Chartered Governance Institute UK & Ireland

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HM Treasury
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By email: ESGRatingsConsultation@hmtreasury.gov.uk

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Dear Sir / Madam,

HM Treasury Consultation on the Future regulatory regime for Environmental, Social and Governance (ESG) ratings providers

We welcome the opportunity to comment on HM Treasury's consultation on the future regulatory regime for Environmental, Social and Governance (ESG) ratings providers.

The Chartered Governance Institute UK & Ireland is the professional body for governance and the qualifying and membership body for governance professionals across all sectors. Its purpose under Royal Charter is to lead 'effective governance and efficient administration of commerce, industry and public affairs', working with regulators and policy makers to champion high standards of governance and providing qualifications, training and guidance. As a lifelong learning partner, the Institute helps governance professionals to achieve their professional goals, providing recognition, community and the voice of its membership.

One of nine divisions of the global Chartered Governance Institute, which was established 130 years ago, The Chartered Governance Institute UK & Ireland represents members working and studying in the UK and Ireland and in many other countries and regions including the Caribbean, parts of Africa and the Middle East.

As the professional body that qualifies Chartered Secretaries and Chartered Governance Professionals, our members have a uniquely privileged role in companies' governance arrangements. They are therefore well placed to understand the issues raised by this consultation document. In preparing our response we have consulted, amongst others, with our members. However, the views expressed in this response are not necessarily those of any individual members, nor of the companies they represent.

Our views on the questions asked in your consultation paper are set out below.

General comments

As the Chartered Governance Institute, we have an interest in the effective governance of ESG ratings providers themselves. It is clear to us that the ESG ratings industry requires appropriate checks and balances and, fundamentally, that robust and effective governance structures are put in place. This will go a long way towards ensuring that ESG ratings are applied appropriately, that they are updated regularly, that mistakes are corrected and that the methodologies underpinning them are transparent. The regulation proposed by HM Treasury is a welcome step in achieving this.

We particularly commend the recommendations of IOSCO and its focus on four key outcomes: transparency, good governance, the management of conflicts of interest and robust systems and controls. We are heartened to see the FCA's adoption of these recommendations in its voluntary Code of Conduct and its commitment to embedding them into any future regulation.

There are several governance issues within the ESG ratings industry, in part due to the particular characteristics of this industry. Perhaps the most prominent is the issue of conflicts of interest. In cases where a firm provides ESG ratings to another, and also provides consulting or other services such as insurance and audit to that same firm, conflict of interest issues may occur. This is reflected in the IOSCO final report, which sets out the need for internal frameworks to mitigate these risks, as well as in the code of conduct from the Japanese Financial Services Agency, which suggests the implementation of firewalls between data-providing and consultancy staff. The European Commission's proposed regulation goes much further and will require agencies to divest from conflicting activities such as consulting, or risk being fined up to 10% of annual turnover. It is difficult to predict the implications of this on the ESG ratings providers market (particularly as it remains relatively immature), or on individual ratings providers themselves. Nevertheless, the Institute supports the intention behind this proposal, which is to ensure good governance practices and avoid conflicts of interest.

Another potential governance issue is the extent to which there is a financial incentive for the creation and adoption of ESG ratings, without regard to their quality. Many firms benefit from the use of ratings – be they advisory or consultancy services advising companies on how to improve their ratings, or audit firms which are paid to assure the veracity of ESG data, or investors who pursue and implement ESG strategies into their products. This widespread demand for ratings (reflected more broadly in an increasing appetite for vast amounts of ESG data) has the potential to incite ratings providers to produce ratings for an increasing number and breadth of companies, without necessarily having sufficient source data on these companies.

Finally, there are also several incentives at play which impact ratings providers' methodologies, and their (un)willingness to disclose these methodologies and be transparent about them. Many rely on proprietary technology to calculate ESG ratings and may be tempted to adopt more aggressive methodologies to increase their market share or recognition. For example, there could be cases in which assigning a particularly low or high rating to a company could compel the company to increase its disclosure, or to look more favourably on the ratings provider (which is especially the case when that ratings provider also provides other services such as consulting).

In order to address this, ESG ratings providers should be bound to publicise information about their methodologies as well as any changes made to them, including the specific ESG factors considered and their respective weightings. Currently, updates to a provider's calculations and methodology can result in revisions or changes (either upwards or downwards) to a company's rating – without any of the underlying data about that company having changed. When ratings are updated, it needs to be made clear as to whether this is as a result of a company's actions (or inaction), or simply a result of the calculations behind a rating. This would enable market participants to better assess and replicate ratings.

Specific questions asked in the consultation form

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

Yes. There is currently very little, if any, consensus as to how ESG ratings should be calculated, both in terms of the source data used and the methodologies applied to this data. More fundamentally, there remains a tension between the dual meanings of ESG, as to whether ESG refers to risk (the risks posed to a company's current or future financial performance by ESG factors such as climate change) or to impact (the impact of a company on ESG issues such as climate). Whilst this lack of clarity remains an issue not only for ESG ratings providers, but also for all those involved in the sector, it is particularly pertinent for ratings providers whose goal is to provide a 'one-stop shop' for ESG information.

The lack of a market standard – or even a universally agreed upon definition of ESG – means that there is a large amount of divergence between ratings of the same company from different providers. Research indicates that this divergence is not necessarily reduced by increased corporate disclosure. Users may compare or combine ratings without fully understanding the limitations of each providers' approach, and therefore be unable to mitigate any risk arising from those limitations. This subjectivity makes it more difficult for this information to be applied and relied upon in investment decisions. Indeed, some have suggested that they are best understood as opinions, much like the buy, hold, or sell opinions of sell-side analysts, rather than being understood as analogous to credit ratings.

ESG ratings have begun to play an important part in many types of market-based decisions, including transactions, suppliers, and inclusion in funds and indices – that is, they influence the allocation of capital. In order to avoid market decisions being made on the basis of misleading information, it is essential that these ratings are based upon sufficient data, sound methodologies and that they are transparent. As the UK moves towards a Net Zero economy, their importance is likely only to grow, and the Institute welcomes HM Treasury's move to regulate the providers of these ratings.

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.

Not applicable.

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

We do not have a view on this.

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

We do not have a view on this.

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

Yes, the Institute agrees with the definition of such ratings – whether or not labelled as ratings, 'scores', 'marks' or 'assessments'. Such a definition incorporates ratings produced both by analysts and by

algorithms, and also ensures that future products which are not yet part of the market continue to fall into scope. In particular, it is encouraging to see that this applies to assessments which refer to factors falling under only one of the ‘E’, ‘S’, or ‘G’, and not solely to assessments referring to all three in aggregate.

6. **Do you agree that ESG data, where no assessment is present, should be excluded from regulation?**

Under the scope of this particular regulatory regime, we agree that ESG data which has undergone no assessment and only the most minimal processing should be excluded. However, there is a need for separate regulatory intervention with regards to ESG data itself, and the ways in which this is provided.

Whilst it is crucial for ratings (i.e. the processing of ESG data) to be regulated, it is also important for the providers of ESG data – which is often companies themselves – to provide consistent and accurate data in the first place. In response to investor and stakeholder demand, larger companies in particular often produce and report on vast quantities of ESG-related data. Companies have reported receiving numerous questionnaires from ratings providers on an ad-hoc basis and with short turnaround times, including on issues which are not material to their business. This creates an onerous obligation for the company as a data provider, and the data itself requires collating, analysing and summarising in order to be beneficial to users. As the companies themselves are reporting on this, there is the possibility of a lack of transparency, objectivity and reliability, not least because the increasing, and sometimes conflicting, demands for such data may exceed the data providers’ own level of understanding of the data. As such, it is not only the ‘data processors’ (i.e. the ratings providers) which require regulation, but also the data provision requirements and, to some extent, the ‘data creators’ (i.e. the companies themselves, whether providing data directly to ratings agencies, or indirectly through public disclosure, and by extension, intermediaries which collate this ESG data and pass it on to ratings providers). Such regulation comes in the form of reporting requirements, such as those set out by the TCFD and TNFD, as well as global reporting frameworks such as the ISSB.

Without attempts to regulate the quality and veracity of data which is used in ESG ratings, any regulation of the ratings providers and their methodology will not sufficiently address the issues with these ratings. Conversely, as more consistency and reliability are achieved in the reporting of companies’ ESG data, it is likely that the quality of ESG ratings will also improve, as ratings providers will have access to more consistent and comparable information, for example, through the presentation of ESG data in standardised formats and units. This trend is also noticeable in the increased prevalence of third-party verification and assurance of ESG-related data, although the use of these remains limited in breadth and scope for now. Investor demand for more rigorous assurance and audit of ESG-related data has to be balanced with companies’ ability and the resource available to provide such data, particularly when the number of data points requested can be large and, in many cases, not necessarily material to the business of the company.

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

Yes, in our view this proposal is a reasonable means by which to regulate the provision of ESG ratings. In order for this to be workable, it is important that the results of this consultation demonstrate that ratings providers are aware of when their ratings will be used in relation to an RAO specified investment. It seems likely to us that this will be able to be established either in user contracts and service

agreements, or through the application of particular products and bundles which are sold by ESG ratings providers.

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

Not applicable.

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

As is stated in HM Treasury's consultation document, there are certain applications of ESG ratings which go beyond the scope of RAO specified investments, such as voluntary carbon credits. It may be that the regulation of such ratings falls under the scope of other regulatory frameworks. Particularly as the ESG space and related markets expand, it is likely that a variety of products will emerge in future, to which ESG ratings apply. It is important that the proposed regulatory framework is future-facing enough to tackle these where appropriate, but that it also does not overextend itself.

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?

Overall, this list of exclusions appears reasonable. However, we are of the view that not-for-profit ratings providers should, where their main activity is providing such ratings, and beyond a certain size threshold, be subject to regulation. It seems amiss that not-for-profits are excluded, when some of them rank amongst the main players in this space (such as CDP and JUST Capital). However, to reflect the demands on not-for-profits, the size threshold at which regulation applies to not-for-profits should be set higher than the size threshold for the classification of 'smaller' for-profit / corporate ratings providers. As a cross-sectoral organisation, the Institute's view is that effective governance (which would be encouraged by the proposed regulation) is just as important in the not-for-profit sector as it is in the corporate sector. Whilst such not-for-profit organisations are less likely to come across conflict of interest issues, there remains a need for transparency about their methodologies and means of collecting ESG data.

We agree that ratings created by an entity solely for that entity's own purposes need not be included, but that regulation should apply where those ratings are used both internally and externally. The question of intra-group ratings is more complex. Excluding ratings which are produced and used within a group from regulation could have implications for competitiveness in the ratings market.

Credit ratings should be excluded from regulation, as proposed, despite often incorporating ESG data and ratings either implicitly or explicitly. As they are subject to the Credit Ratings Agencies Regulation, any potential lack of alignment between this and eventual ESG ratings providers regulation could lead to difficulties.

The Institute agrees that exclusions should apply to investment research products, external reviews, consulting services and academic research or journalism. Whilst all of these products could have implications for capital allocation, the final products are much more likely to go beyond a headline ESG rating and to incorporate several other factors, thus diluting the risk that a potentially unsound ESG rating could mislead investment decisions.

We do believe that there is a case to be made for the regulation of proxy advisors, but although this would in many ways be analogous to the regulation of ESG ratings providers, we believe this to be separate issue.

11. Are there any other exclusions which should be provided for?

We have no further suggestions.

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?

Yes. This would ensure a level playing field, as well as adequate protection for UK users. There is, however, a risk of restricting UK users' access to overseas products. For several key jurisdictions, this may be able to be overcome by the recognition of overseas regimes as being in sufficient alignment with the UK's regulation. Issues of territorial equivalency are addressed below under question number 16.

13. (For UK users of ESG ratings) Are you concerned that this proposal would hamper the choice of ESG ratings available to you?

Not applicable.

14. Should any instances of direct provision of ESG ratings to users in the UK be excluded from regulation (for example, the provision of ESG ratings to UK branches of overseas firms, or to retail users who are temporarily physically located in the UK)?

In order to ensure that regulation is proportionate and can be fully implemented, there are cases where direct provision of ratings to UK users should be excluded from regulation. One such case is set out in the consultation and is the provision of ratings to retail users who are temporarily located in the UK.

15. Are there any scenarios of indirect provision of ESG ratings to UK users which should also be regulated?

Yes, the provision of ESG ratings to UK users by third parties or intermediaries should also fall under the scope of regulation. This will ensure a level playing field and avoid a situation by which overseas ratings providers can simply bypass UK regulation by selling their ratings through a third party. For reasons of practicality and enforceability, it is likely that this could only apply to UK-based third parties and intermediaries.

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?

The territorial scope as set out in the consultation refers to the idea of territorial equivalency, by which HM Treasury will recognise overseas regulatory regimes. It is unclear how HM Treasury or the FCA will assess regulations outside of the UK and determine whether these are adequately aligned with UK regulation. This process and the requirements for sufficient alignment should be made explicit to. As the FCA has stated its intention to follow the recommendations of the IOSCO report, it is likely that there will be considerable overlap between UK regulation and that of other jurisdictions such as the USA and

Japan. However, the application of the IOSCO's principles could result in significant differences. Furthermore, there remain several jurisdictions where no such regulation is likely to introduced, or if it is, that it will be materially different to the UK's regime.

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

Yes, as ever, it is important that regulatory requirements are proportionate and tailoring such requirements to the size of firms is a key means of achieving this. In the context of ESG ratings providers, the concentration and market share of the largest providers is of concern. It is important that regulation does not unduly create barriers to entry in the ESG ratings market. As this area is rapidly evolving – as well as increasing in influence – it is essential that smaller players are able to participate and innovate in this space.

Additionally, there may be a proportionality argument that less burdensome requirements should apply to those firms for which providing ESG ratings is a very small fraction of their overall business model and revenue generating activity, but this needs to be balanced against their overall size and the impact of their ratings on their client base.

18. (For ESG ratings providers) What impact would an authorisation requirement have on your business? Please provide information on the size of your business when answering this question.

Not applicable.

19. Do you have any views on an opt-in mechanism for smaller providers?

An opt-in mechanism could be a neat solution to the question of proportionality, allowing smaller providers to compete on the same terms as larger providers, without requiring all smaller firms to necessarily adhere to the full range of regulations. It could go some way to avoiding competitive disadvantages compared to larger providers. However, if this is to be adopted, the relationship between such an opt-in mechanism and the voluntary Code of Conduct must be made explicit.

As the regulatory framework for providers will take some time to materialise, the Institute welcomes the FCA's development of a voluntary Code of Conduct as a means to support effective governance and increased transparency amongst providers.

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

The Institute supports HM Treasury's proposal to evaluate the size of ESG ratings providers in alignment with the criteria set out in the Companies Act 2006. The requirement to sit below a certain threshold in two out of the three factors of turnover, balance sheet total and number of employees provides a clear means for delineating company size. In addition, this definition is likely to be very familiar to firms which are affected, thus maintaining consistency between this proposed regulation and other existing regulation.

However, we are of the view that these criteria should be applied to determine the proportionality and extent of regulation to which providers are subject, rather than to determine whether any of them are exempt from regulation. Several ratings providers will fall under the 'small companies' threshold under

the Companies Act, particularly in cases where they may focus on ratings within one sector or on one specific topic. This should not mean that future regulation does not apply to them, although it should, of course, be proportional.

21. What level could the criteria for small ratings providers be set at (i.e., how could 'small ratings provider' be defined)?

As above, the Institute is of the view that the criteria defined in the Companies Act 2006 are valuable and could readily be applied in this case. Regulatory requirements should be more stringent for the largest providers, but some regulation should apply to all companies which exceed the micro-entities threshold as set out in the Companies Act. Whilst the European Commission's proposed regulation for ratings agencies sets the threshold for smaller agencies at less than 8 million euros turnover a year, our view is that this threshold is too high. Introducing regulation in a staggered fashion according to the size of the ratings providers will ensure proportionality whilst also protecting users of ESG ratings. The thresholds which are set should be kept under review as the ratings market evolves.

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

As mentioned above in both our general comments and under question number 6, the issue of unsound ESG ratings cannot solely be addressed through regulating the providers of such ratings. The quality of the data that underpins these ratings must also be addressed. One means of increasing the quality and quantity of data used is to increase the amount of communication between ratings providers and the companies they rate. Whilst this may seem unattractive to ratings providers, who aim to keep operating costs as low as possible, there could be significant advantages.

In contrast to credit rating agencies which are engaged by the company being rated, ESG ratings are often paid for by investors. This can lead to the ratings provider having insufficiently detailed information about the company being rated, as they may rely solely upon publicly available data rather than having access to management. Indeed, our members have reflected that their companies have, at times, been rated without any contact from the ratings providers at all. The question of inadequate data is exacerbated by the fact that several companies report their ESG-related data points across different sources, including annual reports, sustainability reports and on their websites, as was stated in IOSCO's 2021 report. According to a paper publicised by the Harvard Law School Forum on Corporate Governance, in cases where ratings providers do not have access to data that they need, they will sometimes estimate, approximate or even assume a firm's performance for a particular metric to 'fill in the gap', for example by simply assigning it the industry average.[1] This can lead to a lack of accuracy in the resulting ratings, or to companies feeling obligated to report on ESG issues which may not be material to their business but which ratings providers look out for. To address this, ESG ratings providers could be encouraged to consult with companies as to what data is most relevant to their industry. This has the added benefit of making ESG data more accessible and thus increasing ratings providers' coverage both across industries and geographies.

In alignment with the findings of ESMA's 2022 call for evidence, our members have expressed frustration about their interactions with ratings providers and, particularly, about the difficulty of sharing feedback or

[1] Tayan, B. ESG Ratings: A Compass without Direction, *Harvard Law School Forum on Corporate Governance*, 24th August 2022. Accessible from: https://corpgov.law.harvard.edu/2022/08/24/esg-ratings-a-compass-without-direction/ (last accessed 22nd June 2023).

having errors corrected. In cases where ratings providers do actively reach out to companies to source ESG data, this often takes the form of burdensome questionnaires which are resource-intensive to complete and which do not necessarily provide enough transparency around their requirements. Additionally, they most often arrive unscheduled and on an ad hoc basis, requiring a quick turnaround, which means that companies may be unable to source the data in time. Our members would also like to see named contacts at ESG ratings providers with whom they can liaise to address any inaccuracies. In the FRC's recent report on the influence of proxy advisers and ESG ratings providers, companies commented that they were concerned investors may rely on the headline rankings for voting decisions, which may not entirely reflect the companies' performance. Opening up the channels of communication between ratings providers and the companies they rate could improve outcomes for the ratings providers, who would have access to more and higher quality data, as well as for companies and those who invest in them.

If you would like to discuss any of the above comments in further detail, please do feel free to contact me.

Yours faithfully,

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