared confidentially;
- adopting and implementing written policies and procedures designed to address the use of non-public information only for purposes related to their ESG ratings and data products or otherwise in accordance with their confidentiality arrangements with the entity; and
- including information on data confidentiality management and on the protection of non-public information to the extent terms of engagement are published.

GP6: Improving information gathering processes with entities covered by their products.

GP7: Responding to and addressing issues flagged by entities covered by their ESG ratings and data products while maintaining the objectivity of these products.

ESG ratings and data products providers should consider:

- where the information is collected from covered entities on a bilateral basis: i) communicating sufficiently in advance when they expect to request this information regarding their ESG ratings and data products; and ii) including in their requests, pre-inputted information either from publicly available sources or from the covered entities previous submissions, where possible, for the covered entities' review or confirmation;
- providing a clear and consistent contact point with whom the covered entity can interact to address any queries relating to the assessment provided by the ESG ratings and data products provider;
- informing covered entities of the principal grounds on which an ESG rating or ESG data product is based before the publication of the ESG rating or data product;
- allowing the covered entity time to draw attention to any factual errors in the product, including the data and information underlying the product; and
- publishing terms of engagement describing how and when the ESG rating and data providers will typically engage with their covered entities, including when information is likely to be requested and the opportunities available to the covered entity for review.