MSCI

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HM Treasury
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Submitted via email: ESGRatingsConsultation@hmtreasury.gov.uk

HM Treasury's Consultation on Future Regulatory Regime for ESG Ratings Providers ("Consultation")

MSCI ESG Research[1] ("MSCI") welcomes the opportunity to provide feedback to HM Treasury on the Consultation. As a leading global provider of ESG ratings, MSCI is well positioned to comment on the proposed measures. We operate to the highest standards of ethical conduct in assigning ESG ratings and agree that it is important that ESG ratings assigned in the United Kingdom are, and are seen to be, credible.[2]

In this cover letter, we offer a few observations on the Consultation and respond to the Consultation questions in the Annex.

1. **Consider adopting a Code of Conduct** – Prior to the expansion of the regulatory permitter to include ESG ratings, we would encourage HM Treasury to support the implementation of the voluntary Code of Conduct which is currently being developed by the ESG Data and Ratings Working Group. The Code of Conduct will be principles-based and will encourage broad adoption by ESG rating and data product providers. Firms will have the flexibility needed to adopt different approaches while conducting business in accordance with the principles established in the Code, which are likely to be based on international best practice, as set out by the International Organization of Securities Commission ("IOSCO")[3].

2. **Align the definitions of ESG ratings and data with market practice** – While we agree with HM Treasury's efforts to introduce common definitions, ESG ratings should be defined in accordance with market practice and as recommended by IOSCO.[4] Therefore, an ESG rating

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1 MSCI ESG Ratings, research and data are produced by MSCI ESG Research LLC. MSCI ESG Research (UK) Limited is a subsidiary of MSCI ESG Research LLC.

2 IOSCO Consultation Report – Environmental, Social and Governance (ESG) Ratings and Data Products Providers (July 2021), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf ; see also MSCI's Response to the IOSCO's Draft Report on ESG Ratings and Data Product Providers (6 September 2021), *available at* https://www.msci.com/documents/1296102/23400696/MSCI_Comments_IOSCO_Consultation+Report+on+ESG+Ratings+and+Data+Products+Providers.pdf.

3 IOSCO, Final Report on ESG Ratings and Data Products Providers, November 2021, *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf.

4 *Id.*

provides "an opinion regarding an entity a financial instrument or a product, a company's ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment that are issued using a defined ranking system of rating categories."

3. **Regulate the activity, regardless of the type of provider** – MSCI appreciates the importance of embedding proportionality in the regulatory framework. However, this should not lead to the automatic exclusion of certain firms or sectors. In regulating the provision of ESG ratings, the type of provider should not be a determining factor for exclusion. This is because the risk of harm to an investor is the same regardless of who is providing the rating. By limiting the scope of the regulation to focus on entity, rather than activity, investors and users of the rating are exposed to material risks and potential conflicts of interest.

4. **Territorial scope should require activity in the UK** – The approach proposed by HM Treasury focusing solely on "use" of the rating would expose individual ratings to multiple, potentially conflicting, regulatory regimes if adopted globally. Moreover, there will be difficulties in knowing how and where an ESG rating will be used once it has been provided to the user.

   It is important for HM Treasury to include some form of "activity" in the UK to establish jurisdiction. Therefore, the scope of the proposed regulation should include only those ESG ratings assigned in the UK and providing ESG ratings to users in the UK. This is a similar approach to what has been proposed by the EU Commission.[5] This approach would require the adoption of a third-country regime for ratings assigned in other jurisdictions to qualify for use in the UK.

   We would also recommend that HM Treasury consider requiring that UK-regulated firms only use ESG ratings assigned by an ESG rating provider authorised in the UK or qualifying under an appropriate third-country regime, using the IOSCO Recommendations as the basis for such recognition.

We welcome ongoing engagement with HM Treasury in the development of its policy initiatives for ESG ratings.

Yours sincerely,

/s

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5 European Commission, Proposed regulation on ESG rating activities, Article 2, Scope, June 2023, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52023PC0314.

ANNEX

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

As noted in our cover letter, we support the introduction of a voluntary Code of Conduct based on the recommendations included in the IOSCO Final Report on ESG Ratings and Data Products Providers.[6] This is currently being developed by the ESG Data and Ratings Code of Conduct Working Group ("DRWG") initiated by the Financial Conduct Authority ("FCA").

As noted by the FCA in forming the DRWG, the development of a voluntary Code of Conduct for ESG ratings providers is expected to (i) help build trust in the market, (ii) protect market integrity, and (iii) promote effective competition.[7] The Code of Conduct will help support the aims outlined in this Consultation, without the need to unduly expand the regulatory perimeter. Eventually, the Code of Conduct could inform potential future regulation, with a view to ensure a globally consistent approach.[8]

Given the nascent ESG market, we would encourage HM Treasury to allow sufficient time for the implementation of these principles through non-legislative means, such as the voluntary Code of Conduct. A Code of Conduct will effectively address the challenges outlined by HM Treasury in the "rationale for regulation" section of the Consultation, including concerns around transparency of methodologies and investor confusion about what an ESG rating implies.

Q2. (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.

As one of the leading providers of ESG ratings to the global investment community, MSCI is committed to follow IOSCO recommendations. As such, MSCI has incorporated recommendations regarding transparency, good governance, management of conflicts of interest and robust processes.

For example, with respect to transparency of methodologies, methodologies related to MSCI ESG ratings are available on our website, including the methodologies behind each of the key pillar components of the ESG rating. By fully disclosing our MSCI ESG ratings methodologies to all stakeholders we are promoting a clear and consistent understanding of our methodologies.

However, if the regulatory framework being proposed by HM Treasury were to include ESG data products, this would exponentially increase compliance costs and introduce intellectual

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6 IOSCO, Final Report on ESG Ratings and Data Products Providers, November 2021: "*regulators could consider whether there are opportunities to encourage industry participants to develop and follow voluntary common industry standards or codes of conduct", available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf

7 https://www.fca.org.uk/publication/documents/drwg-terms-of-reference.pdf

8 *Id.*

property concerns, for example, with respect to the publication of models and methodologies. See our response to Question 5.

Q3. Are there any practical challenges arising from overlap between potential regulation for ESG ratings providers and existing regulation?

As part of this Consultation, we understand that HM Treasury will consider how any new regulatory requirements could overlap with existing regulations, such as the UK Benchmarks Regulation (“UK BMR”). We would encourage HM Treasury to avoid any duplication of requirements for ESG ratings providers, which are already captured under the UK BMR.

Q4. Are there any other practical challenges to introducing such regulation?

The practical challenges of introducing a regulatory framework include:

(i) Interoperability with other international frameworks and global standards will be vitally important to avoid the risk of regulatory fragmentation or duplication. A particular challenge arising from HM Treasury’s proposed scope of “use” could be a situation where the same ESG rating is regulated multiple times across different jurisdictions.

(ii) Adopting definitions of ESG ratings and ESG data products which align with existing market practice will be key in avoiding unnecessary compliance burdens for firms. For example, by defining ESG ratings too broadly whereby it captures ESG data products, the proposed regulation could lead to unintended consequences such as a requirement to publish the methodologies of thousands of data points within an analytical solution.

(iii) More broadly, the ESG ratings market is relatively nascent and continues to evolve. Any regulation needs to be balanced against increased costs for the market and the barriers to entry for new firms.

Q5. Do you agree with the proposed description of an ESG rating?

While we understand that the proposed description of an ESG rating is deliberately broad and intended to capture a range of ESG assessments, it is critical that the description is consistent with the unique features of ESG ratings, aligns with their purpose and does not unintentionally capture ESG data products. We would therefore propose that HM Treasury align with the definition applied by IOSCO.

ESG ratings provide an assessment of an entity, an instrument, or an issuer exposure to ESG risks and/or opportunities. ESG ratings are produced by applying methodologies, quantitative models, and qualitative analysis. Among the key features of an ESG rating that distinguishes it from an ESG data product, as well as from other metrics, is that an ESG rating provides an opinion expressed using an established and defined ranking system of rating categories that provide a relative measure of performance of a rating target against its peer group.

In contrast, ESG data products provide ESG-related information through a range of different products and services including screening tools[9] and controversy alerts[10]. These products and services do not provide a qualitative assessment relative to a peer group, but rather provide a measure in absolute or binary terms. Despite these common characteristics, the proposed description of ESG ratings would capture all forms of ESG data products other than the narrow category of raw or "minimally processed data".

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

Yes. We agree that a regulatory framework should exclude ESG data and ESG data products, particularly unprocessed raw data, minimally processed data and ESG data where no assessment has taken place.

However, as discussed in response to Question 5, HM Treasury's proposed scope excludes only a very narrowly defined segment of ESG data (i.e., data where no assessment has been carried out).

As we have raised with the IOSCO and with regulators in other jurisdictions, the regulation of ESG data products presents a number of challenges:

(i) The universe of what constitutes ESG data is rapidly evolving. Defining boundaries and/or devising rules across so many different types of data sources is not feasible and will create an overly broad regulatory framework that is not appropriately tailored, stifles innovation and slows down the rapid evolution of solutions to assist the market in understanding and measuring ESG risk and opportunities.

(ii) Provisions that may be appropriate for ESG ratings present significant challenges if applied to ESG data products. For example, publishing methods and process for the computation of data, which could extend to thousands of data points within an analytical solution. This will simply not be feasible, undermine intellectual property and discourage service providers from creating solutions to address climate and ESG risk.

(iii) Not feasible to regulate the entire supply chain of raw data. A framework that seeks to capture ESG data products as ESG ratings is overly broad and unmanageable.

(iv) It will be problematic to have ESG ratings capture "anything else where market participants currently consider these to be data products". Market participants may consider raw ESG data products (i.e., GHG emissions) as "data products" and therefore in scope of regulation. Also, market participants will have differing views on what should or shouldn't be considered an ESG rating, thereby opening the definition to misuse.

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9 Screening tools assess the exposure of companies, jurisdictions and bonds to ESG risks in order to define a portfolio based on ESG criteria. IOSCO, Final Report, November 2021, *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf.

10 Controversies alerts enable investors to track and monitor behaviours and practices that could lead to reputational risks and affect the company and more broadly its stakeholders. Controversies can also be taken into account in ESG ratings. *Id.*

Q7. Do you agree with the proposal to regulate the activity of providing ESG ratings to be used in relation to RAO specified investments?

We believe that the list of RAO specific investments included in the Financial Services and Market Act comprehensively covers those financial activities where provision of ESG ratings are currently applied.

Q8. (For ESG ratings providers) Do you know when an ESG rating you provide will be used in relation to a specified investment?

ESG rating providers may not always know the full extent of how a rating is used, especially further down the investment value chain. Although licenced agreements and contracts provide a common understanding between a specific rating provider and a specific user, the rating in question may be used in ways which are beyond the control of the provider or the contractual understanding between the provider and the user (i.e., use by a third-party if the rating is public).

Q9. Are there ESG ratings used in relation to anything other than an RAO specified investment which also should be included in regulation?

See our response to Q10.

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?

We do not agree that all the firms and sectors listed in the eight scenarios should be automatically excluded from a regulatory framework for ESG ratings. The type of firm conducting the activity of publishing proprietary ESG ratings on a systematic basis should not be a determining factor for exclusion. The risk of harm to an investor is the same regardless of the entity assigning the rating.

In some cases, non-profit organisations publishing ESG ratings could, and do, have "material influence" on the markets.[11] Similarly, widely read business newspapers and journals who publish proprietary ESG ratings should be in scope of a future regulatory regime.

MSCI does not object to the proposed regulatory framework excluding asset managers who create proprietary ratings for their own internal use only.[12] However, if asset managers systematically publish their proprietary ESG ratings for whatever purpose the regulatory framework should capture the activity, regardless of the existing regulatory framework. A failure to bring this in scope of regulation could lead to:

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11 HM Treasury, Future regulatory regime for ESG ratings providers, March 2023, *available at* https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1147458/ESG_Ratings_Consultation_.pdf.

12 See paragraph 3.3 of the Consultation.

- *Conflicts of interest* – this could arise because the asset manager has a clear incentive to assign a higher rating to encourage investment in its funds or assign a lower rating to other funds to dissuade investors from investing in those funds.

- *Lack of transparency* – there will be no requirement for the asset manager to publish its rating methodology or to disclose the rating process. The user of the rating will potentially have no insight other than an alpha-numeric scale/score on which to base their investment decision.

Therefore, by limiting the scope of the regulation to focus on entity, rather than activity, there is a very real risk of outcomes that would undermine the intent behind HM Treasury's proposals and lead to unlevel playing fields and the exposure of retail investors to material conflicts of interest.

Q11. Are there any other exclusions which should be provided for?

No. See response to Q10.

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?

We believe it will be challenging for HM Treasury and the FCA to identify and implement a workable territorial scope of a future regulatory regime for ESG ratings providers as that proposed in this Consultation.

First, there are inherent difficulties in knowing how and where an ESG rating will be used once it has been provided to the user. For example, a UK user could make an ESG rating available to its non-UK intermediaries and vice-versa, thereby blurring the lines of the territorial scope.

This is further complicated when you consider the "direct provision" element of the proposed regulatory scope. For example, a UK user may access and be "materially influenced" by an ESG rating which it has received through "indirect provision" from a non-UK subsidiary or a publicly available ESG rating from outside the UK. In practice, this will mean the activity goes unregulated, despite the UK user being exposed to the same potential risks.

Second, the proposed approach would potentially subject the same ESG rating to multiple and potentially conflicting regulatory regimes. If multiple jurisdictions adopted a similar use-based approach, a single use case could trigger regulatory supervision in a particular jurisdiction. This approach would introduce significant uncertainty and challenges for ESG rating providers to make their ESG ratings available for use in multiple jurisdictions and would likely lead to fragmentation and fewer globally comparable ESG ratings available for use in the UK.

Third, the proposed approach suggests that ESG rating providers with operations in multiple jurisdictions would be required to register each entity that publishes ESG ratings provided to users in the UK. This would create unnecessary redundancies and burdensome administration of the regulatory framework.

Considering the challenges outlined above and the ongoing development of similar regulatory regimes in other jurisdictions, we believe HM Treasury should narrow the territorial scope of proposed regulation to include ESG rating providers operating in the UK and providing ESG ratings to regulated users in the UK. The regulatory framework could also be designed to incorporate a third-country framework to ensure that ESG ratings issued by third-country providers which are based on the IOSCO Recommendations could also be used in the UK.

Q13. (For UK users of ESG ratings) Are you concerned that this proposal would hamper the choice of ESG ratings available to you?

To provide the appropriate level of user protection being sought by HM Treasury[13], we would recommend that the regulation require UK-regulated entities to only use ESG ratings assigned by an ESG rating provider authorised in the UK. See our response to Question 12.

Q14. 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 response.

Q15. Are there any scenarios of indirect provision of ESG ratings to UK users which should also be regulated?

Yes. If the intention of HM Treasury's proposal is to regulate the activity, in this case the provision of ESG ratings, then whether or not the firm is an "indirect" provider should not be a determining factor for exclusion. This is because the user of "indirect provision" is exposed to the same potential risks associated with "direct provision". For example, as we outlined in our response to Question 12, a UK user may access and be "materially influenced" by an ESG rating which it has received through "indirect provision" from a non-UK subsidiary or intermediary.

Furthermore, as explained in our response to Question 10, by limiting the scope of the regulation to focus on entity, rather than activity, there is a very real risk of outcomes that would undermine the intent behind HM Treasury's proposals and lead to unlevel playing fields and the exposure of retail investors to material conflicts of interest.

Therefore, firms which produce ESG ratings for their own use but then publish the ratings as part of marketing material or other material on a consistent basis should not be excluded from the proposed regulation. This includes asset managers who assign their own ESG ratings to their affiliated funds or financial products and publish the ratings in fund/product documentation for retail investors to assess the ESG characteristics and risk profile of a particular fund.

Q16. 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?

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[13] See paragraph 4.3 of the Consultation.

As we mentioned in our response to Question 12, it will be challenging for HM Treasury and the FCA to implement a workable and internationally aligned territorial scope for the proposed regulatory framework.

We are aware of other jurisdictions proposing ESG ratings regulation, such as the EU. This could add a further challenge in ensuring that the UK regime is aligned with these other developing frameworks and does not introduce excessive regulatory burden on ESG ratings providers due to duplicate requirements. Given the inherently global nature of the ESG ratings market, harmonisation with the IOSCO Recommendations will be critical.

Q17. Should smaller ESG ratings providers be subject to fewer or less burdensome requirements?

A future regulatory framework should not place an excessive regulatory burden on *any* firm, regardless of size, and be proportionate to the actual level of risks posed to users of the ratings. For example, if an ESG ratings providers clients are mostly sophisticated institutional investors, those users will have the technical expertise to understand the rating and therefore are less likely to find themselves at risk of undue "material influence".

Q18. (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.

No response.

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

See response to Q17.

Q20. What criteria should be used when evaluating the size of ESG ratings providers?

See response to Q17.

Q21. What level could the criteria for small ratings providers be set at (i.e., how could 'small ratings provider' be defined)?

See response to Q17.

Q22. Is there anything else you think HM Treasury should consider in potential legislation to regulate ESG rating providers?

While we support HM Treasury's efforts, we would caution against introducing a regulatory framework for ESG rating providers prematurely. Introducing a hardwired regulatory framework now risks freezing the industry in its current state without allowing for innovation and evolution.

Rather, we would encourage HM Treasury to first consider a "regulatory pathway" which starts initially with a voluntary Code of Conduct, as the one currently being developed.