



# HMT CONSULTATION: FUTURE REGULATORY REGIME FOR ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) RATINGS PROVIDERS

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ICAEW welcomes the opportunity to comment on the *Future regulatory regime for environmental, social and governance (ESG) ratings providers* published by HM Treasury on 30 March 2023, a copy of which is available from this [link](#).

For questions on this response, please contact the ICAEW Financial Services Faculty at [fsf@icaew.com](mailto:fsf@icaew.com) quoting REP 59/23.

This response of 21 June 2023 has been prepared by the ICAEW Financial Services Faculty. As a leading centre for thought leadership on financial services, the faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk, auditing and reporting issues facing the financial services sector. The faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services. ICAEW's Corporate Finance Faculty has also input to this response.

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## EXECUTIVE SUMMARY

### Introduction

1. ESG indicators increasingly drive investment decisions both for companies and the investor. It is clear that the role of ESG ratings providers could be critical in establishing trust in ESG products, particularly as this is a relatively new area and we can see the public relying on rating providers as an expedient in determining what is or is not a 'good' ESG investment.
2. We agree with the concerns raised by HM Treasury: the challenges faced by market participants in deciphering what a rating implies amidst opaque decision making; concerns about how an ESG ratings provider interacts with the rated entity and potential for conflicts of interest.
3. We also note that both the International Organization of Securities Commissions (IOSCO) and Organisation for Economic Co-operation and Development (OECD) have recommended regulators pay more attention to ESG ratings and data and other jurisdictions, such as the EU, have published proposals for regulation of ESG ratings providers.

### ***Q1. Do you agree that regulation should be introduced for ESG ratings providers?***

4. As such, we agree with HM Treasury that there is clear benefit to be gained from improving the transparency of methodologies, governance, and processes of ESG ratings providers through regulation. This would apply to the direct provision of an assessment of environmental, social, or governance factors to a user in the UK, where the assessment is used in relation to a specified investment in the RAO, unless an exclusion applies. We welcome engagement on the potential scope of a regulatory regime.
5. We believe the focus of any regulations should be on ensuring the integrity of outcomes and boosting standards – this will build trust in ESG ratings and help prevent greenwashing. Our feedback is given through this lens.

### Promoting the integrity of ESG data

### ***Q6. Do you agree that ESG data, where no assessment is present, should be excluded from regulation?***

6. We do not fully agree that ESG data, where no assessment is present, should be excluded from regulation. While we recognise regulating all sources of ESG data might not be feasible or practical, we firmly believe that there needs to be regulation around the data used by ESG ratings providers. This is because the ratings are only as good as the data used to compile them.
7. We encourage regulation that requires ESG ratings providers to have strong internal control environments over ESG data. This would promote transparency and accountability, enhancing the reliability of ESG reporting and preventing misleading claims of "greenwashing". It would also contribute to building trust among stakeholders and investors.
8. The current proposals are not explicit about how data integrity might be achieved. We welcome clarification of the FCA's thinking on this matter. Is the intention of the regulator to put the onus on the ratings provider to ensure the veracity of ESG data used in coming up with the ratings?
9. If so, HM Treasury should indicate how far does the liability lie with the ratings provider. For example, short of auditing the data, how can ESG ratings providers demonstrate the accuracy and completeness of the data used? We recognise the benefits of regulations not being too prescriptive in order to maintain agility and not constrain innovation and choice. However, the guiding principle here should be transparency and clarification as to how this can be achieved.
10. An alternative approach, instead of regulating the data providers, could be to require ratings providers to provide disclosures about the quality of data and their reliance on it. This would be supported by a robust internal control environment at the provider. Such an approach

would require elaboration on a consistent methodology of disclosure to allow comparability and transparency, both of which are key.

11. Care should be taken in the guidance provided to ensure there is no duplication of verification process. For example, we would expect limited additional due diligence to be performed by the ratings provider for a rating based on audited financial information from publicly available accounts.
12. However, we would still expect disclosures by the ESG ratings provider to reflect the nature and extent of assurance over those publicly available accounts that it has taken into consideration. The regulator needs to strike a balance between ensuring the reliability of data and avoiding an excessive regulatory burden that could hinder reporting efforts.
13. Given this is an evolving area, consideration should be given to whether it may be appropriate to extend regulation to certain ESG data providers in the future. This could be necessary if a few entities start to dominate the field in providing data to ratings providers.

### **Exclusions – not-for-profits and intra-group ratings**

#### ***Q10. 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?***

14. We agree generally with the excluded scenarios in paragraphs 3.2, 3.3 and 3.5, with the exception of two matters.
15. First, we believe that not-for-profits providing ratings specifically for investment purposes should be brought into the regulatory perimeter. This is because this covers a large swathe of the market, and the potential for an entity from this sector to dominate ratings yet be subject to less scrutiny. Potential carve outs can be provided for if the ratings are provided solely for a user's internal use. For example, if provided by a trade association as a paid for service to its members.
16. Second, we believe a distinction should be drawn between not-for-profits providing ratings for investment purposes (which should be regulated) versus those providing ratings on a company's performance in relation to specific ESG issues ancillary to campaigning purposes. The latter could be used by investors to consider the desirability of companies to invest in (potentially out of scope).
17. We are of the view that more detail is needed to support the FCA's proposal for excluding not-for-profits.
18. We agree with the caveat in paragraph 3.6 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 an ESG rating would be in scope of regulation.
19. Caution needs to be exercised if excluding intra-group ratings – we believe it should only be excluded if there is no chance that the proprietary intra-group ratings are implicitly or directly included in the marketing of a fund, or the ratings forms the basis of inclusion of assets into a fund that is then offered to the public.
20. The guidance should clarify that the exclusion only applies to intra-group ratings used internally within a group and cannot be used to market externally.

### **Expansion of territorial scope**

#### ***Q12. 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?***

21. Direct provision is currently defined as where an ESG rating is provided to a UK user who has paid for that rating, either on its own or as part of another service or bundle of products.
22. We do not believe this is appropriate, as a number of ratings are likely to be free at the point of use. If the point of the regulation is to protect the consumer, it should include all ESG rating providers that provide a rating to evaluate an investment, free or otherwise. For

example, we frequently observe equity analysts at banks offering “buy, hold, sell” ratings for free and it is foreseeable that the same may apply to ESG ratings going forwards.

23. In terms of geographical coverage, we believe the scope should be expanded to cover UK entities providing services to non-UK residents and should establish equivalence with other jurisdictions.
24. Recent examples of this approach to geographical scope can be found in UK Consumer Duty and cryptoasset regulations. Otherwise, we risk asymmetry in regulations with other jurisdictions and domestic and international firms operating in the UK.

### **Proportionality considerations**

#### ***Qu17. Should smaller ESG ratings providers be subject to fewer or less burdensome requirements?***

25. It is important that any potential carve out for smaller providers does not undermine the focus on maintaining the quality of ESG ratings.
26. A minimum standard should be set across all providers, but potentially, the supervisory aspects can be made proportionate once the provider is regulated, as proposed in the first bullet of paragraph 5.4. This could potentially in part be achieved by requiring all providers to adopt an ESG Data and Ratings Code of Conduct.
27. We believe rating providers may find aspects of regulation desirable. For example, where it may act as a competitive advantage and where it reinforces legitimacy in the ratings provided.
28. Whilst we recognise a more flexible, tiered approach to authorisations in first instance (as suggested in the second bullet of paragraph 4.5) may allow firms to grow, we can also see the market potentially demanding the higher standard for investment, thus negating the benefits of bifurcation. HM Treasury should perform research into the market to assess the best approach (one or two-tier) for regulating this nascent area.

#### ***Q19. Do you have any views on an opt-in mechanism for smaller providers?***

29. The opt in mechanism may go some way to address issues around proportionality identified above as it would allow smaller players to adopt the full regulatory framework should it choose to, reaping the benefits of full authorisation.
30. While the current proposals cater to SME businesses, it is important to consider the impact on not-for-profit organizations. If not-for-profits are not brought into the regulatory perimeter, they will be excluded from the opt-in and will not have the same legitimacy as authorised peers, creating an uneven playing field.
31. To ensure the ongoing competitiveness of UK ratings providers, the regulator should be prepared to adhere to evolving international standards while adapting to UK-specific risks and needs.