

## UKSIF response to HM Treasury consultation: Future regulatory regime for Environmental, Social, and Governance (ESG) ratings providers

### About UKSIF

The UK Sustainable Investment and Finance Association (UKSIF) is the UK's leading membership organisation for sustainable finance, committed to promoting a financial system that works for the benefit of the environment, society, and us all.

UKSIF represents a diverse range of financial services institutions committed to these aims, and our 300+ members- representing over £19trn of global assets under management (AUM)- include investment managers, pension funds, banks, financial advisers, ESG data and research providers, NGOs, among others.

UKSIF and our members have played a prominent role to help better embed sustainability in the UK's policymaking and regulatory framework over recent years, and find ways to overcome barriers to the growth of sustainability in the UK. For example, UKSIF is a representative on a number of advisory groups to policymakers providing guidance on delivery of a number of sustainable finance initiatives, including the 'green taxonomy,' the Sustainability Disclosure Requirements (SDRs), voting disclosures, and the treatment of social issues in the pensions sector. For more information, please visit [www.uksif.org](http://www.uksif.org).

## Introduction

The UK Sustainable Investment and Finance Association (UKSIF) is the leading membership organisation for sustainable finance in the UK, committed to promoting a financial system that works for the benefit of the environment, society, and us all.

**We are supportive of the Treasury's and FCA's initiatives exploring new regulatory measures for ESG ratings providers, with ESG ratings used increasingly by investors and financial market participants.** This includes as a tool to help inform capital allocation and investment decisions in the economy and to comply with regulatory frameworks across jurisdictions. We expect that the demand in the UK, and internationally, for these types of products will grow markedly in the coming years, and it is absolutely crucial for investors and other users to have full confidence in ESG ratings, including their underlying methodologies.

Above all, we believe that greater transparency and high-quality standards are required in this market, which would bring considerable benefits for both ESG ratings providers and users. There is also a good opportunity for ratings providers and industry associations, such as UKSIF and others, to more effectively inform the users of ratings, and wider stakeholders, of the prominent role of ratings today in financial markets and the wider economy, and how they can be placed to support the transition a more sustainable future.

**In Treasury's upcoming work, we would like to see transparency prioritised as a core, over-arching objective,** alongside those areas outlined in the International Organization of Securities Commissions (IOSCO) recommendations [paper](#) published in November 2021. This includes effectively addressing conflicts of interest and promoting good governance.<sup>1</sup>

Separately to this, we very much look forward to seeing the FCA's work on the UK's voluntary 'Code of Conduct' progress at pace in the coming months. We would advise that Treasury draw on, where possible, the 'Code of Conduct' in its upcoming work, and we remain optimistic of the direction of travel pursued by the industry-led working group and its predominant focus so far on enhancing transparency in ratings. We hope to see the voluntary Code quickly enhance standards, innovation, and competition across the market in the UK ahead of the introduction of the Treasury's regulatory regime.

In our response to Treasury's consultation, we express our support for the direction of travel of a number of the proposals in the consultation.<sup>2</sup> UKSIF's response draws on the detailed perspectives of our diverse membership network that includes a number of leading global and UK-based ratings providers, investors, and other users of ratings.<sup>3</sup>

We are very grateful for the engagement with Treasury and FCA on the consultation, and we would be pleased to convene further discussions with our membership in due course. UKSIF looks forward to continue supporting the Treasury's and FCA's work on ESG ratings, and seeing this work progress at pace in the coming months.

### **1. Do you agree that regulation should be introduced for ESG ratings providers?**

**We see a very good case for formal regulation of ESG ratings providers in the UK,** and we are supportive of both government and the FCA's initiatives considering measures in this market. We would very much encourage further co-ordination between the Treasury and FCA's respective initiatives, as well as the communication of their respective objectives to promote further clarity for actors in this market and financial services firms at large.

Given the growing prominence of ESG ratings and use of ratings as a tool to inform investment firms' investment strategies, capital allocation, and stewardship, we would agree that there is a need for introducing a regulatory framework that supports greater transparency in this market.

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<sup>1</sup>The International Organization of Securities Commissions (IOSCO), *Environmental, Social and Governance (ESG) Ratings and Data Products Providers: Final Report*, November 2021.

<sup>2</sup>Our response builds off a private briefing we published in September last year on the UK's 'Code of Conduct', which indicated that the IOSCO report's core recommendations represented a good starting point for the Code and emphasised transparency as an over-riding consideration.

<sup>3</sup>UKSIF's response is informed by our membership, though this does not necessarily reflect the views and perspectives of our entire membership, either individually or collectively. Our response draws on a number of private roundtables we have convened with representatives from our member firms.

We expect that the demand for these types of products to continue to rise over the coming years, especially as the range of investment themes typically considered by investors expands. Investors also appear to be increasingly making use of multiple ratings and opinions from a number of different providers (both large and small providers), beyond simply relying on one provider alone. For these reasons, among others, it is absolutely critical for investors, and other users, to have full confidence in ratings in making their investment decisions.

More broadly, we know that promoting more reliable and consistent information relating to sustainability across the investment chain, and wider economy, will be necessary in driving the UK's transition to net-zero and supporting economic growth. **We believe that enhancing transparency in this market should be a core priority for HM Treasury in regulation**, and we would like to see more transparency over the methodologies that are used by ratings providers to calculate their metrics, in particular ratings products, and the process by which ESG ratings are determined.

A key objective should be to reduce 'black box' methodologies and promote greater rigour in the ratings market. More specifically, the European Commission's recent draft regulatory framework outlines a number of appropriate criteria that ESG ratings methodologies must seek to meet, including that they should be: rigorous, objective, continuous, reviewed at least annually to promote accuracy, and subject to validation. We would encourage Treasury to draw on these criteria proposed by the Commission in order to boost transparency in rating providers' methodologies, and how these are disclosed in documentation to their clients.

One area that Treasury may wish to explore further is in regards to ESG ratings providers' forecasts and estimates of data such as scope 3 emissions or forward-looking assessments including Climate Value-at-Risk (Climate VaR). Extending the scope of the rules in these areas may be necessary due to the subjectivity of these assessments.

Separately, a number of our investor members have noted a tendency by some ratings providers to use relatively outdated data sets, for example in instances when reporting cycles for companies do not align with those of providers. We think this would support the case for greater transparency on underlying data sources that have been used.<sup>4</sup> Users should be able to have full clarity over when providers may have used out-of-date information, and where possible look to address this directly with their providers.

While providers should not be expected to share publicly full details of their underlying methodologies, a greater understanding is needed on how providers are ultimately reaching their decision on a company and what the ESG rating is reflecting in practice. This could address common concerns from our investor members that it can be very challenging to identify where certain ESG scores are originating from, and what raw ESG data points have been utilised to construct scores.<sup>5</sup>

**Further progress in regards to transparency will improve trust in the UK's ratings market and ensure that appropriate guardrails are put in place.** There is, at present, a relative lack of clarity on the underlying rationale for different approaches adopted by some ratings providers, while investors and other users have concerns on 'what happens under the hood' of an ESG rating, and the internal operations of some ratings providers.

Given the pressing need to address transparency in the ratings market, **we would recommend that Treasury consider the introduction of a wider transparency rule, or an over-arching principle, as part of the UK's upcoming regulatory regime.** This could set out clearer expectations of all providers in regards to transparency, regardless of providers' product types, and include a principle stating that all ratings products must clearly disclose to their users their methodologies and objectives, as well as more detailed requirements on transparency.

A very positive outcome from Treasury's consultation will be enhancing transparency in the market, as opposed to direct regulation of ratings providers' assessments and methodologies. Other aims of regulation should include: addressing conflicts of interest, promoting 'best practice' standards-such as minimum criteria for rating providers to adhere to-, and consideration of new guidance for investors and users on the use of third-party data.

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<sup>5</sup>This points to concerns from clients on transparency over the underlying inputs and data used in ratings and scores, as well as providers' methodologies. A further example can relate to the lack of a clear delineation- in some instances- between subjective and objective conclusions, with some users finding it challenging to discern between opinions versus facts. One cited example is the treatment of breaches of the United Nations Global Compact (UNGC) principles.

We appreciate that this guidance may be beyond the scope of Treasury's consultation, and could require further work alongside the FCA, the industry-led working group overseeing the UK's voluntary 'Code of Conduct', and other stakeholders.

**Guidance for users could cover good practice in due diligence to assist investors in their selection of ratings providers, and reiterate that ratings products should only be seen as one of many inputs, and an initial starting point,** in terms of impacting capital allocation decisions. This is particularly relevant we think for active investors, while all investors should be clear in their interactions with their institutional and retail clients over how their ratings are being used to inform investment decisions.<sup>6</sup> Guidance, or more formal obligations in time, may be required on service providers' suppliers, who should be encouraged to comply with the Code of Conduct.

**A further consideration for policymakers is promoting the appropriate sequencing between various initiatives in the UK,** which would enhance the policy landscape for providers operating in this market, users, and wider financial institutions. Clarification is required from Treasury on how the voluntary UK 'Code of Conduct' for ESG data and ratings will interact in future with, and effectively complement, Treasury's work to consider bringing in ratings providers into the FCA's 'regulatory perimeter.'

In terms of the Code, we look forward to seeing this work continue to progress in the coming months, and have confidence that the Code could quickly enhance investors' trust in the market in advance of a formal regulatory regime. There are lessons that could be learned from the experience of the UK Stewardship Code, including its emphasis on transparency, and its approach in naming firms and accrediting their activities and performance, as well as follow-up assessment to ensure consistent, measurable progress over time.

Linked to this, **further clarity would be extremely valuable on the extent to which these regulatory initiatives in the UK will be consistent and interoperable with rules and codes under development in other jurisdictions, and HMT's position regarding equivalence arrangements.** In our response to Q.12, we provide further views on how Treasury could approach equivalence.

Given the inherently global nature of the ESG ratings market, as much harmonisation as is possible with the recommendations from the IOSCO, as well as regulations from the European Union and other regions of the world, would deliver benefits for this market. Clearer signalling from policymakers in regards to both the sequencing of initiatives in the UK and interoperability between the UK's regime and rules in leading jurisdictions would be beneficial. We would recommend that this clarity is outlined in due course from HM Treasury and FCA in policy statements in the coming months.

Finally, there are clear opportunities we see for the UK to adopt a world-leading approach that learns some of the lessons from IOSCO's experience and other jurisdictions, taking advantage of its 'fast-follower' status behind the EU in terms of sustainable finance regulation.

**2. (For ESG ratings providers) If your firm were subject to regulation in line with IOSCO's recommendations, and aimed at delivering the four key regulatory outcomes in Figure 1.A, how would this impact your business? Please provide information on the size of your business when answering this question.**

While we would not be well-placed to comment here as a membership association, we do represent a number of ratings providers and would be pleased to convene a group of our members to share their perspectives on estimated costs of the regime in due course.

**3. Are there any practical challenges arising from overlap between potential regulation for ESG ratings providers and existing regulation?**

As previously highlighted in our response, **one of the primary regulatory overlaps we identify is between Treasury's consultation on ESG ratings and the ongoing work of the voluntary UK 'Code of Conduct'.**

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<sup>6</sup>Constraints on firms' resources to consider in detail underlying data and an ESG rating, or score, can be a challenge, particularly for smaller firms.

A clearer over-arching vision will be required from policymakers in the UK on the inter-links between these two initiatives, the extent to which they will be integrated, their respective objectives, and what areas of the market and precise types of the products each initiative will seek to encompass.

**We would very much welcome the publication of specific timelines, envisaged phases, and the overarching objectives for both initiatives from Treasury and FCA**, and for this to be regularly updated for the market going forward. Clarification would be beneficial for our members in terms of which body is co-ordinating and overseeing certain aspects of rulemaking, and how Treasury and FCA will work together in this respect. This clarity would assist our service providers members to better understand the costs and implications of the regulation that is being proposed by both regimes.

One recommendation to ease envisaged implementation issues in the market and to ensure that smaller providers are not unduly disadvantaged would be for **consideration from Treasury for a phased-approach to be applied to formal regulation for smaller firms**, and re-confirmation that compliance with the 'Code of Conduct' would be on a 'comply or explain' basis to encourage wider compliance among firms.<sup>7</sup> With that said, there may inevitably be limits to the benefits for smaller firms of a phased, proportionate approach, given that their clients may expect firms-regardless of their size- to fully comply with all rules.

This means that **further consideration will be needed to assist smaller players operating in the UK's market** in order to facilitate healthy competition in the UK's market, and not provide built-in, incumbency advantages from the onset of the regime for larger providers. Later in our response, we provide further views for how policymakers should approach the treatment of smaller providers.

Finally, the UK's recent experience in delivering other sustainable finance regulatory initiatives, such as the Taskforce on Climate-Related Financial Disclosures (TCFD) and UK Stewardship Code, could be drawn on by Treasury in its upcoming work, including in regards to effective sequencing of rules.

#### **4. Are there any other practical challenges to introducing such regulation?**

**A practical challenge that will need to be addressed ahead of the introduction of new requirements relates to definitional challenges for ESG ratings, raw ESG data, ESG scores, and other products.** This is particularly important given the nascency of this market and the anticipated further evolution we expect to take place.

From our view, it has generally appeared to be an easier process for regulators and stakeholders to define ESG ratings and scores versus raw ESG data; the boundaries for regulation have been relatively less clear in regards to the latter. In addition, the objectives of various ratings products are broadly more similar to one another, when compared with ESG data products. Broadly, there appears to be a wide range of products that could, depending on an individual's perspective, fall in between ESG ratings and ESG raw data, and the uncertainties in this respect should be taken into account by Treasury.

**Policymakers will need to be attuned to a number of complexities in determining which precise groups of ESG ratings firms and ESG products may fall within scope of a regulatory regime in the UK.** One example of such a complexity relates to products that could be categorised and fall in between an ESG score and raw ESG data, such as Climate Value-at-Risk (Climate VaR). To drive up standards in the UK's market as quickly as possible, we would recommend an initial regulatory focus on ESG ratings to begin with.

Drawing on the previous experience of the Financial Services Agency of Japan (JFSA) in devising a voluntary code of conduct, our understanding is that the process for determining the exact range of data and ratings products falling within scope experienced various delays. The long lead-in time led to negative outcomes, and similar delays in the UK in defining the precise scope for products will need to be avoided as far as possible, especially given the rapid evolution we are seeing in this market globally.

A further definitional challenge relates to the distinction between subjective and objective assessments, and we would welcome improved standards and principles governing the use of subjective assessments.

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<sup>7</sup>A 'comply or explain' approach for the Code will likely be needed, we believe, given our expectation that not all of the Code's main principles will uniformly apply to all types of products currently in the market, and firms may need to disclose why they have not necessarily applied all the principles to certain ESG products.

We expect this will come with a number of challenges given that objective data and subjective data can often be mixed together, and new guidance from Treasury and FCA in this area may be beneficial. One issue is that some investors' clients may raise questions over the ESG rating of a company in response to media reports, which in themselves are subjective in nature, bringing in greater subjectivity to some assessments of companies.

**The challenge of ensuring that formal regulation sufficiently reflects changes in the market and are 'future-proof' will be an important consideration for Treasury.** We will need to avoid as far as possible a continual re-classification exercise in assessing which types of ESG ratings and data products could fall within scope of the UK's regulatory framework, and making sure that any regime could operate effectively in the long term as the market continues to develop.

One benefit we see in the UK's upcoming 'Code of Conduct' will be the 'comply or explain' approach, which should provide some flexibility and capture a greater portion of the market we hope in the coming years by being more principles-based. For example, some of the principles of the UK's Code do not necessarily apply to certain data products. In order to minimise risks of ongoing reclassifications of ESG ratings and data products captured in the UK's regime, the Treasury and FCA could consider more clearly outlining different categories and guidelines that capture the significant diversity of products in the market.

**One suggestion we would reiterate is the publication of timelines, both shorter and longer term, for rules that would cover different types of products,** with a longer timeframe more appropriate arguably for non-ESG ratings products. While ratings should be considered in the first instance, other areas of the market could then be frequently monitored by Treasury and FCA as the market evolves, avoiding delays in the creation of a regulatory framework in the UK.

**A separate challenge lies in the understanding by stakeholders of the different objectives pursued by various ESG ratings products,** with some aimed at measuring ESG risks while others focusing on impacts. Furthermore, ratings can be more backward-looking than forward-looking, and they can be used in very different ways by investors and other users. One example could be the difference in the way equities investors and fixed-income investors typically use ratings. Further clarity on how regulatory-linked products and "controversy" models would be treated would be welcome too. Above all, it should be noted that a rich diversity of opinion and assessments provided by the ESG ratings industry is a positive development, and should be clearly acknowledged.

The very varying use-cases points to the necessity to improve far more the communication between ratings providers and users over products' use-cases and key objectives. The following use-cases we identify include: informing capital allocation decisions; use for reporting purposes; integration into investment processes or stewardship strategies; guiding internal decision making; or benchmarking sustainability performance. The use-cases can vary for different asset types, for example between listed equities, sovereign bonds, fixed income, and real estate. Another factor to note is that some investors may use a number of different providers simultaneously and for quite different purposes.

**One challenge in regards to use-cases can be that providers will not necessarily, in every single case, be aware of how their ratings and products are being used in practice** once they are sold in the marketplace to firms, or by whom the ratings are being used. Providers' clients will generally not inform their providers how ratings have been used in the investment process, and it can be difficult to know how a client will then behave on the basis of the rating.<sup>8</sup>

This can bring up the issue of how users of ratings can properly inform their own clients over how ratings have been used on their behalf in investment decisions. One recommendation to remedy this issue would be to require, or at least actively encourage, providers to take further steps to refine their narrative to clients on what exactly they think a rating means in the real world in respect to sustainability factors.

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<sup>8</sup>A related challenge is that some investors may consider the individual components of a rating product separately.

**The quality of climate and sustainability-related data that is available is another key challenge that remains**, with corporate data reported publicly still not sufficiently robust and decision-useful to meaningfully inform financial market participants' investment decisions and price assets as accurately as possible.<sup>9</sup>

Policymakers, both here in the UK and globally, need to continue to consider ways to enhance underlying corporate disclosures, among both listed and unlisted companies, which will be key in facilitating our members' ability to evaluate holdings to deliver positive outcomes for clients, comply with their own disclosures and reporting requirements, and reduce greenwashing risks across their value chains.

This is why **we would like to see the UK, and other jurisdictions, consult with the market and stakeholders, at the earliest opportunity, on full implementation of the recently published International Sustainability Standards Board (ISSB) sustainability-related and climate-related standards** across the UK's economy. We see the application of these standards in the economy, in time, providing our members with the sustainability disclosures and information required to better support growth opportunities and help drive the transition to net-zero.

Improvements in the quality of sustainability data and disclosures will go some way in assisting how investors make use of ratings, and promote the objective of ensuring that users (particularly active managers) are doing their own in-depth investment and research analysis, and due diligence alongside their use of ratings products.

Greater confidence in underlying data is critical, particularly with a lot of data from publicly listed companies still self-reported voluntarily, and our investor members very much relying on third-party providers for data estimates; for example, on companies' Scope 3 carbon emissions. In some instances, estimates for this category of emissions can be the most accurate form of reporting available to investors, and we welcome the UK's recent commitment in the updated 'Green Finance Strategy' to consult further in this area.

A lack of progress in strengthening corporate disclosures in the coming years will result in continued over-reliance by investors and other institutions on data estimates and imperfect data. Ratings products continue to be heavily dependent on underlying ESG data and information, and continued errors in underlying data will cause issues for providers' ratings and their methodologies. Regulation of ratings providers is a necessary step, though it will not fundamentally resolve the continued issues in regards to good-quality and comparable corporate data on ESG across jurisdictions, which still requires a degree of assessment in order to make reported company data more consistent.

Linked to this, there is the question of verification of sustainability data, and whether this should be the responsibility ultimately of an investor, the provider, a verified independent body, or other party, and how independent verification could promote confidence in the consistency of data.

Finally, **a much broader challenge we identify is the wider, collective lack of understanding across stakeholders on the distinction between ESG ratings and ESG data**. Wider work will be necessary we believe to enhance all stakeholders' and financial market participants' understanding of what ESG ratings are and what objectives they are seeking to achieve. Providers and industry associations, such as UKSIF, will have a role to play in this respect, explaining how the market functions and addressing some of the misconceptions in industry and wider discussions.

#### **5. Do you agree with the proposed description of an ESG rating?**

We largely agree with the proposed description of an ESG rating as set out in the consultation, though we would advise that Treasury consider, as far as possible, alignment with the definitions outlined by the IOSCO and European Union.

There may be a case in the coming months to review certain aspects of the proposed definition, and promote a better common understanding among financial market participants, including in the following ways.

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<sup>9</sup>A report from one of our members, FTSE Russell, has shown that many companies are still not sufficiently disclosing their carbon emissions, but instead relying on inaccurate data estimates. The study finds there is a material disclosure gap, and considerable variation in reporting on sustainability issues according to company size, region, and sector. For instance, of the approximately 4,000 large and mid-sized constituents in the FTSE All World index, more than half currently disclose operational emissions data, but 42 per cent of large and mid-caps do not disclose both scope 1 and 2 emissions.

- Further clarity on products that may fall between an ESG rating and a ESG data product:** With the market having rapidly evolved in recent years, this has led to uncertainty over distinguishing between ESG ratings, scores, and ESG data, and where exactly some types of products in the market sit within each of these categories. One specific example of an unclear boundary relates to estimations for companies' scope 3 greenhouse gas emissions, which could be interpreted as a rating given that certain assumptions would typically have been made by providers when building estimates for this data point.<sup>10</sup> In terms of raw ESG data, the priority by policymakers in the UK should be to directly address the gaps here through upcoming global and national reporting frameworks, such as the International Sustainability Standards Board (ISSB) and the economy-wide Sustainability Disclosure Requirements (SDRs).
- Consideration of additional guidance to more clearly define ESG ratings:** This could provide much-needed clarity for providers and users of ratings, given the lack of understanding among many stakeholders in this market and the objectives of ESG ratings. An exhaustive glossary for example could be considered, building off the work of IOSCO, the UK 'Code of Conduct', and existing industry guidance, providing definitions for and distinguishing between ESG ratings, ESG scores, ESG data products, and other product types. Broadly speaking, we will need to be careful to use more consistent terminology in discussions on what we mean by ESG ratings, which would help minimise confusion among clients and improve our collective understanding. We agree with the recommendation in last year's [report](#) from the International Regulatory Strategy Group (IRSG), proposing that industry, regulators, and other groups adopt a common language when describing the ESG ratings landscape. This would need to be sufficiently flexible to accommodate new ESG data products that could emerge in future.<sup>11</sup>
- The need for alignment with emerging international frameworks:** As previously highlighted in our response, Treasury and FCA should continue to actively monitor international developments and assess on an ongoing basis the initiatives of global standard-setters, such as the International Sustainability Standards Board (ISSB). In the first instance, the IOSCO's recommendations provide a good starting point in terms of the definition for ESG ratings and its predominant focus at the level of the provider.

#### **8. (For ESG ratings providers) Do you know when an ESG rating you provide will be used in relation to a specified investment?**

As a membership association representing a number of ratings providers in the UK market, among other financial institutions and groups, our understanding is that providers generally will not know, in all cases, the use-cases of their ratings products provided to their clients. One reason is that some investors may choose to rely on internal, proprietary ratings and models once they have purchased certain products from providers, and could ultimately decide to disregard assessments should they wish to.

Firms may choose to combine different data sets and sources. Furthermore, investors will have very varying use-cases for their products, and seek to measure different objectives and aspects of sustainability, such as single materiality versus double materiality or a certain sustainability factor dimension. The very wide range of use-cases could include: informing capital allocation, delivering real-world impacts, risk management, as well as informing stewardship and engagement activities with companies.

Broadly speaking, **we would like to see a much better dialogue promoted between providers and users of ratings** —Treasury and FCA could consider wider work to enhance understanding between these groups on how ratings are used in practice, as well as promoting consensus around metrics for different sustainability factors. This dialogue should look to actively encourage a healthy two-way conversation where both groups are scrutinising the judgements from ratings products, and users feeling well-placed to understand and, if needed, challenge the findings should they wish to.

We would be pleased to convene private discussions bringing together these groups from our membership in the coming months to consider this further.

<sup>10</sup>This is a particular area of complexity arguably given the lack of consistent reporting by many global companies on their Scope 3 emissions, leading many providers to make data estimates, and there is the question of when these estimates are viewed as assessments by providers

<sup>11</sup>IRSG, *ESG Ratings and ESG Data in Financial Services – A view from practitioners*. February 2022.

### **9. Are there ESG ratings used in relation to anything other than an RAO specified investment which also should be included in regulation?**

One area we identify that is missing in the consultation is the use of ESG ratings for stewardship and engagement purposes.

### **10. Do you agree that each of the eight scenarios listed above (in paragraphs 3.2, 3.3, and 3.5) should be excluded from regulation?**

**We think there is a case for asset managers' ESG ratings that are sold for commercial purposes and distributed publicly in the market to be captured in scope of Treasury's regulation.**

If a fund manager's rating is used in the context of selling of a fund and commercialised in this respect, then the scope should be extended even if there is not a fee necessarily associated with that rating in this scenario. By capturing activities from wider regulated firms, and ensuring good-quality disclosures are in place for all clients, this should foster a level playing-field in the UK's market. **However, should a manager's rating only be used for the purposes of reporting to clients, then this arguably should fall out of the scope of Treasury's rules.**<sup>12</sup>

There may be certain requirements from the FCA's Sustainability Disclosure Requirements (SDRs), and other rules, that will capture fund managers' due-diligence processes and other arrangements in place for their use of ratings, at least in instances for their sustainable-labelled investment funds.<sup>13</sup> These requirements could be drawn on by Treasury in considering any new disclosure requirements that capture managers' own ESG ratings.

One issue we would identify with a more expansive scope is the requirement outlined in the consultation for FCA- authorisation for firms, meaning that other groups offering ratings (such as non-profits, charities, think-tanks, consultancies, and trade journals) will not be captured and this will require further consideration we think from policymakers. We believe that the risk of harm to investors will remain regardless of which entity is providing the rating, and we see natural limits to the UK's upcoming rules should these wider groups not be examined in due course by other policymakers and regulatory authorities.

The exclusion of these groups from any requirements may carry risks, including handing a competitive advantage to certain organisations offering products, and the industry-led Code of Conduct may be the most appropriate mechanism initially to encompass a broader range of groups distributing ratings. Another risk we see is that data sets from some of these organisations can ultimately flow through to service providers in the market.

Finally in regards to proxy advisor services, there is a case for these services and proxy reports to not be excluded from regulation in the UK due to a number of issues we identify in this market (e.g. the accuracy of some information forming the basis of proxy reports, and the strong influence exercised by proxy advisors, including their impact on company annual general meetings). We would acknowledge that there are existing rules in place for proxy advisers, and care would need to be taken to avoid any considerable overlap in rules.

### **12. Do you agree with the proposal to regulate the direct provision of ratings to users in the UK, regardless of the location of the provider?**

**We largely agree with the proposal to regulate the direct provision of ratings to users based in the UK regardless of where the provider is based**, though there is the possibility that separate legislation will be required to capture overseas providers.

A related consideration will be to, where possible, avoid significantly conflicting rules for the market from multiple jurisdictions, and that is why **Treasury and FCA should consider equivalence arrangements (or similar) with the EU and other third-party jurisdictions for overseas providers** to ensure that ESG ratings are not unduly restricted to users in the UK, and to retain a competitive market. This work could draw on the European Commission's upcoming work assessing the regulatory approach to third-party providers based outside of the

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<sup>12</sup>In terms of the use of ratings for reporting purposes, some fund managers may provide this information to their clients to identify investment trends over a time period and to compare investment portfolios.

<sup>13</sup>One specific example from the SDRs is the proposal from the FCA's CP that "a firm must carry out due diligence on any data, research and analytical resources it relies upon (including when third-party ESG data service providers are used), ensuring that any gaps and shortcomings identified are documented and appropriately mitigated."

EU, which we understand requires adherence to the IOSCO's core recommendations as part of its equivalence provisions.

A positive outcome in this area would help to enhance investor protection while maintaining a level playing-field between UK-based and overseas ratings providers. **Broadly speaking, greater harmonisation with international rules could help to reduce barriers for UK-based users in terms of accessing ESG ratings from providers and promote greater innovation**, though we do recognise some of the challenges in promoting alignment.

A greater degree of alignment may support new entrants and smaller players in the UK's market, encouraging this group to market their products to users in the UK. One way of promoting alignment of rules is for discussions in this area to be elevated more regularly to international fora, such as the International Platform on Sustainable Finance (IPSF).

Linked to this, we would stress the importance of making sure that UK providers, and users, are not placed at a relative disadvantage compared with international markets, and that crucially investors can continue to seamlessly access ratings products beyond those based in the UK alone. Finally, Treasury should explore in its approach the ability for providers to use intra-group delegation of functions that are relevant for the provision of an ESG rating, provided that the level of oversight remains within the FCA-authorized entity within the group. This would take into account the set-up of and structure of many global providers, with the issuance of an ESG rating normally involving employees based in a number of countries.

#### **16. How would the territorial scope proposed in this chapter interact with initiatives related to ESG ratings in other jurisdictions, such as proposals for regulation or codes of conduct?**

As previously highlighted in our consultation response, **we would strongly support closer, ongoing co-operation between UK policymakers and authorities in other jurisdictions over regulation and voluntary codes**, with the objective of promoting greater regulatory harmonisation.

The European Commission's recently published proposals should be very carefully considered ahead of the further development of the UK's rules to facilitate policy alignment and reduce the opportunities for regulatory arbitrage. Other jurisdictions' rules and codes will need to continue to be monitored by Treasury and FCA, including in the EU, Japan, India, Singapore, and elsewhere. Given the inherently global nature of the ESG ratings market, harmonisation with the IOSCO's recommendations will be critical.

#### **17. Should smaller ESG ratings providers be subject to fewer or less burdensome requirements?**

**We would very much welcome some form of a proportionate approach from Treasury for smaller ratings providers** in order to continue to promote effective competition and drive innovative approaches in the UK's market.

More competition among providers would bring tangible benefits to the ratings community and users, many of whom, to different degrees, will be reliant on data sets provided by more specialist providers such as those focused on biodiversity and nature data. Many users will welcome disparate ESG data sets, which can provide advantageous insights informing capital allocation, and the depth and diversity of sustainability data provided by this group of ratings providers will need to be maintained under the UK's upcoming roles.

Above all, it will be critical to ensure that the UK's future regulatory framework can encourage smaller providers, including those who may be considering or already in the process of applying for FCA-authorization, to compete in the market and offer a diverse range of products to investors and other users.

There should be a distinction made, we believe, between large and smaller ratings providers, as well as between those providers who may have a significant presence in the ESG market, and other firms who have a relatively smaller ESG offering and imprint as part of their wider activities, though nonetheless would be classified as a larger provider.

Broadly speaking, **Treasury and the FCA should take into account the potential burden of costs on smaller providers that a new regime could present**, and carefully consult in this area for this group, ensuring the barriers to entry are not too extensive. We understand that some of our smaller members have concerns over the ongoing costs associated with FCA-authorization, rather than necessarily costs linked to complying with the new rules.

**There may be a case to provide a short, time-limited exemption for smaller providers from FCA- authorisation**, while retaining the authorisation requirement for larger providers.

In this scenario, we would envisage smaller providers still needing to adhere, on a mandatory basis, to the IOSCO's core principles and signing up to the UK's 'Code of Conduct', ensuring that a minimum baseline of standards are in place for all providers from the onset, regardless of their size. We foresee the expectations of some clients, in time, encouraging smaller providers to seek FCA authorisation in any case, and policymakers will need to be mindful of promoting a level playing-field for all groups in the UK's market in future.

**20. What criteria should be used when evaluating the size of ESG ratings providers?**

As highlighted in our response to Q.17, we would strongly welcome consideration of various mechanisms that could support smaller providers under the UK's regulatory regime, and an 'opt-in mechanism' may be one approach to help achieve this objective.

As Treasury's consultation notes, this mechanism could provide smaller firms with the potential to bear any benefits, including commercial, from a future regime.

**22. Is there anything else you think HM Treasury should consider in potential legislation to regulate ESG rating providers?**

We think Treasury should consider the inclusion of ESG controversy reports and alerts, also known as norms-based research, which would bring benefits to users and providers of ratings. One reason is that controversies are frequently assigned their own rating based on a rating provider's own methodology, and at a minimum providers that publish controversy reports and alerts should adhere to the upcoming principles set out in the voluntary 'Code of Conduct.'

A number of recommendations could be pursued in order to enhance the integrity of these reports and alerts, including: providing the named company an opportunity to review the controversy prior to publication to make sure the most relevant and recent information had been considered; the development of a measure of materiality reflecting the weight of the controversy within the named company; and evaluation of the veracity of information sources relied on to report controversies, including through a hierarchy or weighting of various data sources (e.g. regulatory statements, news reports, or reports from NGOs and civil society).