IRSG
INTERNATIONAL REGULATORY STRATEGY GROUP

IRSG Response to the HM Treasury Consultation on the Future Regulatory Regime for ESG Ratings Providers

The International Regulatory Strategy Group (IRSG) is pleased to respond to the HM Treasury (HMT) consultation on the future regulatory regime for Environmental, Social, and Governance (ESG) ratings providers.

The IRSG is a practitioner-led body of leading UK-based representatives from the financial and professional services industry. It is an advisory body to the City of London Corporation and to TheCityUK. It is one of the leading cross-sectoral groups in Europe for the industry to discuss and act upon regulatory developments. The IRSG and its members are interested in the case for regulation of ESG rating providers and, in February 2022, the IRSG published a report in collaboration with Accenture entitled "ESG Ratings and ESG Data in Financial Services – A view from practitioners." [1] We have taken the approach of answering questions for which there is a broad consensus from across the IRSG membership.

In this response, we identify questions from the HMT Consultation on which we received a broad consensus of views from our members – we do not respond to every question, although we do express clearly the views of our members as regards the direction of travel.

In this connection, we note at the outset that the IRSG supports the overall direction of travel proposed in the consultation. There is a clear justification for increased regulation of ESG rating providers, with a view to increasing the transparency of rating processes and assessments, reducing potential or actual conflicts of interest, and ultimately improving product quality and outcomes for rating users.

An intermediate step towards this will arise through the introduction of the voluntary Code of Conduct for ESG data and rating providers, the working group for which is supported by the IRSG (as co-secretariat with ICMA). The Code of Conduct is not, however, intended to be the final word on the matter of regulation for ESG rating providers, and the HMT proposals would seem the logical next step in this space.

With these opening comments in mind, we turn to address the specific questions raised by HMT.

[1] IRSG & Accenture, 'ESG Ratings and ESG Data in Financial Services – A view from practitioners,' (February 2022) available at: https://irsg.co.uk/assets/Reports/IRSG-Accenture-report-on-ESG-Ratings-and-ESG-Data-in-Financial-Services-FINAL-2.pdf

Question 1: Do you agree that regulation should be introduced for ESG ratings providers?
Question 4. Are there any other practical challenges to introducing such regulation?

The IRSG agrees with HMT's overarching proposal that regulation should be introduced for ESG ratings providers.

With recent growth and focus on sustainable investments, ESG rating products have developed to become an important data point in investment decision making. It is therefore vital that the market is able to have confidence in the integrity of these products – the market should be able to trust that the systems, processes and controls, and the oversight and governance, connected with the product's development and issuance are robust. In the case of ESG rating products, it is also important that rating users can understand, through transparency and engagement, the rating methodologies that are being applied (and therefore the factors on which ratings can be impacted) and that rating users can trust that methodologies are being applied in a consistent and rigorous way.

These concepts are not new – they bear a number of similarities to those that exist in the regulation of credit ratings. As opposed to credit ratings, however, ESG ratings express an opinion or assessment across three broad conceptual factors (Environmental, Social, and Governance) that naturally lead to a greater disparity of outcomes. A high degree of qualitative and subjective interpretation and assessment is therefore required in rating processes (albeit that this may not be the case for certain products, such as ESG scores), as well as decisions concerning the manner and weightings applied against E, S and G factors come together to impact final rating decisions. As such, any regulatory regime for ESG ratings should take into account the differences that exist with the credit rating regime and should focus on the practical elements that should help drive consistency, quality and market understanding. In our view, the key pillars should be as follows (we note that these are largely consistent with those identified by IOSCO and referenced by HMT):

- Good governance, including effective internal oversight;
- Transparency, particularly as regards methodologies, data sources and procedures for data gaps;
- Conflicts of interest, particularly as regards identification, management and disclosure where conflicts may arise;
- Internal systems and controls, particularly concerning internal policies and procedures for rating processes and decision making.

Overarching all of these points, but perhaps of greatest relevance within transparency, is that ESG rating providers communicate sufficient information for users to understand the nature and purpose of their product. Part of this exercise comes with methodology transparency; but part will also come

through clear articulation of whether an ESG rating is assessing ESG impacts by the rated issuer or the impact of ESG factors on the rated issuer.

It is important to ensure that regulation in this sector does not operate as a barrier to continued innovation and product development. Operating a more proportionate regime for certain entrants to the market could, subject to appropriate calibration and baseline standards, be a positive development. Equally, encouraging the FCA to ensure that regulation operates to target the specific areas of focus and does not operate as a undue barrier to entry would also seem sensible. Importantly, the regulatory framework should be sufficiently flexible to allow multiple different operating models and methodological approaches – the key is that these methodologies can be understood.

We envisage two key areas of practical challenge in developing a regulatory framework: clear delineation of ESG rating products from other ESG data products, and ensuring that a UK regime is appropriately interoperable with international regimes. We elaborate on these themes further in this response, but would note one specific area of caution in respect of the latter. The market for ESG ratings is global, and it is important that UK based rating users are able to access and use relevant products from around the world. Many jurisdictions globally are in the process of introducing their own regulatory regimes, or codes of practices, for ESG rating providers that are established in their jurisdiction. A UK regulatory regime should (i) be designed to operate in an appropriate and interoperable way with as many global regions as possible, and (ii) should not operate to apply or overlay an additional layer of UK regulation on global providers that operate in jurisdictions that have their own existing regulatory regime (that may be similar, but have some inconsistencies, with a UK regime).

It is to be hoped that the Code of Conduct will act as a helpful transitional measure towards regulation in the UK for ESG rating providers, and that any UK regulatory regime for ESG rating providers will bear significant similarities to the Code of Conduct (not least given the grounding of the Code of Conduct in the IOSCO recommendations).

Question 5: Do you agree with the proposed description of an ESG rating?

The IRSG agrees that the proposed description of an ESG rating is broad enough to capture all products that would objectively be considered to be ESG ratings. While acknowledging that the definition is drafted with the intention of being broad, the IRSG would note that, as drafted, it would be likely to be considered by a number of market participants to capture a range of ESG data products that would not objectively be considered to be ESG ratings.

The IRSG would encourage close scrutiny of the intended scope of regulation, and a clear articulation of the boundaries of where, in this market, the regulatory perimeter should be drawn. For example, is the intention to include ESG data products in respect of which there lies an assessment performed by a firm (perhaps through a specific algorithm) as to the presentation, weighting or inclusion of E, S and/or G factors? Would the "assessment" need to be carried out by human interaction, or could an ESG score developed through application of an algorithmic process to underlying data also be intended to be caught? The latter of these points highlights the importance of ensuring that there is clarity as to the intended application of the regime as regards ESG ratings and ESG scores (the latter typically being recognised as a different type of product that is generated based on algorithms and quantitative calculations only, without substantial analyst discretion).

If the intention is to start by casting the net broadly, the IRSG would encourage HMT to allow provision for specific additional exclusions to be introduced in FCA rules at the point of implementation (in case in effect it becomes clear that the broadly drafted approach is disproportionate).

Some specific areas where clarity should be provided include as regards the treatment of controversy reports (or controversy alerts as sometimes termed) (which some IRSG members strongly feel should be included within the scope of the regulatory regime), and other styles of "assessment" products. These products would likely fall within the existing broad definition provided by HMT.

The IRSG also queries HMT's decision to exclude certain of the wording used in the IOSCO description of an ESG rating – most notably the phrase "*…using a defined ranking system of rating categories..*." This language is a helpful description that points the reader to the "rating" nature of the product, and its removal from HMT's proposed definition is likely to result in a regime in the UK for ESG ratings that expands considerably into the space of ESG data products. This may differ from international standards as they develop (and indeed HMT's approach would differ from the proposed approach set out in the European legislative proposal for the regulation of ESG rating providers), particularly if the IOSCO approach is typically used as the benchmark.

Question 7: Do you agree with the proposal to regulate the activity of providing ESG ratings to be used in relation to RAO specified investments?

The IRSG supports the move towards the regulation of ESG rating providers. The intention of introducing a new regulated activity of providing ESG ratings to be used in relation to RAO specified investments is a logical approach. We do, however, have two observations in this connection.

First, as regards the application of the regulated activity to RAO specified investments. While the language "to be used in relation to" is a broad linking phrase, consideration should be given to whether the language will be sufficiently flexible to recognise that ESG ratings are typically issued in respect of the entity and not the securities that it has issued. The IRSG suspects that the intention is for the regulatory regime to operate such that the regulated activity is being performed where the

ESG ratings that are issued are to be used in connection with investment decision making – but it is important to note that the ESG rating provider does not have control over how its ratings are *used*; it has control only over the design and delivery of its rating product (and as to the selection of which entities it decides to issue ratings) and over the model that it uses to distribute such ratings.

Second, we note that one effect of the proposal is that some (if not all) ESG rating providers would require full authorisation under FSMA. There is likely to be a timing implication of this: after legislation is published, the FCA will need to consult on and introduce rules for ESG rating providers. Following that stage, there will need to be an authorisation window for firms to seek and obtain authorisation. Some IRSG members have queried whether the full authorisation process is necessary and proportionate for this market, and whether the delay of implementation that is inherent with the approach is appropriate. There is a question – the answer to which may also depend on the timing of the Financial Services and Markets Bill – as to whether this is a market that should in its entirety fall within the Designated Activity Regime. Such an approach could mitigate the regulatory burden on providers, allow for the regime to be tailored and kept consistent with IOSCO and international standards, and allow for more timely implementation of regulation in this market.

Question 10: Do you agree that we should exclude:

- **ESG assessments where ratings are created by an entity solely for use by that entity via an intra-group exemption?**
- **credit ratings which consider the impact of ESG factors on creditworthiness?**
- **investment research products, such as equity research reports?**
- **external reviews, including second-party opinions, verifications, and certifications of ESG-labelled bonds.**
- **consulting services except certain scenarios which are more likely to impact capital allocation?**
- **academic research or journalism, even where that relates to ESG matters?**

Do you agree that where a firm engages in or provides the above activities or products, but also regularly provides ESG ratings for use in relation to specified investments as a separate activity, then the provision of the ESG ratings should be in scope of regulation?

The IRSG notes HMT's proposal that ESG assessments used only within a legal entity should be excluded from the scope of regulation, and wholeheartedly endorses that approach. The IRSG would support the extension of the intra-entity exclusion into an intra-group extension. If HMT proceeds to implement a new regulated activity in the RAO for providing ESG ratings, as currently proposed, then

it would seem proportionate and appropriate to allow the operation of the intra-group exemption at Art 69 RAO in respect of that activity. This would be consistent with many other aspects of the UK regulatory regime. The use of proprietary ESG ratings solely for internal purposes by a line of business (e.g. asset allocation analysis by an asset manager) can often cut across multiple legal entities. In these cases, the risk of harm posed is no greater than if the team were situated within the same legal entity, which we note HMT has identified as low. The "entity" test is also unlikely to have much practical value in groups of financial institutions, given that business lines and divisions are often not located in single entities (and indeed often operate on a global basis).

The IRSG would support an exclusion for credit ratings that incorporate ESG factors. These are not ESG rating products, and they are currently captured by an alternative regulatory regime.

The IRSG supports the exclusion for investment research products, although notes that it will require careful thought and drafting to ensure that the delineation between different products is credible. For illustration, could the exclusion result in a product framed as an equity research report into an issuer's securities falling outside of scope albeit that its content focuses entirely on providing an assessment of ESG characteristics and expresses the impact of those characteristics on a form of ranking scale?

The IRSG does not see a clear basis for the exclusion from scope of external reviews, including second party opinions. As the market develops, the terminology and product sets are likely to change as well. Hard wiring these exclusions in the legislation may not be a prudent step at this time.

The IRSG broadly agrees that there should be an exclusion for consulting services except in certain scenarios which are more likely to impact capital allocation.

The IRSG agrees in principle that academic research or journalism should be excluded, although we suggest that the better way to capture this principle is not through the specific exclusion of these trade areas but rather through exploring whether ESG ratings are being provided by way of business. It may, for example, be more appropriate to elaborate on existing legislation or guidance on the "by way of business" test to explain situations where ESG ratings provided or marketed otherwise than on a commercial basis should be excluded from scope. The IRSG notes that it is possible that journalistic or academic establishments may develop products that are marketed or provided on a commercial, for profit basis, and in that situation there is no justification for an exclusion.

The IRSG agrees that where a firm engages in or provides the above activities or products, but also regularly provides ESG ratings for use in relation to specified investments as a separate activity, then the provision of the ESG ratings should be in scope of regulation. It would, however, be helpful to clarify that financial products that are screened for ESG characteristics and contain information about that screening (such as investment funds the marketing materials for which contain internally produced information concerning ESG factors) are not within the intended scope of ESG ratings.

Question 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?

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

IRSG members support there being a regulatory framework for ESG rating providers and within that for there to be a level playing field with minimal confusion as to whether a rating product made available in the UK has been issued by an entity that is subject to regulatory scrutiny and accountability. For these reasons, there is support for the regulatory framework to cover the direct provision of ratings to users in the UK, even where the provider is based overseas.

It is, however, important to recognise that the ESG rating product market operates globally, and it is important to rating users in the UK to have access to products that are issued by ESG rating providers established in many jurisdictions around the world provided that such products are issued by a provider that is subject to an equivalent standard of regulation. Many global jurisdictions are currently developing regulatory regimes, or codes of conduct based on the IOSCO principles, to which locally established ESG rating providers will be required to comply. As drafted, HMT's proposal would cause those global ESG rating providers to subject themselves to the full scope of the UK regulatory regime as well if they wish to make their products available in the UK. The full scope of UK authorisation carries a number of regulatory burdens that will differ from, and in many cases be more onerous than or inconsistent with, local regulatory frameworks. As such, some members felt that there is a material risk that HMT's proposal will cause some global ESG rating providers to withdraw from the UK market even though they are regulated locally (or at least compliant with an IOSCO-consistent code of practice).

Recognising the desirability of ensuring high quality ESG rating products in the UK, balanced against different international standards, the IRSG would suggest that HMT's proposal could be supplemented with a regime of equivalence. For example, the FCA could permit the direct provision into the UK of ESG rating products from an ESG rating provider that is established in another jurisdiction provided that (i) the regulatory framework in that jurisdiction is identified as being equivalent to, or at least as stringent as, the regime in the UK, and (ii) the provider is authorised in me that jurisdiction and is in material compliance with the relevant standards.

Question 17: Should smaller ESG ratings providers be subject to fewer or less burdensome requirements?

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

The IRSG broadly supports the proposal that the regulatory burden imposed on firms should be proportionate and would suggest that this should have regard to the nature, scale and complexity of the firm's operations. These characteristics should, however, be viewed holistically and not on a purely individual basis: for example, "small" ratings providers can still pose a significant risk of harm in certain circumstances. The *size* of a provider may have little bearing on the quality of its ratings - a small provider of very low-quality ratings to a few market participants could cause greater harm than larger, higher quality providers. As such, the IRSG would acknowledge that it is likely to be complicated to set a threshold for the situation in which regulation should be applied proportionately.

We note HMT's suggestion that some firms, based on a test of proportionality, could be subject to alternate terms of regulation requirements, such as the Designated Activity Regime. The IRSG welcomes that this is a pragmatic and sensible approach in principle, though, as set out in our response to Question 7 above, there is at least a question as to whether the Designated Activity Regime should be the overarching approach that is adopted for all ESG rating providers.

The IRSG would welcome the opportunity to discuss HMT's proposals in more detail, and to engaging further with this topic once the proposals are finalised.

The IRSG wishes to thank those who have overseen production of this response, in particular Slaughter and May.

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