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U.K. Regulator Comments on ESG-labelled Bonds and ESG Ratings

FCA Reminds Issuers of Rules Applicable to ESG-labelled Bond Issuances, Endorses ICMA Principles and Guidelines and Anticipates Regulation of ESG Data and Rating Providers

SUMMARY

On June 29, 2022, the U.K. Financial Conduct Authority (“FCA”) published a feedback statement ([FS22/4](#)) and Primary Market Bulletin 41 ([PMB 41](#)) on its approach to the regulation of green, social, sustainability, and sustainability-linked debt instruments (“ESG-labelled debt instruments”) and ESG data and rating providers. Although the feedback statement and Primary Market Bulletin do not amend existing regulation, the FCA has reminded issuers of ESG-labelled use of proceeds (“UoP”) bonds (i.e. bonds the net proceeds of which, or any amount equivalent to such proceeds, are earmarked for specific ESG projects) of their obligations under the U.K.’s prospectus regime. In particular, the FCA has reminded issuers that ESG bond frameworks, which are customarily published separately from the prospectus for the UoP bonds, must be consistent with the information contained in the prospectus and must not be inaccurate or misleading. The FCA has also endorsed the use of industry standards for ESG-labelled debt instruments, in particular the Green Bond Principles, Social Bond Principles and Sustainability Bond Guidelines (the “ICMA Principles and Guidelines”) developed by the International Capital Market Association (“ICMA”).

The FCA also encourages providers of external assurance for ESG-labelled bond issuances (“second opinion” providers and post-issuance UoP and sustainability-performance target verifiers) to consider voluntarily applying relevant industry standards. It has not ruled out further considering, with the U.K. Government, the case for bringing such providers within its regulatory perimeter in the future.

Lastly, the FCA has stated that there is a clear rationale for regulating providers of ESG data and rating services, and has provided an early indication of its proposed regulatory approach should the U.K. Government act to bring them within the FCA’s regulatory perimeter.

BACKGROUND

The feedback statement responds to a consultation published by the FCA in June 2021 ([CP21/18](#)) which, among other things, included a discussion component to gather views on potential issues associated with ESG-labelled debt instruments and ESG data and rating providers, with a view to policy intervention if appropriate. It also references the U.K. Government's Roadmap to Sustainable Investing (see [here](#)) and the work of overseas regulators in respect of oversight of ESG data and rating providers.

Issuances of ESG-labelled debt instruments, such as green bonds, have increased significantly in recent years. ICMA has reported that global issuances exceeded \$1 trillion in 2021, a 75% increase on 2020. In this context, the FCA's stated concern is to ensure that market participants can trust the claims made by issuers regarding the sustainability characteristics of such instruments and rely on them to perform as they expect.

THE FCA STATEMENTS

The key matters discussed in the feedback statement and Primary Market Bulletin 41 are set out below.

A. CONSISTENCY BETWEEN UOP BOND FRAMEWORKS AND PROSPECTUSES

The FCA's analysis of ESG-labelled debt instruments notes that occasionally the language used in an ESG UoP bond framework could be considered more definitive than the use of proceeds section of the prospectus for the issue of UoP bonds. In some circumstances, prospectus disclosure will clearly state that an issuer is not obligated to use the proceeds in a specific manner notwithstanding that the separately published framework implies a stronger commitment. The FCA is concerned that this potential divergence may lead to investment decisions being based on incomplete or misleading information.

In Primary Market Bulletin 41, the FCA has therefore reminded issuers of ESG-labelled debt instruments that, where a UoP bond framework forms part of a communication that relates to an offer or admission of securities, the framework is likely to be an advertisement for the purposes of the prospectus regime. This regime requires that advertisements must be recognisable as such, and the information included in an advertisement must be not be inaccurate or misleading, should be consistent with the information contained in the prospectus and must not contradict the information in the prospectus or present the information in the prospectus in a materially unbalanced way.

In light of these obligations, the FCA considers that more carefully crafted language may be appropriate within UoP bond frameworks to make clear to investors and other stakeholders which actions the issuer is contractually bound to carry out, in contrast to those actions it aspires to achieve but has not made contractually binding. Generally, issuers are not contractually obligated within the terms of the UoP bond itself to apply the proceeds in any particular manner – although an issuer is often so obligated under the terms of the underwriting agreement.

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The FCA is monitoring activities in this area and, looking ahead, it will consider whether to take further action to better understand the scale of the issue and whether any additional regulatory response is necessary. It may also revisit the case for requiring the central elements of UoP bonds to be set out in the prospectus in the context of the U.K. Government's review of the U.K.'s prospectus regime (on which we reported [here](#)).

The upshot of the FCA's approach is that UoP bond frameworks are likely to be subject to enhanced scrutiny, and issuers will need to ensure they are reflective of what is disclosed in the prospectus and vice versa. Issuers and their advisers will also need to consider whether the significant disclosures on broader sustainability approaches, targets and goals that are usually provided in UoP bond frameworks (consistent with the requirements of the ICMA Principles and Guidelines) should now also be referenced in the prospectus.

In analogous developments in the U.S., the SEC published a sample comment letter to SEC-registrants, asking issuers to consider whether climate-related disclosure included in the issuer's corporate social responsibility report should be included in the issuer's SEC filings as well (on which we reported [here](#)).

The SEC also recently initiated enforcement action against Vale S.A. for alleged misstatements on ESG matters made in its sustainability reports and investor presentations, which were not incorporated into its prospectus documentation (covered in our latest ESG newsletter [here](#)).

B. ENDORSEMENT OF ICMA PRINCIPLES AND GUIDELINES AND NO IMMEDIATE PLANS FOR U.K. GREEN BOND STANDARD

The FCA has expressly encouraged issuers of UoP bonds and their advisors to consider voluntarily applying or adopting relevant industry standards, such as the ICMA Principles and Guidelines. (For an overview of the ICMA Principles and Guidelines, please see our previous updates [here](#) and [here](#).)

As well as advocating voluntary compliance with industry standards, the FCA has confirmed that it does not intend to develop a compulsory standard for ESG-labelled debt instruments at this time.

This contrasts with the position taken by certain other regulators worldwide. Some jurisdictions have issued binding ESG bond rules, including China and India, whilst others, such as Brazil, have issued frameworks and guidelines. The European Union is currently in the process of establishing a green bond standard. The European Commission published a proposal in June 2021, ahead of triologue discussions between the European Parliament, European Council and European Commission, which are currently ongoing (covered in our latest ESG newsletter [here](#)).

The FCA has, however, stated that, subject to U.K. Government policy, it may potentially reassess the case for developing a standard for UoP bonds as part of the ongoing review of the U.K.'s prospectus regime and the development of the U.K.'s own Green Taxonomy.

C. THE ROLE OF EXTERNAL ASSURANCE

In its consultation paper, the FCA sought views on second party opinion (“SPO”) provision and third party verification of UoP bond issuances and sustainability-linked bond issuances (i.e. bonds which have a coupon linked to whether the issuer achieves predefined sustainability and/or ESG objectives, which generally refer to sustainability performance targets supported by detailed key performance indicators (“KPIs”). External assurance usually assesses the post-issuance allocation of proceeds in the case of a UoP bond and the achievement of the KPIs for a sustainability-linked bond.

The FCA identified the following potential issues in the market for SPO provision and third party verification:

- The potential conflict of interest between the SPO provider/verifier and the investors given the issuer pays the SPO provider/verifier; and
- The potential complexity in analysing and assuring performance against sustainability performance targets.

To address these concerns, the FCA has encouraged issuers to consider adherence to relevant industry standards, such as ICMA’s Guidelines for Green, Social, Sustainability and Sustainability-Linked Bonds External Reviews, when selecting external assurers. The FCA also encourages assurance providers to consider voluntarily applying these standards, and to undertake engagements in line with the International Standard on Assurance Engagements (UK) 3000, issued by the Financial Reporting Council (“FRC”), alongside the FRC’s Ethical Standard.

The FCA has not ruled out further considering, with the U.K. Government, the case for bringing assurance providers within its regulatory perimeter in the future.

D. FCA REGULATION OF ESG DATA AND RATING PROVIDERS

Another significant finding in the FCA’s feedback statement is the FCA’s support for the U.K. Government’s proposal, set out in its Roadmap for Sustainable Investing (see [here](#)), to bring ESG data and rating providers within scope of FCA authorisation and regulation. Such providers are currently unregulated.

Any regulatory regime would require the U.K. Government to extend the FCA’s regulatory perimeter and would be subject to public consultation. As such, the timeframe for implementation is uncertain and there is likely to be a considerable lead time.

Although the FCA has not set out detailed proposals for a future regulatory regime at this stage, the FCA has had regard to recent work undertaken by the International Organization of Securities Commissions (“IOSCO”). IOSCO is advocating for an internationally coordinated approach to regulation of the market for ESG data and rating services. In 2021, IOSCO carried out a consultation which explored developments and challenges within the market for such services and sought to understand the implications of the increasingly important role of ESG data and rating providers for financial markets. As set out in its [report](#), published in November 2021, IOSCO has made ten

recommendations targeted at regulators, providers and issuers subject to assessment by providers. The FCA considers that the IOSCO recommendations capture some of the key outcomes the FCA would expect a regulatory regime to achieve, including transparency, good governance, management of conflicts of interest and robust systems and controls.

The FCA has indicated that, in determining a proportionate scope for such a regime, it would expect to take into account factors such as the size of the ESG data or rating provider, the degree of judgement and “value-added” in its service provision, and the nature and degree of usage of the provider’s services in the market.

Given the likely lead time before any regulatory regime would come into force, and as suggested by IOSCO, if the FCA’s regulatory perimeter is extended, the FCA would in the interim work with the U.K. Government and industry participants to establish a voluntary code of conduct addressing matters similar to those listed above and reflecting the IOSCO recommendations. The FCA notes that, once a regulatory regime has been established, such a voluntary code could continue to apply to ESG data and rating providers that fall outside the regime (e.g. to providers that do not meet any minimum qualification requirements for regulation set by the FCA). The FCA has also stated that it sees value in coordinating as far as possible with other jurisdictions on the design of any regulatory approach or code of conduct.

Overseas regulators are also considering how to regulate ESG data and rating providers. On June 27, 2022, the European Securities and Markets Authority published the [results](#) of its consultation on ESG rating providers. The European Commission is carrying out its own consultation on the topic, with a view to evaluating whether a policy initiative is needed. It intends to publish an impact assessment later this year and, if it decides on intervention, to propose an initiative by early 2023. Elsewhere, in January 2022, the Securities and Exchange Board of India published a consultation seeking views on a regulatory framework. And in June 2022, Japan’s Financial Services Agency published a draft report containing the framework for a code of conduct for ESG data and ratings providers, which draws on IOSCO’s work.

E. CLIMATE-RELATED DISCLOSURES FOR ISSUERS OF LISTED DEBT

In the feedback statement, the FCA has stated that it will consider how to strengthen and promote transparency on sustainability representations by debt issuers, including in the context of the review of the U.K.’s prospectus regime.

However, the FCA has not brought forward proposals to extend to issuers of listed debt the “comply or explain” reporting requirements linked to the Task Force on Climate-related Financial Disclosures framework that the FCA introduced for issuers of equity shares listed on the premium and standard segments of the main market of the London Stock Exchange.

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