



**SECURITIES AND  
FUTURES COMMISSION**  
證券及期貨事務監察委員會

## **Report on the fact-finding exercises on ESG ratings and data products providers**

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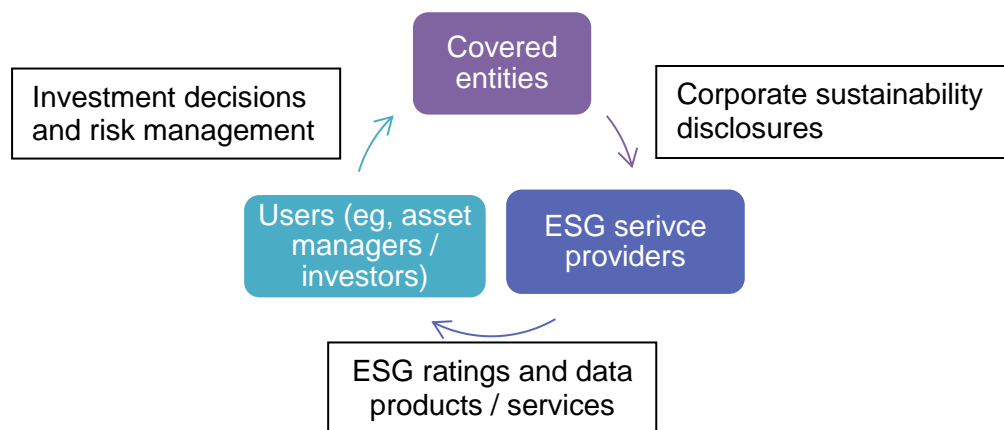
October 2023

## I) Introduction

1. With the increasing focus on environmental, social and governance (**ESG**) in the financial industry, there has been considerable growth in the use of ESG ratings and data products by financial market participants. A survey report from the consultancy firm ERM (Environmental Resources Management) published in early 2023 indicates a substantial increase in the use of ESG ratings and data products by investors globally. While only 12% of investor respondents said that they were required by their employers to integrate ESG ratings and data into investment strategies in 2018/19, this has increased to 43% in 2022<sup>1</sup>. In Hong Kong, the number of SFC authorised ESG funds increased to 209 as of 30 September 2023, representing a more than tenfold increase from five years ago.
2. This growth is accompanied by the rapidly rising number of ESG ratings and data products providers (**ESG service providers**) and the critical role they play in the green and sustainable finance ecosystem, ultimately influencing the users' investment decisions and risk management processes. In early 2020, KPMG published a report indicating that more than 150 major data vendors worldwide “are experiencing rapid consolidation and innovation”<sup>2</sup>.
3. However, the ESG ratings and data products industry are generally not subject to regulatory oversight. Until recently, there was a lack of globally recognised baseline standards on how ESG service providers were expected to derive their products and services and what relevant information should be disclosed to end users. This may ultimately impair the quality of ESG information received by the end users, resulting in the investors misallocating their capitals to areas that are not aligned with their investment strategies.

Figure 1

**Relationships among covered entities<sup>3</sup>, ESG service providers and users in the green and sustainable finance ecosystem**



<sup>1</sup> ERM, Rate the Raters 2023: ESG Ratings at a Crossroads, March 2023 available at <https://www.sustainability.com/globalassets/sustainability.com/thinking/pdfs/2023/rate-the-raters-report-april-2023.pdf>

<sup>2</sup> KPMG, Sustainable Investing: Fast-Forwarding Its Evolution, February 2020 available at <https://assets.kpmg/content/dam/kpmg/xx/pdf/2020/02/sustainable-investing.pdf>

<sup>3</sup> Refers to the entities that are the subject of ESG ratings and data products/services.

4. Against this background, the International Organization of Securities Commissions (**IOSCO**) issued the [Final Report](#) on “Environmental, Social and Governance Ratings and Data Products Providers” in November 2021 (**IOSCO Report**)<sup>4</sup> setting out 10 recommendations in regard to ESG service providers. In November 2022, IOSCO also [called](#) on financial markets voluntary standard setting bodies and industry associations to promote the adoption of its recommendations amongst their members on a voluntary basis. The Securities and Futures Commission (**SFC**) has been closely monitoring the industry and global regulatory developments on the matter to consider a pragmatic approach in promoting the IOSCO recommendations in Hong Kong.
5. Since mid-2022, the SFC has formed a focus group and conducted a fact-finding exercise that includes a survey to understand the business models of ESG service providers and the market practice of local licensed asset managers in engaging with ESG service providers, as asset managers are one of the key user groups for ESG ratings and data products. After the fact-finding exercise, various follow-up meetings were conducted with relevant stakeholders to discuss the way forward.
6. This report is divided into four parts: (II) Definitions and Terminology, (III) Key observations, (IV) Key issues observed from the fact-finding exercise, and (V) Proposed way forward.
7. The SFC would like to thank all market participants involved in the fact-finding exercise and other related discussions for their inputs.

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<sup>4</sup> The IOSCO Report highlighted various greenwashing and related investor protection concerns with respect to ESG ratings and data products as well as their providers. To address these concerns, IOSCO set out 10 recommendations (**IOSCO recommendations**), one of which suggests regulators focus more on the use of ESG ratings and data products and ESG service providers that may be subject to their jurisdiction.

## II) Definitions and Terminology

8. Definitions used in this report are the same as those in the IOSCO Report as follows:

Terms	Definitions per IOSCO Report
ESG ratings	<b>ESG ratings</b> refer to the broad spectrum of ratings products <sup>5</sup> that are marketed as providing 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, whether or not these are explicitly labelled as “ESG ratings”.
ESG data products	<b>ESG data products</b> refer to the broad spectrum of data products that are marketed as providing either a specific Environmental, Social, or Governance focus or a holistic ESG focus on an entity, financial instrument, product or company’s ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment, whether or not they are explicitly labelled as “ESG data products”.
ESG ratings and data products providers	<b>ESG ratings and data products providers</b> , as used in this report, covers providers who offer ESG ratings and/or ESG data products. Where there is a need to single out ESG data products providers who do not provide ESG ratings, the term ESG data products providers is used.
Raw data	<b>Raw data</b> is gathered by ESG data products providers from companies’ public disclosures or from other publicly available information or collected through questionnaires; if raw data is not available, corresponding data points can be approximated. Feedback to IOSCO suggests that all data products derive from either collected or estimated raw data.
Screening tools	<b>Screening tools</b> assess the exposure of companies, jurisdictions and bonds to ESG risks in order to define a portfolio based on ESG criteria.
Controversies alerts	<b>Controversies alerts</b> 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.

<sup>5</sup> The term “ESG ratings” can refer to the broad spectrum of rating products in sustainable finance and include ESG scorings and ESG rankings. ESG ratings, rankings and scorings serve the same objective, namely the assessment of an entity, an instrument or an issuer exposure to ESG risks and/or opportunities. However, they differ in the resources and methodologies used.

### III) Key observations

9. The following key observations were noted based on the fact-finding exercise and subsequent industry outreach:

#### A. ESG service providers

##### (a) Market landscape in Hong Kong

###### Key observation 1

There is a spectrum of large to small ESG service providers that are active in Hong Kong. It is not uncommon that international ESG service providers set up separate legal entities in different jurisdictions to facilitate their business activities.

10. ESG service providers comprise a growing industry. Based on our informal survey, there is a spectrum of large to small ESG service providers that are active in Hong Kong. They include small niche fintech firms, Mainland Chinese firms providing unique coverage and proprietary analysis on Mainland-related data, and other international firms that financial market participants engage with frequently.
11. Out of the surveyed ESG service providers<sup>6</sup>, 80% are headquartered outside of Hong Kong and they have generally set up separate legal entities or representative offices locally to facilitate their business activities.

##### (b) Operating model

###### Key observation 2

The surveyed ESG service providers offer a wide spectrum of ESG ratings and data products.

It was noted that apart from using different approaches in sourcing data, ESG service providers also employ unique and proprietary methodologies to bridge any data gap or derive their ratings products. As a result, the ESG products from different providers for the same covered entity might have similar labels but they may not be correlated and comparable with each other.

###### *Common products and services offered*

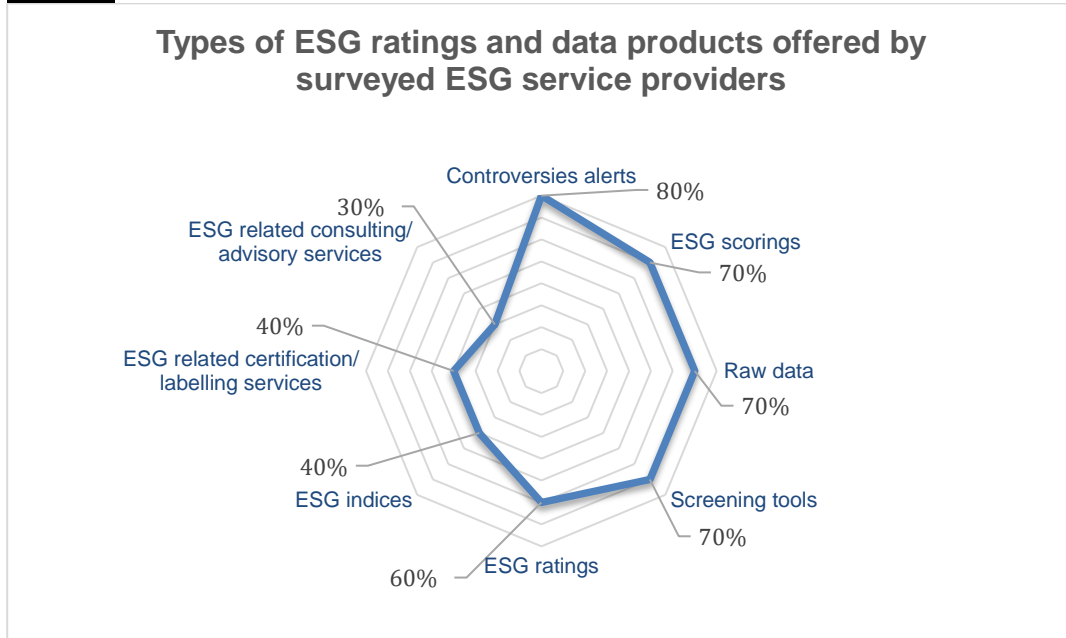
12. Our survey found that the most common type of ESG ratings and data products offered by providers is controversies alerts, followed by ESG scoring, screening tools, raw data and ESG ratings. For ESG ratings products in particular, a number of surveyed providers emphasised that they are using proprietary methodologies in deriving the products, representing each provider's distinct perspective and analysis of the covered entities. A total of 40% of the surveyed providers indicated that they offer ESG indices as well. Some providers also offer other unique ESG related

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<sup>6</sup> Include 10 selected ESG service providers representing medium to large-sized Mainland and international firms.

products or services such as carbon risk ratings, a digital platform that facilitates ESG engagement for financial institutions, and sustainability report verification.

Figure 2



13. In view of market developments and demands from users, some ESG service providers also highlighted that they are continuously exploring and developing new ESG related products and services for the market.

*Approaches in sourcing data*

14. Some common approaches to collect ESG data and information used by the surveyed ESG service providers include:
- (i) using artificial intelligence and machine learning to extract relevant public information;
  - (ii) subscribing for information from other third-party ESG service providers or partnering with them; and
  - (iii) sending questionnaires to covered entities.

**Key observation 3**  
 The most common challenges the surveyed ESG service providers faced are data unavailability and the quality of data being disclosed by covered entities.

15. Many of the surveyed ESG service providers stressed that data unavailability and the quality of data being disclosed by covered entities are the most common challenges they faced, mainly due to the lack of standardised corporate sustainability disclosure standards in the market.

16. As a result of data unavailability, 80% of the surveyed providers used in-house estimation or assumption methodologies to bridge the data gap, especially for ESG data such as greenhouse gas emissions.

*Communication with covered entities*

17. The SFC noted that 60% of the surveyed ESG service providers allowed covered entities to review and verify data of their companies and provide feedback or additional information. Two of them offered an issuer online portal or a contribution tool for covered entities to review, contribute or amend their companies' data and submit feedback.

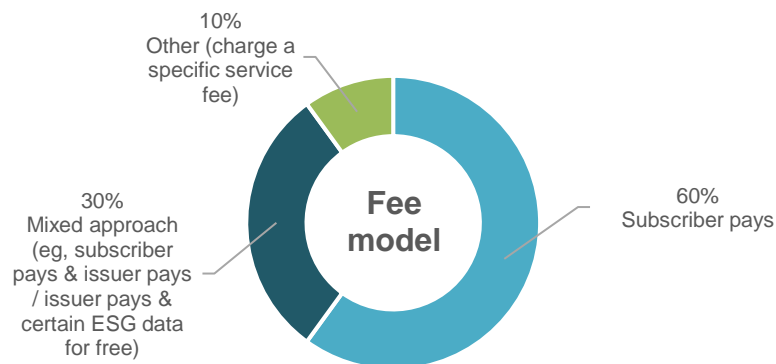
**(c) Fee model**

**Key observation 4**

The surveyed ESG service providers adopt different fee models, depending on the types of ESG ratings and data products.

18. It was noted that while 60% of the surveyed ESG service providers operate under a “subscriber pays” fee model, another 30% operate under a mixed fee model (eg, “subscriber pays” and “issuer pays”, or “issuer pays” along with certain ESG data provided for free). Specific service fees may also be charged to index providers by ESG service providers for providing ESG ratings and research services.

Figure 3



**B. Asset managers**

**(a) Use of ESG service providers**

**Key observation 5**

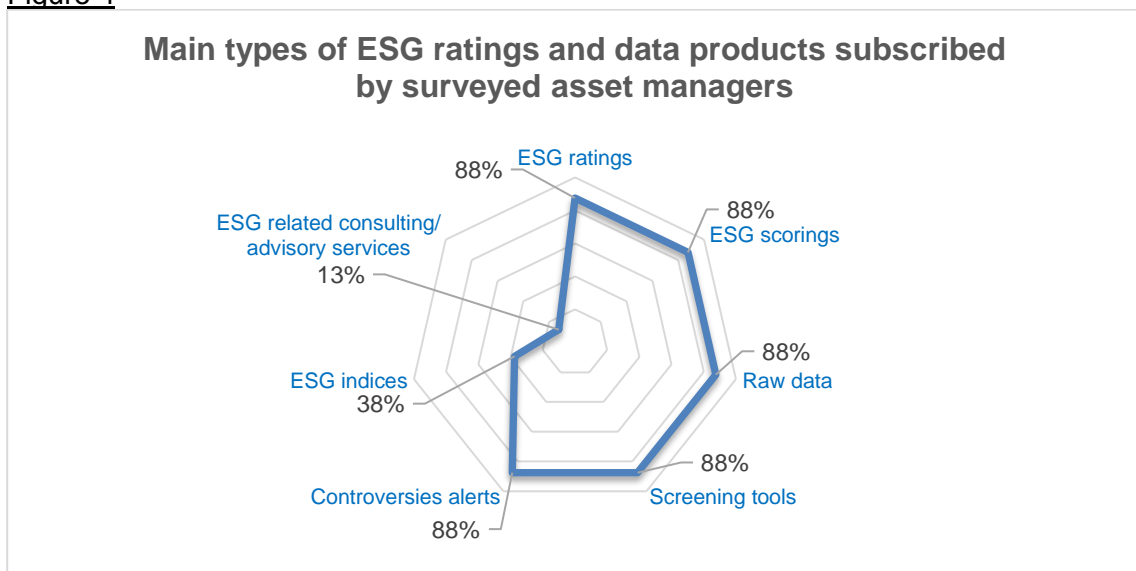
Surveyed asset managers generally engage the services of multiple ESG service providers, which may include sizeable international providers, Mainland providers, or small niche providers. However, these asset managers do not solely rely on the information from the ESG service providers but also perform their own internal analysis, which they believe is the differentiating value-add to this process.

19. A total of nine asset managers<sup>7</sup> were surveyed to understand how the services of ESG providers were engaged. It is noted that each asset manager typically engaged multiple ESG service providers (ranging from two to eight) mainly to cross-validate the information gathered or obtain specific data products only available from certain providers. In subsequent discussions, an industry association highlighted that an asset manager engaged the services of more than 20 primary ESG data providers and obtained additional ESG related information from 40 other different sources.
20. In addition to information (eg, ESG ratings) provided by ESG service providers, a number of surveyed asset managers said that their in-house ESG specialists would further analyse the ESG information from the providers before making investment decisions or for risk management purposes. In fact, these asset managers saw their proprietary in-house analyses and their ESG specialists as the differentiating value-add to the investment decision or risk management process.
21. On the other hand, based on our discussions with industry practitioners, certain asset managers would formulate ESG ratings and other related information based on their proprietary methodologies for internal use or for their clients.

**(b) Common ESG products subscribed**

22. The most common ESG ratings and data products subscribed by the surveyed asset managers<sup>8</sup> included ESG ratings, ESG scorings, raw data, screening tools and controversies alerts.

**Figure 4**



<sup>7</sup> The nine surveyed asset managers represent small to large-sized Mainland and international firms.

<sup>8</sup> Eight out of the nine surveyed asset managers provided such information.



**(c) Challenges and concerns related to the use of ESG service providers**

**Key observation 6**

Common issues of engaging with ESG service providers are mainly related to data coverage and quality, transparency, and conflicts of interest management.

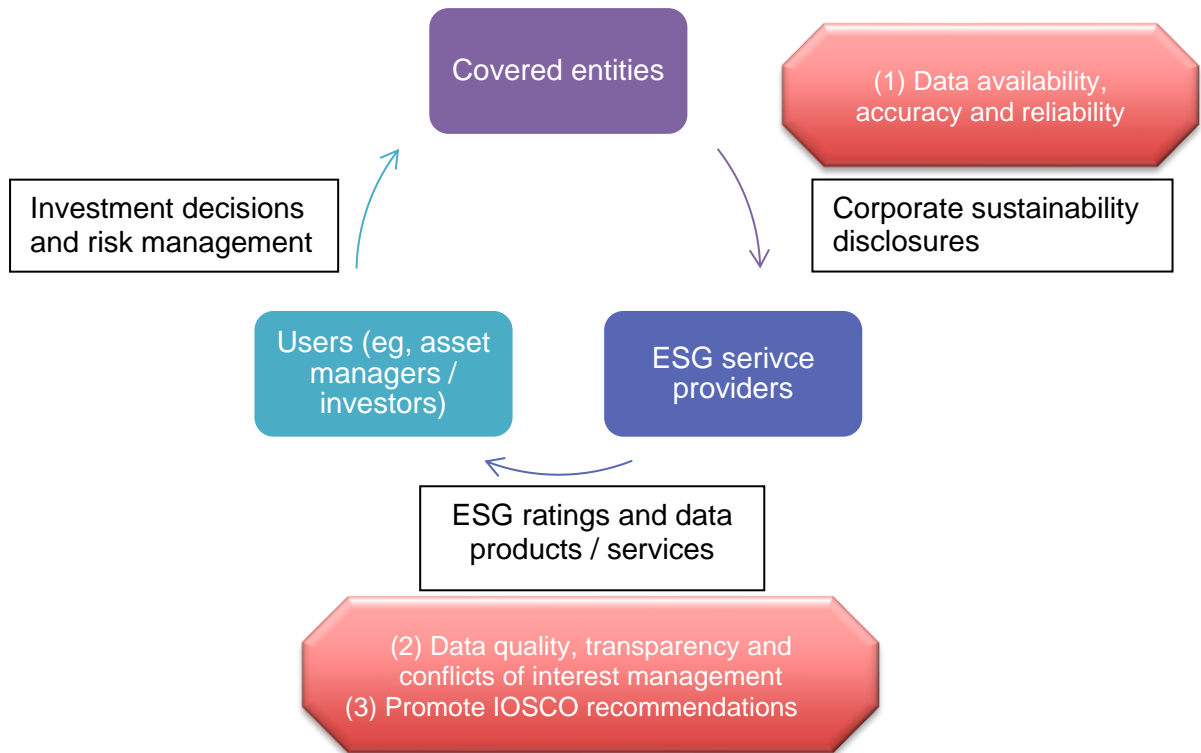
23. The most common challenges and concerns highlighted by the surveyed asset managers when engaging with ESG service providers are as follows:
- (i) data quality and coverage (eg, insufficient data on private companies and emerging markets);
  - (ii) lack of transparency (eg, methodologies of the estimation or assumption used by ESG service providers, the sources of raw data and pricing frameworks); and
  - (iii) conflicts of interest management (eg, the possibility that an ESG service provider downgrades a covered entity's ESG rating, while its advisory or consultancy business line subsequently solicits business with the downgraded entity).
24. While a few surveyed asset managers were concerned about the correlation or comparability of ESG products (eg, ESG ratings) provided by different providers, others were less concerned about the correlation issue as they are of the view that, unlike credit ratings, ESG ratings provided by each provider may reflect different perspectives and assessment of the covered entity. As such, it is more important for ESG service providers to provide sufficient transparency and timely communication for users to better assess the differences.

#### IV) Key issues observed from the fact-finding exercise

25. The key observations summarised in the previous section reveal three critical issues related to ESG ratings and data products and their providers that require further action. First is the availability, accuracy and reliability of ESG data and information. Second is the need to address transparency and conflicts of interest issues to strengthen the trust in the quality of the ESG information on which end users rely for their investment decision making and risk management purposes. Third is how to promote the IOSCO recommendations in Hong Kong where ESG service providers do not currently fall within the remit of the regulators.

Figure 5

##### Key issues that require further actions



26. The first issue stems from the concerns raised by both surveyed ESG service providers and asset managers (ie, users) on data unavailability, quality or coverage. This issue is mainly attributable to the lack of a standardised corporate sustainability disclosure framework in the market. In this regard, the SFC envisages that the introduction of the International Sustainability Standards Board (**ISSB**) sustainability-related corporate disclosure standards and our collaboration with local stakeholders including the Stock Exchange of Hong Kong Limited to develop a comprehensive roadmap for adopting the ISSB standards in Hong Kong will help narrow the data gap gradually.

27. The second issue stems from the concerns highlighted by the surveyed asset managers about ESG service providers' data quality, transparency and conflicts of interest management. In fact, some surveyed ESG service providers believe that the IOSCO recommendations should be encouraged as the baseline standards for ESG service providers which aim to address these concerns.
28. Nonetheless, the ESG service providers also stressed the importance of (i) ensuring that any baseline standards being introduced should be principles-based to allow sufficient flexibility to respond to market developments and encourage innovation and (ii) avoiding fragmentation in regulatory action and policy initiatives globally .
29. Since the publication of the IOSCO recommendations, the SFC, in considering how to tackle the third issue, noted that major jurisdictions are generally taking or planning to take one of the following approaches regarding ESG service providers:
- (i) expand regulatory remit to cover ESG ratings providers and set out mandatory regulatory requirements (eg, the European Union and India); or
  - (ii) introduce voluntary codes of conduct formulated by the regulator, by the industry, or by both the regulator and the industry (eg, Japan, the United Kingdom (**UK**) and Singapore).
30. Despite nuanced differences on the definitions, scopes and coverages, and conduct expectations introduced by each jurisdiction, these initiatives all have a common goal of promoting the IOSCO recommendations and advocating good practices among ESG ratings providers or ESG service providers.

## V) Proposed way forward

31. Whilst ESG service providers are not regulated by the SFC, we believe that we can pursue a pragmatic approach to promote the IOSCO recommendations to ESG service providers providing products and services in Hong Kong and address the issues on data quality, transparency and conflicts of interest management.
32. The initial approach that Hong Kong takes on ESG service providers should also aim to be:
  - (i) balanced, flexible and proportionate in order to nurture rather than hinder the development and innovation of the ESG ratings and data products industry, and avoid further market fragmentation or entry barriers for smaller or niche providers;
  - (ii) globally consistent and interoperable with other major jurisdictions as far as possible; and
  - (iii) able to facilitate licensed corporations' existing due diligence and on-going assessment processes of ESG service providers in ascertaining their fitness and properness.
33. Taking into account these considerations, the SFC has decided to sponsor and support the industry to develop and promote a voluntary code of conduct for ESG service providers providing products and services in Hong Kong (hereafter referred to as the **VCoC**). The formulation of the VCoC will be done via an industry-led working group, namely the Hong Kong ESG Ratings and Data Products Providers VCoC Working Group (**VCWG**).
34. The International Capital Market Association (**ICMA**<sup>9</sup>) will act as the Secretariat of the VCWG (hereafter referred to as **the Secretariat**). The Secretariat will leverage on its relevant experience to convene and lead the VCWG in developing the VCoC and promote interoperability of the code among different jurisdictions. Further details are available in the [terms of reference](#) and [participation list](#) of the VCWG published by the ICMA.
35. The proposed VCoC will set out baseline best practices governing the conduct of ESG service providers based on the IOSCO recommendations, which cover the four key elements of transparency, governance, systems and controls and management of conflicts of interest.
36. Also, the VCoC will be complemented by a self-attestation document as appended to the code. ESG service providers will be encouraged to complete and publish (eg, on their website) the self-attestation in order to foster greater transparency among ESG service providers. This will also facilitate the due diligence process of end users.
37. In addition, the VCoC will be open for ESG service providers to sign up voluntarily once finalised in order to promote the baseline best practices within the local industry.

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<sup>9</sup> A self-regulatory organisation and trade association in the capital markets, the ICMA has been involved in various green and sustainable finance initiatives such as the Green Bond Principles and acts as one of the Secretariats of the ESG Data and Ratings Working Group in the UK in developing a voluntary code of conduct for ESG ratings and data products providers.

38. Considering that the ESG ratings and data products industry is still evolving, the SFC will continue to closely monitor the market and regulatory development regarding ESG service providers and observe if there are any improvements on the conduct of the providers after the introduction of the VCoC. We will re-assess the circumstances and take additional measures when needed.

#### **Licensed corporations on the use of VCoC**

39. We understand from our engagement with asset managers, many already have an internal due diligence process to ascertain the fitness and properness of external service providers before engaging these service providers, including the ESG service providers.
40. The SFC believes that the proposed VCoC will provide a streamlined and consistent basis for asset managers to conduct due diligence or on-going assessment on ESG service providers. The VCoC should also reduce the burden on the part of ESG service providers when responding to due diligence or assessment requests from their clients.
41. Therefore, when the VCoC is finalised, the SFC plans to issue principles-based guidance to licensed corporations on using the VCoC for their due diligence and on-going assessment of ESG service providers.