ESG RATINGS AND ESG DATA: REGULATION AND PRACTICAL ISSUES IN THE EQUITY AND DEBT CAPITAL MARKETS

As sustainable investing continues to become more mainstream globally, ESG ratings and data products play an increasingly central role in the sustainable finance ecosystem. Provision of these products has been largely unregulated and action to address well known concerns has become a priority for standard setters and securities market regulators across the globe.

BACKGROUND

The International Organization of Securities Commissions (IOSCO) has explored the provision of ESG ratings and data products, their use by market participants and the implications for companies and instruments that are the subject of these products. IOSCO's November 2021 Final Report on ESG ratings and data[1] made a series of recommendations aimed at improving issues such as quality, transparency, comparability and reliability. In this briefing, we explore how IOSCO's recommendations are being implemented via mandatory or voluntary policy frameworks in various jurisdictions and consider how the use of ESG ratings and data is evolving in the debt and equity capital markets.

IOSCO RECOMMENDATIONS

Following a fact finding exercise with providers and users of ESG ratings and data products and feedback from the companies that are the subject of such products, IOSCO issued the IOSCO Final Report "Environmental, Social and Governance (ESG) Ratings and Data Products Providers"[2].

IOSCO's recommendations address a number of concerns identified at the fact finding stage:

- a lack of commonly agreed definitions used for ESG ratings, ESG data products or ESG data;
- lack of transparency about the methodologies used to create ratings or data products;

Key issues

- There are varying approaches the application of the IOSCO principles of best practice. Some jurisdictions are introducing voluntary codes regulating ESG ratings and data, whereas others have preferred a mandatory regime to regulate ESG rating activities.
- There is still a general reluctance in equity and debt capital markets to include ESG ratings and data within prospectuses and marketing documents and where these are included extensive risks factors/disclaimers accompany these to limit liability risks.
- The UK and EU Prospectus Regulations lack express requirements to include ESG data or ratings in prospectuses. However, expected reforms at UK and EU level will introduce stronger requirements on inclusion of ESG-related disclosures.
- We can expect more and higher quality ESG data to feature in the capital markets in the future, possibly enabling a common set of comparable metrics underpinning all ESG ratings and reducing the burden on companies dealing with extensive ESG data requests from ratings providers.
- AI-focused ESG rating agencies such as Clarity AI and ESG Book have emerged over the past few years and we can expect AI will likely play a much larger role in future ESG data collection and analytics.

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1 Final Report, "Environmental, Social and Governance (ESG) Ratings and Data Products Providers" – https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf.
2 See footnote 1.

- uneven coverage of the products offered, meaning that some industries or geographies receive less attention than others from product providers;
- concerns around management of conflicts of interest; and
- a need to improve the communication between ESG ratings providers and those entities subject to assessment by ESG ratings providers.

IOSCO's recommendations are based on the view that good quality ESG ratings and data products are underpinned by high quality raw data (which itself can be improved by enhancement to the quality of disclosure at the corporate level, through adoption of international standards such as those in development by the International Sustainability Standards Board (ISSB)3). Transparency with respect to methodologies is key so that investors are able to understand how the products have been created and what they are actually intended to measure or present. Furthermore, the reliability of ESG ratings and data products must be supported by robust and transparent governance processes.

IOSCO's recommendations cover both ESG ratings and data product providers, and are intended to be used as a global benchmark for local regulators to employ. IOSCO itself does not possess direct legislative, regulatory or supervisory powers. Its members implement its recommendations into national legislation, regulation, or voluntary codes of conduct, in line with their domestic frameworks.

Building on its 2021 recommendations, IOSCO published a "Good Sustainable Finance Practices Call for Action" paper[4] in November 2022. In that paper, IOSCO called on voluntary standard setting bodies and industry associations to develop and promote a set of good practices among their members to encourage embedding of its recommendations.

At national level, IOSCO's approach has seen varied interpretations so far, as explored further below.

What are countries doing so far to implement IOSCO's recommendations?

As at the time of writing, several IOSCO member jurisdictions have either created non-mandatory Codes of Conduct or are developing legislative initiatives. In terms of scope of application, Codes of Conduct apply to both ESG ratings providers and ESG data providers. Where jurisdictions have opted to introduce legislative initiatives, these apply to ESG ratings only. The rationale for this is generally one of proportionality, on the basis that ESG ratings products pose greater risks, as they include an assessment in the form of an opinion, score or ranking. ESG data products, on the other hand, are dependent on the quality of available sustainability-related data, which is being addressed through other international initiatives.

IOSCO produced a detailed stocktake in December 2023 of the progress of various jurisdictional initiatives[5]. Elements of the current initiatives are

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3 IOSCO endorsed the ISSB's initial sustainability-related financial disclosures standards IFRS S1 and IFRS S2 in July 2023, calling the standards 'a major step towards consistent, comparable and reliable sustainability information' – see https://www.iosco.org/news/pdf/IOSCONEWS703.pdf.

4 https://www.iosco.org/library/pubdocs/pdf/IOSCOPD717.pdf.

5 See Annex 3 of IOSCO Report F12/23, Supervisory Practices to Address Greenwashing, at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD750.pdf.

summarised in the table below and we consider the UK and EU approaches in further detail.

Jurisdiction	Initiative	Mandatory or voluntary?	Scope	Alignment with IOSCO?
EU	Proposed EU Regulation on ESG Ratings providers.[6] **Implementation:** expected to apply in the first half of 2026.	Mandatory.	ESG ratings providers. **Territorial scope:** ESG ratings providers considered to be operating in the EU.	Based on IOSCO, with EU-specific requirements for operating in the EU.
India[7]	Framework for regulation and accreditation of ESG ratings providers.[8] **Implementation:** July 2023.	Mandatory.	ESG ratings providers. **Territorial scope:** As set out in Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999, Reg 28A.	Draws on IOSCO. ESG Ratings products must contain sector-agnostic ESG ratings and suitably incorporate ESG aspects that are contextual to the Indian market.
Japan	Code of Conduct for ESG Evaluation and Data Providers.[9] **Implementation:** December 2022.	Voluntary – 'comply or explain'.	ESG ratings providers ESG data providers **Territorial scope:** ESG evaluation or data providers that participate in, or provide services to the participants in, Japanese financial markets.	Based on IOSCO 2022 Call for Action. Some elements strengthened or further elaborated.
Singapore	Code of Conduct for ESG Ratings and Data Product Providers.[10] **Implementation:** December 2023.	Voluntary – 'comply or explain'.	ESG ratings providers ESG data providers **Territorial scope**: Entities offering ESG ratings or data product in Singapore to participants in the financial market or providing any such product out of Singapore.	Builds on IOSCO 2022 Call for Action, with additional Singapore-specific best practices.
UK	Voluntary Code of Conduct.[11] **Implementation:** December 2023.	Voluntary – 'comply or explain'.	ESG ratings providers ESG data providers **Territorial scope**: International - entities whose activities involve the provision of ESG ratings/scores and/or data products.	Closely aligned with IOSCO Recommendations - designed to be internationally interoperable.

6 Text adopted by European Parliament at plenary session 25 April 2024, available at: https://www.europarl.europa.eu/doceo/document/TA-9-2024-0347_EN.html.

7 Note: Content relating to India is based on our experience as international counsel representing clients in their business activities in India. We are not permitted to advise on the laws of India and should such advice be required we would work alongside a domestic law firm.

8 See SEBI Master Circular, July 2023, at https://www.sebi.gov.in/legal/master-circulars/jul-2023/master-circular-for-esg-rating-providers-erps-_73856.html.

9 Available at: https://www.fsa.go.jp/news/r4/singi/20221215/02.pdf.

10 Available at: https://www.mas.gov.sg/publications/consultations/2023/consultation-paper-on-proposed-code-of-conduct-for-esg-rating-and-data-product-providers.

11 The Code of Conduct is available on ICMA's website, at https://www.icmagroup.org/sustainable-finance/icma-and-other-sustainable-finance-initiatives/code-of-conduct-for-esg-ratings-and-data-products-providers-2/.

UK Voluntary Code of Conduct and future regulatory regime

The UK launched its finalised Code of Conduct for ESG Ratings and Data Providers on 14 December 2023 (UK Code). The UK Code, intended to be available for use by providers in any jurisdiction, is owned and operated by the International Capital Markets Association (ICMA).

The UK Code sets out six best practice principles which are aligned with IOSCO's recommendations :

1. **Good Governance** – ESG ratings and data products providers should ensure appropriate governance arrangements are in place that enable them to promote and uphold the principles and overall objectives of the Code of Conduct.
2. **Securing Quality (Systems and Controls)** – ESG ratings and data products providers should adopt and implement written policies and procedures designed to help ensure the issuance of high quality ESG ratings and data products (aligns with IOSCO Recommendation 2).
3. **Conflicts of Interest**
    - ESG ratings and data products providers should adopt and implement written policies and procedures designed to help ensure their decisions are independent, free from political or economic interference, and appropriately address actual or potential conflicts of interest that may arise from, among other things, the ESG ratings and data products providers' organisational structure, business or financial activities, or the financial interests of the ESG ratings and data products providers and their officers and employees (aligns with IOSCO Recommendation 3).
    - ESG ratings and data products providers should identify, avoid or appropriately manage, mitigate and disclose actual or potential conflicts of interest that may compromise the independence and integrity of the ESG ratings and data products providers' operations.
4. **Transparency** – ESG ratings and data products providers should make adequate levels of public disclosure and transparency a priority for their ESG ratings and data products, including their methodologies and processes to enable the users of the product to understand what the product is and how it is produced, including any potential conflicts of interest and while maintaining a balance with respect to proprietary or confidential information, data and methodologies (aligns with IOSCO Recommendation 5).
5. **Confidentiality (Systems and Controls)** - ESG ratings and data products providers should adopt and implement written policies and procedures designed to address and protect all non-public information received from or communicated to them by any entity, or its agents, related to their ESG ratings and data products, in a manner appropriate in the circumstances (aligns with IOSCO Recommendation 6).
6. **Engagement (Systems and Controls)**
    - ESG ratings and data products providers should regularly consider whether their information gathering processes with entities covered by their products leads to efficient information procurement for both the providers and these entities. Where potential improvements to

information gathering processes are identified, ESG ratings and data products providers should consider what measures can be taken to implement them (aligns with IOSCO Recommendation 8).

- Where feasible and appropriate, ESG ratings and data products providers should respond to and address issues flagged by entities covered by their ESG ratings and data products and by users while maintaining the independence and integrity of these products (aligns with IOSCO Recommendation 9).

The UK Code has been developed to ensure that it is "sufficiently clear and flexible to have relevance in its application to the broad spectrum of ESG ratings or data products providers that exist in the global market". "ESG rating/score" and "ESG data product" have been defined widely, such that the UK Code is flexible enough to be used by providers of second party opinions and controversy alerts. In terms of product scope, while the UK Code is purposely broad, it is not intended to capture proxy advisory services, investment research, or financial benchmarks with an ESG or climatic focus where benchmark providers are already applying IOSCO’s Principles for Financial Benchmarks.

The UK Code is a precursor to introduction of a regulatory regime for ESG ratings providers in the UK. HM Treasury consulted in March 2023 on extending the UK's regulatory perimeter to make provision of ESG ratings a UK-regulated activity. HM Treasury announced in the March 2024 Spring Budget that it planned to introduce the relevant legislation, and expected to publish a formal consultation response and draft legislation later in 2024. Similar to the approach taken by other jurisdictions, HM Treasury does not intend to make ESG data provision a regulated activity. It is envisaged that the UK's Designated Activities Regime would be used to provide a more proportionate regime for smaller providers without the need for UK authorisation. The UK's Financial Conduct Authority (FCA) plans to consult on a regulatory framework to enhance transparency of ESG ratings products and methodologies, and to promote strong governance, operational systems and conflicts management. Timing is as yet uncertain as to when the relevant legislation and regulation will be introduced.

The EU approach

In contrast with the voluntary UK Code, the EU will introduce a mandatory regime on the transparency and integrity of ESG rating activities. In February 2024, political agreement was reached on the European Commission's proposal for a regulatory framework for ESG ratings activities. Following adoption by the European Parliament in April 2024, the EU Ratings Regulation is expected to be formally adopted by the Council and published in the Official Journal in late Q3 or Q4 2024 and is set to apply 18 months after its entry into force. The EU Ratings Regulation has considered IOSCO's recommendations closely, in particular the final report on ESG Ratings And Data Providers12.

Significant disagreements arose between the EU co-legislators during negotiation of the text. The exclusion from scope of raw ESG data was criticised. Concerns were also raised that the new regulatory system would overlap with products covered by existing regimes such as Sustainable Finance Disclosure Regulation (SFDR) and the MiFID framework. With respect to management of conflicts of interest, proposals to require ESG

[12] See footnote 1.

ratings providers to separate their activities from, for example, consulting or audit services also proved controversial.

The adopted EU Ratings Regulation made several changes made to the text as it was originally proposed. These include:

- The recognition of the need to avoid duplication with information already published in accordance with existing regulatory requirements. ESG ratings (issued by regulated financial undertakings) that are incorporated into products/services that are already regulated under EU law (e.g. MiFID) are expressly excluded from the scope of the adopted EU Ratings Regulation – this includes mandatory disclosures pursuant to Articles 6, 8, 9, 10, 11 and 13 of the SFDR, and disclosures pursuant to Articles 5, 6 and 8 of the EU Taxonomy Regulation;
- ESG ratings produced exclusively for internal, in-house or intra-group use are excluded from scope;
- A temporary regime will apply for small ESG ratings providers;
- Third country ESG ratings providers will be able to provide ESG ratings in the EU in accordance with the adopted EU Ratings Regulation's equivalence, endorsement and recognition provisions; and
- In relation to mitigating conflicts of interest, additional clarifications have been added to Article 16 of the adopted EU Ratings Regulation to introduce some derogations from the originally proposed strict separation of business activities. However, a late addition to the list of prohibited activities means that ESG ratings providers will not be permitted to provide statutory auditing on financial statements and assurance engagements on sustainability reporting.

ESG ratings and data in the equity and debt capital markets

Limited use of ESG ratings

Neither the EU and UK Prospectus Regulations, as they stand today, require any specific mandatory ESG disclosures in equity or debt prospectuses. Companies need only comply with the general obligation to publish the "necessary information which is material to an investor to make an informed investment decision". However, both the UK's FCA and the European Securities and Markets Authority (ESMA) have interpreted this general disclosure obligation in light of ESG. This approach has been taken given the potential financial materiality of climate and ESG-related risks and opportunities and, consequently, the need for information of this nature to be disclosed in the prospectus where relevant.

In July 2023, ESMA published a public statement on sustainability disclosure in prospectuses, stating that companies should "provide the basis for any statements concerning their sustainability profile or that of the securities they issue" by, for example, referring to any research or analysis by third parties, which can be read to include ESG ratings.

Since UK and EU prospectus regulations require that the information contained in an advertisement (such as an investor presentation) is consistent with information contained in the prospectus, discussions concerning the disclosure of ESG ratings also typically arise in the context of reviewing an investor presentation and aligning it with the prospectus.

Underlining the growing importance of ESG credentials for investors, we are seeing early examples of ESG ratings in prospectuses and related marketing documentation in both ECM and DCM transactions. As ESG matters have become more significant, companies tapping the capital markets have simultaneously become more interested in marketing their ESG ratings to investors. We have seen instances of companies providing information on their sustainability profile to investors in issuances of shares and even for issuances of bonds which did not include any ESG element (i.e. not green, blue or social use of proceeds bonds or sustainability-linked bonds, or where ESG is not fundamental to the company's strategy or equity investment proposition).

In some EU jurisdictions, including Germany and the Netherlands, companies have become more comfortable with referencing ESG ratings in their prospectuses (albeit with related disclaimers). However, there is still a reluctance in other markets (particularly London) to do so. This has been due to a range of factors such as the fact that, unlike credit rating agencies, ESG ratings providers have not been subject to regulation. ESG-related claims and ratings are often produced using inconsistent and/or non-standardised data and will often contain more assumptions compared to credit ratings. In addition, the rating scales used for ESG ratings are not yet well established and their use of point or letter systems as rating scales are not necessarily meaningful without context. The UK Code (and incoming regulatory regime) as well as the incoming EU Ratings Regulation are expected to bring in a more consistent approach from ratings providers and assuage some of these current concerns in the market. It is also likely that improved accuracy and comparability of ESG data resulting from corporate sustainability disclosure and reporting requirements will increase the reliability and usefulness of ESG ratings.

It should be borne in mind that the purpose of ESG ratings is not to provide an indicator of how "green" a company is or how "sustainably" it performs as a business. Rather, ESG ratings are intended to indicate a company's own exposure to material ESG risks, and how well the company is managing those risks. Nonetheless, companies and underwriting banks involved in the production of prospectuses will be exposed to liability risks in relation to any ESG-related information that is inaccurate, incomplete or misleading. To cover these risks, disclaimers will often be included either within the risk factors section or within the ESG ratings disclosure itself, to present the limits of ESG ratings to investors as well as providing context as to the meaning of the rating.

Concerns around the use of ESG data

As noted above, concerns over liability risks have resulted in a reluctance to voluntarily include ESG-related statements in equity and debt prospectuses unless it is fundamental to the company's strategy or investment proposition and required from a materiality perspective to satisfy prospectus disclosure requirements. Due to significant scrutiny around greenwashing, inclusion of ESG-related statements in the prospectus typically requires careful verification, particularly in the context of equity prospectuses. The verification process may entail a thorough review of past data and preparation methods, ensuring that the figures presented in the prospectus are fair and accurate.

Depending on the materiality of the statements, verification may also necessitate a review by dedicated ESG and litigation teams of lawyers acting for both the company and underwriting banks, in addition to scrutiny by the banks' ESG and sector teams.

An inherent tension arises between, on the one hand, the extensive data that ESG ratings providers require privately for corporate ESG ratings and, on the other, the obligation to include all material information in the prospectus. This tension can become especially pronounced during initial public offerings, when corporate ESG ratings are sought for the first time. In this context, lawyers must ensure that data shared with ESG ratings providers is either materially identical to, or a more granular form of, the information presented in a different format in the prospectus, otherwise the incremental data must be included in the prospectus.

The concerns with ESG disclosures are especially heightened when ESG data and information is forward-looking. These concerns are exacerbated by the lack of an established practice in equity capital markets for third-party assurance as to ESG data. In debt capital markets, the position is much the same. Where we advise on issuances of green or sustainability-linked bonds, second party opinion providers, which play a key role in the issue of these instruments, will only confirm alignment of a company's bond with the relevant market-led standard. However, they will not confirm or validate specific underlying ESG data.

Whilst there are no current firm plans to regulate ESG data products or providers (in contrast to the position regarding ESG ratings providers), the incoming reforms to the EU and UK regimes are expected to address or at least impact the disclosure of ESG data in prospectuses. For instance, the UK is contemplating making forward-looking information in prospectuses, including specifically any forward-looking sustainability information, 'protected' or subject to a higher threshold for liability. The intention of this is to encourage companies to disclose their sustainability plans and goals in prospectuses.

Impact on capital markets from improved ESG corporate reporting?

In sharp contrast to the position in the capital markets, a more developed ESG disclosure regime is taking shape within UK and EU general corporate reporting, where more expansive ESG disclosures are being required of large or listed companies, such as in their annual reports. While these are currently predominantly climate focused, they will expand to cover much broader areas of sustainability with the expected UK ISSB standards and the EU's European Sustainability Reporting Standards (ESRS). We can expect these efforts to organically result in more and better quality ESG data in capital markets transactions as ESG disclosures are increasingly being seen as 'material information' and investors start to expect them to be included in prospectuses for consistency.

Importantly, we are also seeing the gradual introduction of third party assurance in the corporate reporting space. For example, the EU is expected to require audit firms to express an opinion on the compliance of a company's sustainability reporting with EU requirements[13]. This will initially be in the form of negative assurance (where the auditor states it has not identified any matter

[13] See European Commission's webpage on Corporate Sustainability Reporting: https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en.

to conclude that the subject matter is materially misstated) before moving to a higher standard requiring a positive opinion by the auditor. We can also expect to see the UK introduce assurance requirements once work at a global level on the development of assurance standards has progressed.

Acknowledging the widening gap between prospectus requirements and mandatory ESG disclosures in annual reports for large and listed companies, the FCA is actively considering reforms to its prospectus regime to address ESG data. These may expressly require companies to include ESG data stemming from corporate reporting in their prospectuses. The EU is also heading in a similar direction, by envisaging that, where a company must already comply with corporate sustainability reporting, a prospectus will need to reference its sustainability report.

We can conclude from this that, whether through regulation or organically driven by the expectations of investors and a desire for consistency with the corporate reporting space, we can expect more and higher quality ESG data to feature in capital markets documentation in the future. An optimistic take is that this expansion and standardisation of ESG reporting could enable a common set of comparable metrics to underpin all ESG ratings and improved ESG data. This would shift the business of ESG ratings providers from collecting non-standardised and voluntary disclosure towards interpreting data available to all. It would also reduce the burden on companies dealing with varied ESG data requests, often involving hundreds or even thousands of data points.

Finally, this shift may also enable another long-term driver in the space: artificial intelligence. AI-focused ESG rating agencies such as Clarity AI and ESG Book have emerged over the past few years, and we can expect AI will likely play a much larger role in future ESG data collection and analytics.

Concluding thoughts

With market demand for the standardisation of ESG ratings and data, it is likely that the regulatory uptake of IOSCO's best practice recommendations will increase across the globe, with the potential for comparable metrics underpinning all ESG data and ratings. In particular, the EU has sought to align itself with IOSCO's objectives, stating in its Corporate Sustainability Reporting Directive (CSRD)[14] that it aims to achieve a "shared understanding of what sustainable means." Whether such unification can be achieved across the EU may assist in trialling the standardisation of ESG ratings methodologies, and allowing for an examination of whether IOSCO's principles work successfully in both equity and debt capital markets.

[14] Directive (EU) 2022/2464 of the European Parliament and of the Council of 14 December 2022 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32022L2464.

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