

## SETTING THE BENCHMARK: INDIA'S FIRST-OF-ITS-KIND LEGISLATION ON ESG RATING PROVIDERS

### 1. INTRODUCTION

Ascertaining the environmental, social, and governance (“ESG”) profile of a potential investee is a complex task, often requiring dedicated personnel and subject-matter expertise. Investors, especially asset management companies and institutional investors, typically rely on research products, usually in the form of ratings, scores, or opinions, offered by third-party agencies called ‘ESG Rating Providers’ (“ERPs”).<sup>1</sup>

On July 04, 2023, the Securities and Exchange Board of India (“SEBI”) amended the SEBI (Credit Rating Agencies) Regulations, 1999 (the “CRA Regulations”) to introduce a regulatory framework for governing entities engaged in the business of issuing ratings based on ESG parameters (the “Amendment”).<sup>2</sup> Post the Amendment, ERPs will be required to seek registration with SEBI prior to commencing business. With this, India becomes one of the few jurisdictions to regulate ERPs, ahead of developed jurisdictions such as the European Union (“EU”), United States, United Kingdom (“UK”), and Singapore. The Amendment has been notified in the backdrop of the consultation papers titled ‘ERPs for Securities Markets’ (the “Consultation Paper I”)<sup>3</sup> and ‘Regulatory Framework for ERPs in Securities Market’ (the “Consultation Paper II”)<sup>4</sup> released by SEBI on January 24, 2022, and February 22, 2023, respectively.<sup>5</sup>

This article critically analyses the Amendment and attempts to compare it with the proposed legislations in the EU<sup>6</sup>, the UK<sup>7</sup> and Singapore<sup>8</sup>. We also delve into the impact of the Amendment on ease of doing business as well as its lack of technological foresight. The schedule to this article provides a comparative analysis of the Amendment and the proposed legislations in the EU, the UK, and Singapore.

### 2. OVERVIEW AND CRITICAL ANALYSIS OF THE AMENDMENT

The Amendment sets out the regime governing ERPs, which we have summarized and analyzed below.

#### 2.1. Scope of the Amendment

<sup>1</sup> Paragraph 2.1 of the Consultation Paper I.

<sup>2</sup> The CRA Regulations (along with the Amendment) can be accessed here: <https://www.sebi.gov.in/legal/regulations/jul-2023/securities-and-exchange-board-of-india-credit-rating-agencies-regulations-1999-last-amended-on-july-4-2023-73593.html>.

<sup>3</sup> The Consultation Paper I can be accessed at: <https://www.sebi.gov.in/reports-and-statistics/reports/jan-2022/consultation-paper-on-environmental-social-and-governance-esg-rating-providers-for-securities-markets-55516.html>.

<sup>4</sup> The Consultation Paper II can be accessed at: <https://www.sebi.gov.in/reports-and-statistics/reports/feb-2023/consultation-paper-on-regulatory-framework-for-esg-rating-providers-erps-in-securities-market-68337.html>.

<sup>5</sup> In Consultation Paper I and Consultation Paper II, SEBI had observed that the ESG rating products ecosystem faced multiple issues, including, lack of clear use of terminologies, inconsistency in disclosures and transparency of the methodology and rating process, unregulated nature of market, potential conflicts of interest, and lack of India-specific ERPs. Accordingly, SEBI had recommended issuance of regulations for governing ERPs.

<sup>6</sup> The Proposed EU Regulation can be accessed at: <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52023PC0314>.

<sup>7</sup> The UK Consultation Paper can be accessed at: [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1147458/ESG\\_Ratings\\_Consultation.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1147458/ESG_Ratings_Consultation.pdf).

<sup>8</sup> The Singapore Consultation Paper can be accessed at: <https://www.mas.gov.sg/-/media/mas/news-and-publications/consultation-papers/consultation-paper-on-proposed-code-of-conduct-for-esg-rating-and-data-product-providers.pdf>.

### 2.1.1. Scope of products and services regulated under the Amendment

Any person who is engaged in the business of issuing rating products marketed either as opinions about the ESG profile or exposure to ESG risk of an issuer or a security, issued using a defined ranking system of rating categories (“**ESG Ratings**”), is required to seek registration under the CRA Regulations.<sup>9</sup> Entities offering ESG Ratings shall be considered as ERPs, whether or not such products are explicitly labelled as ESG Ratings. SEBI has thus adopted a functional definition of ESG Ratings. This is in line with the proposed regulation of the EU titled ‘Regulation of the European Parliament and of the Council on the transparency and integrity of ESG rating activities’ (the “**Proposed EU Regulation**”)<sup>10</sup> and the UK’s consultation paper titled ‘Future regulatory regime for ESG ratings providers’ (the “**UK Consultation Paper**”)<sup>11</sup>.

ERPs can provide ratings basis, both, ESG profile or exposure to ESG risk, and impact of the ESG profile of an entity on society, climate, and the environment. Thus, a wide spectrum of ESG products, including both risk-based and impact-based ratings, are covered. The Amendment provides a prescriptive list of products that ERPs must offer, without incorporating necessary flexibility in terms of the range of products which may be offered without requiring registration. In contrast, the Proposed EU Regulation specifically excludes nine ERP products from its scope.<sup>12</sup> These include private ESG ratings not intended for public disclosure, raw ESG data, second-party opinions on sustainability bonds, a third-party providing ratings released by an authorized ERP, and ESG ratings issued by public authorities.

Similarly, the consultation paper released by the Monetary Authority of Singapore titled ‘Proposed Code of Conduct for ESG Rating and Data Product Providers’ (the “**Singapore Consultation Paper**”) excludes ratings that take into account the ESG profile of an entity to assess its creditworthiness, and research analysis or reports relating to any investment product issued by a financial advisor.<sup>13</sup> Likewise, under the UK Consultation Paper, certain products and services are proposed to be excluded from the scope of the regulation. These exclusions encompass ESG ratings provided by not-for-profit entities, credit ratings which consider the impact of ESG ratings on creditworthiness, investment research products, consulting services related to ESG, as well as academic research and journalism.<sup>14</sup>

### 2.1.2. Eligibility Criteria<sup>15</sup>

To be eligible to register as an ERP, an entity must, amongst other, meet the following criteria. It must be:

- (a) a company incorporated under the Companies Act, 2013, and shall have specified ESG rating as the main object in its memorandum of association; and
- (b) exclusively engaged in the business of issuing ESG Ratings of: (i) issuers, or securities listed, or proposed to be listed on a SEBI recognized stock exchange; (ii) issuers, or products, as may be required by any other financial sector regulator or authority; or (iii) any other product or issuer, as may be

<sup>9</sup> Regulation 28B(1)(b) of the CRA Regulations read with regulation 28B(1)(c) of the CRA Regulations.

<sup>10</sup> Article 3(1) of the Proposed EU Regulation.

<sup>11</sup> Paragraph 2.3 of the UK Consultation Paper.

<sup>12</sup> Article 2(2) of the Proposed EU Regulation.

<sup>13</sup> Paragraph 3.6.4 of the Singapore Consultation Paper.

<sup>14</sup> Paragraphs 3.2 and 3.5 of the UK Consultation Paper.

<sup>15</sup> Credit Rating Agencies or any other intermediaries (such as foreign institutional investors, merchant bankers, portfolio managers and investment advisers) registered with SEBI are not permitted to register themselves as ERPs.

required by another financial sector regulator, as may be specified by SEBI, under guidelines of such regulator.<sup>16</sup>

The eligibility condition stated at paragraph 2.1.2(b) is concerning as it creates significant barriers to entry in the ERP market. Potential entrants will be required to exclusively undertake the business of offering ESG Ratings. Further, credit rating agencies and any other intermediaries registered with SEBI will not be permitted to register themselves as an ERP. In comparison, the Proposed EU Regulation prescribes a negative criterion, listing activities that ERPs cannot engage in.<sup>17</sup> These activities include consulting activities to investors or undertakings, issuance and sale of credit ratings, development of benchmarks, investment activities, audit activities, and banking, insurance, or reinsurance activities. Barring these, ERPs are allowed to undertake any other business activities as long as there is no risk of conflict of interest with their role as an ERP. This approach minimizes potential conflicts of interest while simultaneously enabling ERPs to diversify their business offerings and manage risks.

### 2.1.3. Governance of ERPs registered outside India

The Amendment is only applicable to ERPs set out below:

S. No.	Location of ERP	Asset class in securities market	Location of ESG Rating user	Applicability of the Amendment
1.	India	Indian	India	Yes
2.	India	Indian	Outside India	No
3.	India	Global	India	Yes
4.	Outside India	Indian	India	Yes
5.	Outside India	Indian	Outside India	No
6.	Outside India	Global	India	No

As evident in the above matrix, an ERP located outside India must register with SEBI before offering ESG Ratings of an Indian asset class to users located in India.<sup>18</sup> In contrast, under the Proposed EU Regulation, ERPs from non-EU countries can provide ESG ratings in the EU, without obtaining a certification, pursuant to an ‘equivalence decision’ between the EU and the relevant competent authority in their respective jurisdictions.<sup>19</sup> The UK Consultation Paper has also kept this possibility open.<sup>20</sup>

By introducing this registration requirement, SEBI’s intent appears to be to ensure the legitimacy of ERPs and prevent entities from evading regulatory scrutiny by registering in a foreign jurisdiction while offering services in India. While this intent is fair, allowing foreign entities to operate in the Indian ERP market can bring certain benefits, such as increased quality of business offerings and innovation. Therefore, SEBI could have considered an alternative approach of allowing foreign-registered ERPs to operate in India without

<sup>16</sup> Regulation 28E of the CRA Regulations.

<sup>17</sup> Article 15 of the Proposed EU Regulation.

<sup>18</sup> Regulation 28C of the CRA Regulations read with the fourth schedule of the CRA Regulations. The CRA Regulations contain a transitional provision i.e., a person operating as an ERP can continue to do so until January 3, 2024, or if it has made an application for registration before January 3, 2024, till the disposal of such application.

<sup>19</sup> Article 9 of the Proposed EU Regulation. An equivalence decision would confirm that the legal and supervisory framework for ERPs in the third country is equivalent to the framework in the Proposed EU Regulation, including provisions for regular and effective supervision and enforcement.

<sup>20</sup> Paragraph 4.4 of the UK Consultation Paper.

undergoing the same registration process as a domestic ERP. However, this should be subject to the inclusion of certain safeguards to mitigate concerns around the authenticity and competence of foreign entities.

## 2.2. Measures relating to transparency, governance, and prevention of conflict of interest

One of the primary intents behind introducing the Amendment is to prevent greenwashing and misallocation of capital. To achieve this intent, the Amendment embodies the principles of transparency, disclosure, and prevention of conflict of interest. Accordingly, under the CRA Regulations, ERPs would be required to maintain a website and provide extensive disclosures, such as:

- (a) ESG Ratings, their type (risk-based, impact-based, or otherwise), individual scores on ESG and other parameters;
- (b) rating methodology, except proprietary or confidential aspects of such methodologies, and any changes made to rating methodology, as well as the extent to which an ESG Rating has changed owing to change in the methodology of the ERP;
- (c) archives of past rating methodologies and ESG Ratings; and
- (d) whether the ESG Ratings provided to clients were solicited or unsolicited, as well as the general nature of compensation arrangement with clients.<sup>21</sup>

## 2.3. Classification of ERPs

The Amendment classifies ERPs as either Category I or Category II, with stricter eligibility and compliance requirements for the former. In this regard, in the Consultation Paper II, SEBI had clarified that the classification is intended to incentivize start-ups and new entrants to join the ERP industry.<sup>22</sup>

A brief overview of the differences between Category I and Category II is set out below:

Requirements	Category I	Category II
Minimum liquid net worth <sup>23</sup> ( <i>at the time of making the application</i> )	Minimum liquid net worth, higher of: (a) INR 10 crores, or (b) INR 5 crores and a target on cumulative cash losses until the applicant breaks even.	Minimum liquid net worth, higher of: (a) INR 20 lakhs, or (b) INR 10 lakhs and a target on cumulative cash losses until the applicant breaks even.
Minimum liquid net worth ( <i>post registration</i> )	Minimum liquid net worth of INR 5 crores.	Minimum liquid net worth of INR 10 lakhs.
Scope of services	Permitted to provide ESG Ratings for all types of securities.	Not permitted to provide certification of green debt securities.

<sup>21</sup> Regulation 28K of the CRA Regulations.

<sup>22</sup> Page 13 of the Consultation Paper II.

<sup>23</sup> The CRA Regulations define 'Liquid net worth' as net worth deployed in unencumbered liquid assets (i.e., a low risk asset that can easily be converted into cash in a short period of time).

Requirements	Category I	Category II
Additional Criteria for promoters	Promoters will be required to satisfy qualification (such as registration with specified financial regulators) or minimum net worth related requirements.	No specific requirements for promoters.
Infrastructure	Mandatorily required to have physical office space.	Not required to have physical office space.

## 2.4. Regulatory Gaps

### 2.4.1. Subscriber-pays Model

The Consultation Paper I proposed that a mandatory subscriber-pays model should be followed by ERPs.<sup>24</sup> This meant that payment consideration to ERPs would primarily be offered by potential investors, instead of the company to which the ratings would pertain. This would ensure minimal conflict of interest in the ratings issuance process. However, the Amendment makes no mention of any payment model requirement for ERPs.

### 2.4.2. Use of Artificial Intelligence (“AI”) and Machine Learning (“ML”)

AI and ML are increasingly being used by businesses to enhance the quality of their business offerings. ERPs too extensively use data analytics and natural language processing in providing products. They can, thus, leverage AI and ML to boost the efficiency and quality of their data analysis. The Amendment, however, does not specifically envisage and regulate use of AI or ML by ERPs. This is also the case with regulations pertaining to investment advisers (“IAs”) and mutual funds (“MFs”). This regulatory ambiguity created the need for SEBI to issue clarifications and consultation papers in the past. For instance, SEBI released a consultation paper in 2016, clarifying that it does not expressly prohibit use of automated tools by IAs, but proposed to prescribe additional compliances for the same.<sup>25</sup> Further, in 2019, SEBI issued a circular for MFs to report details of AI and ML applications and systems offered or used by them, on a quarterly basis to the Association of Mutual Funds in India, who shall then consolidate the same and forward it to SEBI.<sup>26</sup> This experience evidences the need for the CRA Regulations themselves to accommodate the possibility of use for AI and ML by ERPs and prescribe appropriate safeguards and restrictions.

Further, it is essential for the legislation to account for other existing and possible future developments in the ERP market to ensure relevance and protect investors’ interests. This is critical to bring India on the global map for AI regulation, and in line with jurisdictions such as the EU, which is on the path to becoming a global leader in AI regulation.<sup>27</sup>

## 3. CONCLUSION

<sup>24</sup> Paragraph 11.8. of the Consultation Paper I.

<sup>25</sup> [https://www.sebi.gov.in/reports-and-statistics/reports/oct-2016/consultation-paper-on-amendments-clarifications-to-the-sebi-investment-advisers-regulations-2013\\_33435.html](https://www.sebi.gov.in/reports-and-statistics/reports/oct-2016/consultation-paper-on-amendments-clarifications-to-the-sebi-investment-advisers-regulations-2013_33435.html).

<sup>26</sup> [https://www.sebi.gov.in/legal/circulars/may-2019/reporting-for-artificial-intelligence-ai-and-machine-learning-ml-applications-and-systems-offered-and-used-by-mutual-funds\\_42932.html](https://www.sebi.gov.in/legal/circulars/may-2019/reporting-for-artificial-intelligence-ai-and-machine-learning-ml-applications-and-systems-offered-and-used-by-mutual-funds_42932.html).

<sup>27</sup> <https://www.bloomberg.com/news/articles/2023-07-31/ai-regulation-how-the-european-union-is-leading-the-charge>.

The Indian regulatory system is slowly but steadily making its way in the ESG space, of which ESG Ratings constitute an important part. Since the global ERP market is still in its early stages, finding the right balance between regulatory scrutiny and growth of the ERP market is essential. The move towards a phased and proportionate regulatory model by jurisdiction like Singapore reflects this need for flexibility.<sup>28</sup>

The Amendment is a positive step towards combating the risk of greenwashing, safeguarding investors' interests, and promoting transparency. However, to promote ease of doing business, greater regulatory flexibility with respect to registration requirements for foreign ERPs can be adopted. Further, prescription of a payment model requirement for ERPs would aid in aligning ERPs' business operations with the principles of transparency embodied in the CRA Regulations.

There is also a need for the law to keep pace with technological advancements in the ERP market, particularly in areas like AI or ML. Including specific safeguards will ensure responsible and ethical use of these technologies by ERPs. Overall, a balanced approach, one that fosters innovation while maintaining oversight, will pave the way for a robust and credible ESG ecosystem in India. This will not only benefit businesses but also contribute to sustainable and responsible investment practices in the country.

**Authors:** Shantanu Jindel | Shivani Singh | Supriya Shekher

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**Practice Areas:** Corporate and Commercial | Government and Regulatory

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<sup>28</sup> Paragraph 3.10.2. of the Singapore Consultation Paper. As per the "comply or explain" approach, ERPs would either have to comply with best practices or explain the reasons for their non-compliance.

SCHEDULE

COMPARATIVE ANALYSIS

	India	EU	UK	Singapore
<b>Status</b>	Legally binding.	Proposed to be legally binding.	Undergoing consultation.	Undergoing consultation. A phased and proportionate regulatory approach is proposed to be followed, starting with a voluntary industry code of conduct for the ERPs.
<b>Definition of ESG ratings</b>	ESG Ratings have been defined as rating products marketed as opinions about the ESG profile of an issuer or a security and issued using a defined ranking system of rating categories, whether or not they are explicitly termed as “ESG Ratings”. Both risk-based and impact-based ratings are included.	ESG ratings have been defined as opinions, scores, or a combination of both, given to third parties, regarding the ESG profile of an entity or financial instrument, based on an established methodology and defined ranking system of rating categories, whether or not they are explicitly termed as “rating” or “ESG score”. <sup>29</sup> Both risk-based and impact-based ratings are included.	The definition is proposed to include any assessment product regarding the ESG profile of an entity, including assessments generated algorithmically. <sup>30</sup>	ESG ratings have been defined as products providing opinion regarding one or more ESG characteristics of an entity, expressed through an established and defined ranking system of rating categories. <sup>31</sup>

<sup>29</sup> Article 3(1) of the Proposed EU Regulation.

<sup>30</sup> Paragraphs 2.1, 2.2, and 2.3 of the UK Consultation Paper.

<sup>31</sup> Paragraph 3.6.4 of the Singapore Consultation Paper.



	India	EU	UK	Singapore
<b>Definition of ERPs</b>	ERPs are defined as companies engaged or that propose to be engaged in the business of providing ESG Ratings.	ERPs are defined as legal persons professionally providing ESG ratings or scores. <sup>32</sup>	No strict definition of ERPs has been provided.	ERPs are defined as entities providing ESG ratings in or out of Singapore relating to activities and institutions in the securities and derivatives industry. <sup>33</sup>
<b>Classification of ERPs</b>	ERPs are classified as Category I or Category II, with stricter compliance requirements for the former.	No classification system for entities has been proposed.	Two ways of classification have been proposed: (a) Entities could be classified on the basis of their size, with enhanced compliances for larger providers, or (b) Only large providers could be subjected to authorization requirements, while smaller entities would not be subject to authorization requirements, but governed using other mechanisms, such as a bespoke regime. <sup>34</sup>	No classification system for entities has been proposed.
<b>Provision for foreign ERPs providing</b>	No such provision.	Entities registered in countries having a similar legal and regulatory	The UK Consultation Paper keeps the possibility of such	No such provision.

<sup>32</sup> Article 3(4) of the Proposed EU Regulation.

<sup>33</sup> Paragraph 3.7.3 of the Singapore Consultation Paper.

<sup>34</sup> Paragraph 5.4 of the UK Consultation Paper.



	India	EU	UK	Singapore
<b>services post an equivalence decision</b>		framework as the EU can provide their services post an equivalence decision and cooperation arrangements between EU and the competent authority in their respective jurisdiction. <sup>35</sup>	arrangements in the future open for consideration. <sup>36</sup>	
<b>Provision regarding use of AI or ML by ERPs</b>	No such provision.	The Proposed EU Regulation specifically covers ESG score derived from data, using a rule-based methodology, and based only on an algorithmic system or model, without any additional substantial analytical input from an analyst.	While there is no explicit and specific provision mandating disclosures or prescribing safeguards, the UK Consultation Paper does envisage the possibility of ERPs algorithmically generating their ratings and includes such ratings within its regulatory scope. <sup>37</sup>	No such provision.

<sup>35</sup> Article 9 of the Proposed EU Regulation.

<sup>36</sup> Paragraph 4.4 of the UK Consultation Paper.

<sup>37</sup> Paragraph 2.3 of the UK Consultation Paper.