CFA Society United Kingdom

30th June, 2023

Baroness Penn
Treasury Lords Minister
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Submitted by e-mail to: esgratingsconsultation@hmtreasury.gov.uk

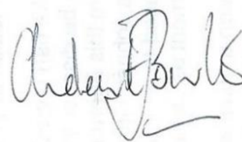
Dear Lady Penn,

CFA UK response to HMT's Consultation regarding the future regulatory regime for Environmental, Social and Governance (ESG) ratings providers

The CFA Society of the UK (CFA UK)[1] strongly supports the government's intention to bring ESG ratings into the regulatory perimeter and welcomes the opportunity to respond to this Consultation. We have been advocating that ESG ratings, and some other related activities, be brought into the regulatory perimeter for some time due to the influence they can have in the capital allocation process[2] and are pleased to see this initiative make progress.

We provide detailed answers to the questions set in the Consultation in Appendix II. In line with our Society's purpose, we aim to highlight relevant issues to help the investment community to serve its stakeholders well and to build a more sustainable future.

Yours sincerely,



Will Goodhart
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With thanks to contributions from:

[1] CFA UK is a professional body representing over 11,000 investment professionals in the UK. Many of our members are now either users or providers of ESG ratings, or other ESG-related services. Appendix I contains summary of the mission, purpose and activities both of CFA UK and our umbrella organisation, CFA Institute.

[2] CFAUK response to the FCA regarding CP21/18: Enhancing climate-related disclosures by standard listed companies and seeking views on ESG topics in capital markets (September, 2021): https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/ccdr-letter-to-fca-cp21-18-psc-final.pdf

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and for the oversight of the Professionalism Steering Committee.

APPENDIX I: About CFA UK and CFA Institute

CFA UK serves over eleven thousand leading members of the UK investment profession. Many of our members work either managing investment portfolios, analysing and advising on investments, or in some form of investment operations and oversight role. Many either provide or are users of ESG ratings.

The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.

Founded in 1955, CFA UK is one of the largest member societies of CFA Institute and provides continuing education, advocacy, information, networking and career support on behalf of its members.

CFA UK has pioneered the development of ESG-related examinations for investment professional in recent years, specifically the Certificate of ESG Investing (now run by CFA Institute), the Certificate of Climate Investing and the Certificate of Impact Investing (currently under development).

Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

For more information, visit www.cfauk.org or follow us on Twitter @cfauk and on LinkedIn.com/company/cfa-uk/.

CFA Institute is the global association for investment professionals that sets the standard for professional excellence and credentials.

The organisation is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.

It awards the Chartered Financial Analyst® (CFA) and Certificate in Investment Performance Measurement® (CIPM) designations worldwide, publishes research, conducts professional development programs, and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.

CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst® (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.

For more information, visit www.cfainstitute.org.

APPENDIX II: Responses to questions

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

   Yes, as we have previously argued, CFA UK agrees. ESG ratings perform an increasingly important function in the allocation of capital across listed and unlisted markets. Whilst many of the current leading providers will already be likely in compliance with the eventual regulations that the FCA will bring, the introduction of regulation will establish a minimum baseline for conduct and practices and should help raise trust and transparency in the sector.

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.***

   CFA UK is not a provider of ESG ratings.

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

   We list below a number of potential overlaps and situations requiring cross-referral and there are bound to be more. We believe the overlaps are significant. It is important that the FCA consults thoroughly in due course so that certain services which contain ESG assessments but are not ESG ratings, are not unintentionally caught in the scope of the regulation in the same way, for example, as certain structured products were caught under the EU PRIIPs regulation.

   - An important area is definitions, and there will be obvious overlaps with the EU's Taxonomy and SFDR as well as the UK's Green Taxonomy and SDR once they arrive.
   - In terms of practices there are obvious areas of overlap are with credit ratings and independent and sell-side equity and credit research, mostly governed by MiFiD II.
   - There is also overlap with investment advisory regulation in, for example, manager and fund selection where consultants provide a rating or an assessment on the quality of a fund's ESG processes (rather than its underlying investments).
   - As the Consultation observes, there are also strong inter-dependencies between benchmarks and ESG ratings and both have conflicts of interest which need navigating/regulating.

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

   CFA UK has identified the following challenges:

- We believe it is very important that any future regulation does not result in all ESG ratings looking the same. The regulation should be designed to ensure that the methodologies used by ESG ratings providers are fair and robust but should not prescribe a required process in detail as this could lead to uniformity and a lack of homogeneity. The future regulation should aim to provide a competitive market that fosters innovation and caters for different perspectives and transparency.
- As ESG ratings are a global product, it is fundamentally important that the market place is consistently regulated globally. We welcome the fact that the proposed regulation will align with IOSCO's four principles and encourage the FCA to liaise with other leading global regulators in the formulation and structuring of the regulation.
- The future regulation will need to strike a balance between the requirement for transparency on the one hand and, on the other hand, the need for ESG ratings providers to defend and retain their sources of competitive advantage.
- ESG data is to varying degrees sparse, rapidly developing and inaccurate. What allowance(s) should any future regulation of ESG rating providers make for this? That is a challenging aspect.

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

HM Treasury propose that *"an ESG rating in the context of a new regulated activity would cover an assessment regarding one or more environmental, social, and governance factors, whether or not it is labelled as such."*

We agree completely that the regulation should focus on the substance of the activity and the end to which it is used and not what it is called or labelled. We also think it is sensible to make the link to their use in investment decision-making (to be regulated under RAO) as opposed to a wider, more general use within investment research.

We believe it should specifically apply to funds as well as to (para 1.2) "entities such as companies and sovereigns; or of products, like financial instruments."

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

Yes, as we have previously argued[3], CFA UK agrees that ESG data providers should be excluded. We believe that to include such providers would risk making the regulation very hard to implement and enforce.

We do not dispute that an ESG ratings provider relying on poor or incorrect ESG data will lead to poor or incorrect ESG ratings. It therefore follows that it becomes the

[3] See p15, CFAUK response to question 20b: https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/ccdr-letter-to-fca-cp21-18-psc-final.pdf

responsibility of ESG ratings providers to ensure to the best of their ability that the ESG data which they use is robust and true.

ESG data forecasts are an interesting aspect. Whilst they are based on historic data they embed future assumptions and therefore could be deemed to become an assessment, and one which might influence the allocation of capital: Paris-aligned emissions forecasts are a notable example of this which the FCA will need to consider.

We note that providers of ESG ratings are often also providers of ESG data. The FCA will need to provide those firms with guidance about which activities are regulated and which not and this may trigger the need for organisational restructurings within some groups providing ESG ratings.

We observe also that some firms sell repackaged ESG data; taking several data series and combining them in such a way to make them more immediately decision-useful and consumable by investment clients. Provided there is no assessment of the data involved we would exclude these providers also.

We also note that some ESG data may already be subject to other existing regulation.

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, CFA UK agrees with the proposed scope.

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

   No comment. CFA UK is not an ESG rating provider.

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

   No comment. We cannot identify any additional relevant uses.

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?***

    CFA UK agrees/disagrees as follows:

    - **Not-for-profit entities:** CFA UK believes that NFPs should be included within the regulatory perimeter. The prime aim of the regulation is to protect the UK consumer from poor ESG ratings and we do not consider that the ratings of a provider will be safe just because that provider doesn't aim to make a financial profit from them. Unlike credit ratings, ESG ratings frequently can require judgement on highly political issues and we are conscious that an ESG rating

published by a politically motivated or national government foundation is just as likely to be exposed to bias as a rating from a provider that fails to manage its commercial conflicts properly. We note that many not-for-profit providers of ESG ratings would be currently classified as 'small' and we would therefore propose to exclude them from the regulation anyway on grounds of proportionality. Multinational NGOs such as UNPRI could be excluded.

- **Internal ESG Ratings:** CFA UK agrees that ESG ratings provided and used by one legal entity of a consolidated group may be excluded from the regulation.

- **Dual-purpose Internal & External Ratings:** CFA UK agrees that ESG ratings provided and used by one legal entity but used both within that entity and sold as part of a bundled package of products should not be excluded the regulation since the third-party users may be UK consumers that should be protected from poor ratings.

- **Intra-group ratings:** CFA UK agrees that ESG ratings provided by one legal entity of a consolidated group and used by another legal entity within that same consolidated group can be excluded from the regulation provided they are only used (by those other legal entities) within that same consolidated group. If these ratings become purposefully or inadvertently available outside of that consolidated group, then they should be included in the regulatory perimeter.

- **Credit Ratings Agencies ("CRA"s)**: CFA UK disagrees that Credit Ratings Agencies should be excluded from the primary legislation introducing the new regulation on the basis that they are already regulated[4]. As we wrote in our answer to question 20c of CP21/18[5] ESG Ratings and Credit Ratings are not identical products. The Credit Rating market is mature and dominated by a few providers whereas as the ESG Ratings market is continuing to evolve rapidly and is highly fragmented. It is possible that either initially, or subsequently, the regulatory requirements of CRAs will differ from those of ESG ratings providers. However, CFA UK believes that the FCA could grant CRAs an exemption from the regulation so long as they believe that the then current requirements of the CRA regulation and the ESG ratings regulation are aligned. As for sell-side and independent credit research below, the FCA's decision on this should be ultimately determined by whether the credit rating reports themselves include a systematic assessment or grading of ESG risks or restrict themselves only to a commentary on ESG risks.

- **Sell-side or independent equity or credit research:** CFA UK agrees that ESG commentary provided by sell-side banks or by independent firms for the purposes of providing an opinion on an equity or corporate bond security trading in the secondary market may be excluded from the regulation provided that the reports' primary purpose is to provide an opinion on the valuation of the security

[4] FCA Regulation of Credit Rating Agency firms: https://www.fca.org.uk/firms/credit-rating-agencies
[5] See p15, CFAUK response to question 20c: https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/ccdr-letter-to-fca-cp21-18-psc-final.pdf

itself and not to provide an ESG assessment in a systematic way or within a scoring framework that looks like an ESG rating. Sell-side and independent equity and credit researchers providing an opinion on ESG matters pertaining to an individual corporate entity should not be in scope of the regulation provided that (i) any commentary does not extend to the provision of an overall ESG score, grading or assessment in any way as part of the security analysis or (ii) support the issuance of new equity or corporate securities in the primary market.

- **External Reviews, Second-Party Opinions ("SPO"s), Verifications and Certifications:** CFAUK agrees that SPOs or expert External Reviews should be included within the scope of the regulation when the primary purpose of these reports is to provide an expert opinion on ESG matters in support of a new issue of equity or bond security (like a Use of Proceeds bond, for example).[6] If the purpose of the provider's reports is not directly linked to an investment decision or providing a rating framework for investment then they should not be included, however.

- **Proxy Advisor Services:** CFAUK agrees that these providers should not be included within the scope of the regulation as (i) the primary purpose of their reports is to provide an opinion on a corporate action (which may concern ESG matters) and not to provide an ESG score or grading and (ii) they are already regulated in a way sufficient to protect the consumer[7].

- **Consultant reports:** CFA UK agrees that, consistent with our comments above for sell-side and independent equity and debt research and also SPOs, ESG commentary or opinion provided by consulting firms may only be excluded from the regulation if the report's primary purpose is neither to support the issuance of new equity or corporate securities in the primary market or systematically influence the allocation of capital in the secondary market. Manager selection fund research that contains ESG ratings should probably be included where the ratings are systematic and influence capital allocation.

- **Academic research or journalism:** CFA UK agrees that, as with consultants reports above, ESG commentary or opinion provided by academics or journalists may be excluded from the regulation provided that the reports' primary purpose is neither to support the issuance of new equity or corporate securities in the primary market or systematically influence the allocation of capital in the secondary market.

[6] See p13, CFAUK response to question 15: https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/ccdr-letter-to-fca-cp21-18-psc-final.pdf
[7] FCA regulation of Proxy Advisors: https://www.fca.org.uk/markets/primary-markets/proxy-advisors

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

For the avoidance of doubt, the provider of any ESG ratings distributed by an overseas third-party distributer into the UK such as Bloomberg or Refinitiv should be in scope of the regulation.

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, CFA UK agrees. Most leading providers of ESG ratings are domiciled outside of the UK.

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

No, we are not concerned. We note that other major financial centres are considering adopting similar regulations. This answer is of course predicated on the regulation being correctly calibrated so as not to stifle innovation (see our answers to question 17-22).

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)?

No. Branches of overseas firms located in the UK should not be excluded. Such branches and their customers are all UK consumers. Furthermore, to exclude such entities from the regulation could introduce a loop-hole for the successful implementation of the regulation.

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

We agree that all issuer-paid ESG opinions, reports, commentaries should be included in the regulation. Such reports are prone to issuer-bias in any event by virtue of the entity that is paying for their issuance.

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?

It is important that internationally proposed regulations/codes are considered in the expanded regime (e.g. FCA follow on work) to try ensure consistency globally.

We note the work that the FCA are currently undertaking with regard to establishing a code of conduct for ESG ratings providers and any UK provider of ESG ratings should be required to become a signatory under that code. In so far as possible that code of conduct should be consistent with ESG ratings related codes in other markets.

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

We believe the IOSCO principles upon which the future regulation will be based should not be onerous for any ESG ratings provider to adopt; indeed, the principles provide a framework which all good ESG ratings providers should adopt. Ultimately, we believe all providers of ESG ratings that influence the allocation of capital should be subject to the same regulation.

At the same time, we recognise that there are many small ESG ratings providers that will be caught by this new regulation. We appreciate how the introduction of a new regulation, and in particular the registration and authorisation process, can be disproportionately burdensome for small firms. We further recognise that the FCA may not have the resources to regulate all these firms from the implementation date.

We therefore conclude that ESG ratings providers below a certain size threshold could be exempted from the new regulation for a 3-5 year period. After this period, the appropriateness of the exemption should be scheduled for mandatory review in the context of the development of the market for ESG ratings provisions over that period. Thus, this new regulation could be phased in in a way similar to TCFD reporting with the following benefits:

- FCA resources would be prioritised on the large and most impactful providers;
- UK users of ESG ratings would not see an immediate reduction in the number of ratings providers due to the implementation of the new regulation. Innovative approaches and niche market operators should not therefore disappear from the UK market overnight;
- Small firms would have time to plan to adopt the new regulation, by which time a service infrastructure will have developed to facilitate registration and authorisation and the FCA will have a well-established registration and authorisation process;
- The ESG ratings sector will have further time to evolve and continue the current consolidation trend in which we expect smaller niche providers to be bolted onto larger players, reducing the number of firms that will require regulating.

An alternative approach to make the regulation more proportionate for smaller firms would be to regulate those ESG ratings providers above a certain size under the Regulated Activities Order (“RAO”) and to make smaller firms subject to less onerous requirements in the Designated Activities Regime (“DAR”). This would mean that smaller firms would not need to go through the potentially cumbersome authorisation process (until such time as the regulation was phased in to include them).

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.

CFA UK is not a provider of ESG ratings. We have no comment.

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

If small firms are subject to an exemption which is subject to mandatory review as we contemplate in our response to question 17 above, then potentially they may find themselves at a competitive disadvantage. Clients are likely to be reassured by the presence of regulatory oversight; some may ask or encourage their ESG ratings providers to become regulated. Ultimately, we believe that the adoption of the new regulation will make firms better providers of ESG ratings. We would therefore support the opt-in mechanism in combination with the mandatory review in 3-5 years time. This would allow and encourage smaller ESG ratings providers to apply to be regulated once and as soon as they are ready.

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

We believe the size threshold of the ESG ratings provider should be linked to the impact of its ESG ratings activity rather than any of the existing company size definitions in the Companies Act. ESG ratings providers come in many different shapes and sizes. Some do not charge for their ratings or bundle the ESG ratings services with other services and so have no directly attributable turnover. Some firms are multi-product with large employee bases but actually provide relatively few ratings. Some firms may contract rather than employ analysts; some analysts might work part-time. Some are niche operators providing highly, respected opinions in specific, key sectors, having high impact and earning relatively high revenue but having few employees and issuing few ratings.

We would therefore bring an ESG ratings provider into the scope of the regulation if it exceeded any of the following thresholds: (i) a certain number of ratings; or (ii) a certain turnover or (iii) contracting/employing a certain number of ESG analysts on an FTE basis.

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

We find this difficult to respond to with precision as our answer depends on how onerous the regulation will be for firms to comply with, both to register and be authorised and then subsequently to operate under.

Using the criteria we specified in our answer to question 20 above, certainly we would expect a firm with over 50 ESG ratings analysts, or publishing over 500 ratings or earning more than £5 million annual turnover from ESG ratings services to be in scope.

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

As alluded to in our answers to questions 17 and 19 above, there are many small niche providers of ESG ratings currently who provide valuable expertise in niche markets, either by geography or industry sector. We feel it is critical that such providers do not suddenly cease servicing UK clients as a direct result of the introduction of the new regulation. One

option could be to give such providers guidance, based on the IOSCO principles, of how they would be expected to operate and govern their ratings processes.

Claims and accusations of greenwashing and misrepresentation in the investment press are widespread but to date no legal case has been brought against an ESG rating provider. If this new legislation and regulation is to be effective it must be easily enforceable.