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ESG Rating Regulation in Sustainable Finance: Methodological Pluralism, Process-Based Supervision, and Global Regulatory Coordination

Meng Xu ¹ and Min Xu ^{2,*}

¹ School of Law, Dianchi College, Kunming 650228, China

² School of Law, Yunnan University of Finance and Economics, Kunming 650221, China

* Correspondence: m1388238080@163.com

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Abstract: Financial markets have taken climate and sustainability more seriously since the 2015 Paris Agreement. ESG ratings have emerged as a key mechanism for translating corporate sustainability information into assessments that inform investors, asset managers, index providers, and product design. But greater influence has also meant greater scrutiny, revealing problems such as rating divergence, opacity, poor data, conflicts, and market concentration. Drawing on the European Union’s ESG Rating Regulation (EU 2024/3005), Japan’s Code of Conduct for ESG Evaluation and Data Providers, and the International Organization of Securities Commissions (IOSCO) principles, this paper argues that global ESG rating regulation should adopt a process-based approach rather than mandating uniform rating outcomes. This argument is grounded in reflexive law theory and the principle of proportionality, which emphasize that regulation should shape the organizational environment and decision-making processes of rating agencies without dictating substantive rating conclusions. The paper demonstrates that methodological pluralism is both inevitable and desirable, provided that rating processes are transparent, data sources are traceable, conflicts of interest are managed, and rating limitations are clearly communicated. The paper makes three contributions. First, it identifies a composite legitimacy framework for ESG rating regulation, comprising investor protection, market integrity, and—as an indirect but necessary dimension—the governance of environmental and social externalities. Second, it systematically articulates the institutional pathway through which process-based regulation can address market failures while preserving methodological diversity. Third, it operationalizes the principles of transparency, interpretability, traceability, and accountability into concrete regulatory mechanisms, including disclosure formats, data-version control, conflict-management rules, and complaint-handling procedures. The paper concludes that effective global coordination requires a common procedural foundation rather than substantive harmonization of rating methodologies. Jurisdictions should calibrate regulatory intensity to local market conditions, institutional capacity, and the developmental stage of their ESG ratings markets, while adhering to minimum standards on anti-fraud, conflict prevention, methodological transparency, and data governance.

Keywords: ESG ratings; financial regulation; information intermediaries; sustainable finance



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1. Introduction

As sustainable finance expands globally, ESG (Environmental, Social, and Governance) ratings have become a critical information intermediary connecting corporate sustainability performance with the allocation of financial resources [1,2]. These ratings influence not only individual investment decisions but also the structure of portfolios, the design and marketing of financial products, the construction of sustainability-themed indices, and the assessment of climate-related financial risks. Major ESG rating agencies—including MSCI, Sustainalytics (Morningstar), Refinitiv (LSEG), S&P Global, and ISS ESG—evaluate thousands of companies worldwide, and their assessments are widely used by institutional investors, asset managers, and financial regulators [3].

However, the ESG ratings market exhibits significant structural problems. First, rating divergence is pervasive: studies show that the correlation among leading ESG rating agencies' scores for the same company can be as low as 0.38 to 0.71, far below the 0.92 to 0.99 correlation observed among credit rating agencies [4–6]. Berg, Kölbel, and Rigobon (2022) decompose this divergence into differences in scope (which ESG issues are measured), measurement (how issues are assessed), and weight (how issues are aggregated), with measurement differences accounting for the largest share of variance [4,7]. Second, conflicts of interest arise when rating agencies simultaneously provide consulting services to rated companies, construct ESG indices, or manage investment products, creating incentives that may compromise rating independence [8,9]. Third, data quality is uneven: corporate ESG disclosure remains incomplete and unstandardized, forcing rating agencies to rely heavily on estimates, industry averages, and model-based imputations, the extent and reliability of which are often not disclosed [10,11]. Fourth, market concentration is pronounced: a small number of large agencies dominate the market, raising barriers to entry for new providers and potentially reducing competitive pressure for methodological innovation [11,12].

These structural problems have implications not only for investor protection and market integrity but also—indirectly—for the governance of environmental and social externalities. ESG ratings do not directly internalize externalities in the manner of carbon taxes or emissions caps. However, by influencing the cost of capital, asset pricing, and the allocation of investment flows, ratings can transmit environmental and social costs into financial decision-making [13–16]. When ESG ratings are opaque, inconsistent, or distorted by conflicts of interest, they may fail to accurately reflect material sustainability risks, thereby undermining capital allocation efficiency and enabling greenwashing. Conversely, when ratings are transparent, data-traceable, and methodologically sound, they can help investors identify companies with poor environmental performance, weak labor practices, or governance failures, thereby increasing the cost of capital for such firms and creating market-based incentives for improved ESG performance [17–19]. This transmission mechanism provides an indirect but important justification for ESG rating regulation, complementing the direct rationales of investor protection and market integrity.

Against this backdrop, regulatory initiatives have emerged across multiple jurisdictions. The European Union adopted Regulation (EU) 2024/3005 on the transparency and integrity of ESG rating activities in November 2024, establishing a comprehensive authorization and supervision framework [1,2,20,21]. Japan's Financial Services Agency (FSA) published a Code of Conduct for ESG Evaluation and Data Providers in December 2022, promoting transparency and conflict management through principles-based guidance. The International Organization of Securities Commissions (IOSCO) issued recommendations in November 2021 on ESG ratings and data product providers, addressing transparency, data quality, conflicts of interest, governance, and regulatory cooperation [8]. Several jurisdictions have taken steps to regulate ESG ratings. The EU has adopted Regulation 2024/3005 establishing a comprehensive mandatory regime. Japan has issued voluntary principles-based guidance. The UK has completed public consultation on a mandatory authorisation framework but has not yet finalised rules as of September 2026.

This paper examines the regulatory challenges posed by ESG ratings and explores the institutional foundations for effective global coordination. It makes three contributions. First, it identifies a composite legitimacy framework for ESG rating regulation, comprising investor protection, market integrity, and the governance of environmental and social externalities. While the governance of externalities is an indirect regulatory basis—ESG ratings are not policy instruments for directly internalizing externalities—it is nonetheless necessary to understand the role of ratings in transmitting sustainability information into capital markets and thereby shaping incentives for corporate ESG performance.

Second, the paper articulates a process-based regulatory approach grounded in reflexive law theory and the principle of proportionality [22]. Unlike earlier work that observes the existence of rating divergence or notes that “regulation should focus on process rather than outcomes” [8,23], this paper systematically demonstrates how process-based regulation can be institutionalized through concrete mechanisms including functional definitions of rating activities, authorization criteria focused on organizational capacity rather than methodological approval,

mandatory disclosure of rating purpose and limitations, data-version control and traceability requirements, conflict-management rules, and complaint-handling procedures. The paper also addresses a key counterargument: that process-based regulation may be insufficient to prevent systemic risks such as greenwashing or capital misallocation. It argues that process transparency, combined with ex post accountability and targeted substantive intervention in cases of fraud or severe procedural failure, provides a more effective and less restrictive regulatory framework than ex ante methodological standardization.

Third, the paper operationalizes the principles of transparency, interpretability, traceability, and accountability—widely endorsed in policy documents [8]—into specific regulatory mechanisms. For example, transparency is operationalized through mandatory disclosure of (i) the purpose and scope of the rating, (ii) the definitions of E, S, and G factors, (iii) the materiality perspective (financial vs. impact), (iv) indicator weights and calculation logic, (v) data sources and the proportion of estimated data, and (vi) methodological limitations. Traceability is operationalized through requirements to maintain data-version records, model-version records, and historical rating files, enabling regulators and market participants to verify whether the disclosed methodology was actually applied. Accountability is operationalized through complaint-handling procedures that allow rated entities to challenge factual errors while preserving rating independence, and through supervisory mechanisms that distinguish procedural compliance from substantive rating accuracy.

2. Legal Framework and Analytical Methodology for ESG Ratings Regulation

2.1. The EU ESG Rating Regulation: Scope and Structure

Regulation (EU) 2024/3005 establishes a comprehensive framework for the authorization and supervision of ESG rating activities in the European Union. The Regulation defines an “ESG rating” as an opinion or score regarding an entity’s, financial instrument’s, or financial product’s ESG profile, characteristics, or exposure to ESG risks, based on an established methodology and defined ranking system of rating categories, provided to third parties on a commercial basis (Article 3(1), [21]).

A critical definitional issue concerns the concept of materiality. The EU’s sustainable finance framework, particularly under the Corporate Sustainability Reporting Directive (CSRD) and European Sustainability Reporting Standards (ESRS), adopts a “double materiality” perspective: companies must disclose information that is material either because it affects the company’s financial performance (financial materiality or “outside-in”) or because the company’s activities have significant impacts on people or the environment (impact materiality or “inside-out”) [24]. ESG rating agencies may assess financial materiality (the effect of ESG factors on enterprise value), impact materiality (the effect of business activities on sustainability), or both. However, ratings often do not clearly specify which materiality perspective they adopt, contributing to user confusion and rating divergence. Different materiality perspectives can reasonably lead to different rating outcomes for the same company: a firm with strong environmental management systems (low financial risk) may simultaneously have high negative environmental impacts (low impact performance). The EU Regulation requires rating agencies to disclose the “objective and main contents” of ratings (Article 12, [21]), but does not explicitly mandate disclosure of the materiality perspective. This paper argues that clarifying the materiality perspective—whether the rating assesses financial risks, sustainability impacts, or both—should be a core element of methodological transparency.

The Regulation distinguishes ESG ratings from other activities. Excluded from the regulatory scope are: (i) services that provide raw ESG data without evaluation or aggregation into ratings; (ii) ESG research or analysis provided on an ad hoc or non-commercial basis; (iii) general ESG advisory services; (iv) internal ESG assessments not provided to third parties; and (v) credit ratings subject to the Credit Rating Agencies Regulation (Article 2(2), [21]). This functional approach seeks to capture activities that materially influence investment decisions while avoiding over-regulation of general information services.

ESG rating providers must obtain authorization from the European Securities and Markets Authority (ESMA) and comply with ongoing obligations concerning organizational requirements, conflicts of interest, transparency, data quality, methodology disclosure, and complaint handling. ESMA is responsible for authorization, supervision, and enforcement, with power to conduct inspections, impose fines, and withdraw authorizations for serious breaches (Articles 22–30, [21]).

2.2. Reflexive Law Theory and Process-Based Regulation

This paper employs reflexive law theory and the principle of proportionality as analytical frameworks for evaluating ESG rating regulation. Reflexive law, developed by Gunther Teubner and other legal theorists, responds to the limitations of traditional command-and-control regulation in complex, knowledge-intensive domains [22]. Where substantive outcomes depend on specialized expertise, evolving knowledge, and normative judgments that

vary across contexts, direct regulatory prescription of “correct” outcomes may be ineffective or counterproductive. Reflexive law instead focuses on regulating the processes through which decisions are made: requiring transparent procedures, disclosure of decision-making criteria, conflict-management mechanisms, and opportunities for affected parties to challenge decisions. The goal is to structure the organizational environment in which private actors operate, ensuring that their decision-making processes are rational, accountable, and open to scrutiny, while leaving substantive outcomes to professional judgment and market competition.

Reflexive law offers a powerful lens for understanding regulation in complex fields like this one. Rather than requiring the law to dictate a single substantively correct outcome, it works through organizational design, procedural rules, disclosure duties, reasoned explanation, internal oversight, and correction channels. These mechanisms make the judgments of professional actors visible, reviewable, and revisable. The consequence is a redirection of legal attention: away from prescribing outcomes and toward shaping the institutional environment in which decisions are made.

However, reflexive law has well-documented limitations, particularly relevant to ESG rating regulation. First, process-based regulation risks formalism: regulated entities may comply with procedural requirements while undermining the substantive objectives those procedures are meant to serve. Second, procedural complexity can create barriers to entry, entrenching market concentration by favoring large incumbents with resources to manage compliance costs. Third, reflexive regulation is vulnerable to regulatory capture: powerful market participants may shape procedural rules to their advantage or exploit procedural autonomy to avoid meaningful accountability. Fourth, the boundary between procedural oversight and substantive intervention is often ambiguous in practice: when may a supervisor challenge a rating agency’s methodology as procedurally deficient versus substantively incorrect?

This paper argues that these limitations can be mitigated through a hybrid approach combining process-based regulation with targeted *ex post* accountability. Regulators should not approve or disapprove specific methodologies *ex ante*, but they may intervene where: (i) a rating agency fails to apply its disclosed methodology consistently, (ii) the methodology is so deficient that it cannot reasonably produce meaningful assessments (e.g., a climate rating that ignores carbon emissions), (iii) the agency knowingly relies on materially false data, or (iv) conflicts of interest demonstrably distort rating outcomes. This approach preserves methodological pluralism while addressing the risk that procedural compliance becomes a shield for substantively defective practices.

Applied to ESG ratings, reflexive law suggests that regulation should focus on the transparency and integrity of the rating process rather than mandating a single “correct” methodology. Rating agencies differ in their assessment objectives (financial risk vs. sustainability impact), materiality frameworks, indicator selection, data sources, and weighting schemes. These differences reflect legitimate professional judgments and diverse user needs. Regulation should ensure that rating agencies clearly disclose their objectives, methodologies, data sources, and limitations; manage conflicts of interest; and maintain processes for correcting errors and handling complaints. It should not dictate which ESG factors to measure, how to weight them, or what rating outcomes to produce.

The principle of proportionality suggests that regulatory measures should be suitable for achieving their objectives, necessary in the absence of less restrictive alternatives, and proportionate in the narrow sense, so that benefits outweigh costs [9]. In ESG rating regulation, proportionality demands that supervisory intensity be calibrated to the risks posed by different types of rating activities and providers. Large agencies whose ratings influence trillions of dollars in investment flows and are embedded in financial product marketing may warrant comprehensive authorization, ongoing supervision, and stringent conflict-of-interest rules. Smaller providers with limited market footprint and narrower user bases may be subject to lighter registration requirements and periodic disclosure obligations. Proportionality also requires that transparency obligations be balanced against the protection of proprietary methodologies: agencies should disclose enough information for users to understand what a rating measures and how it is constructed, but need not reveal every algorithmic detail or database structure.

Together, these frameworks support a regulatory approach that emphasizes process over outcomes, transparency over standardization, and calibrated intensity over uniform rules.

2.3. Comparative Methodology

This paper employs a dual methodological approach combining doctrinal analysis and functional comparison. The doctrinal method involves systematic examination of legal texts, regulatory guidance, and official commentary to identify the structure, logic, and application of legal rules. In this study, doctrinal analysis is applied to three primary sources:

First, the EU ESG Rating Regulation (EU 2024/3005), including its recitals, articles, and related EU legislation (the Sustainable Finance Disclosure Regulation, Corporate Sustainability Reporting Directive, and European Sustainability Reporting Standards). The analysis identifies: (i) the functional definition of ESG rating

activities and the regulatory boundary with adjacent services; (ii) the substantive obligations imposed on rating providers concerning authorization, organizational requirements, conflicts of interest, methodology disclosure, data governance, and complaint handling; (iii) the allocation of supervisory authority to ESMA and the mechanisms for enforcement; and (iv) the liability framework, distinguishing administrative sanctions from civil liability.

Second, Japan's Code of Conduct for ESG Evaluation and Data Providers (December 2022), published by the Financial Services Agency following recommendations from the Expert Panel on Sustainable Finance and the Technical Committee for ESG Evaluation and Data Providers. The Code is structured around five principles: (1) ensuring quality and integrity of ESG evaluations and data, (2) managing conflicts of interest, (3) ensuring transparency of ESG evaluation and data provision activities, (4) ensuring confidentiality of information and data security, and (5) human resources and organizational structure. Each principle is accompanied by guidelines specifying expected conduct. The analysis examines how these principles translate into operational expectations, the degree of specificity in the guidelines, and the enforcement mechanisms (industry self-regulation vs. supervisory oversight).

Third, IOSCO's "Environmental, Social and Governance (ESG) Ratings and Data Products Providers: Final Report" (November 2021), which sets out six recommendations addressed to: (i) ESG ratings and data product providers (transparency, data quality governance, conflicts management, internal governance), (ii) users of ESG ratings and data products (due diligence, understanding limitations), and (iii) securities regulators (monitoring market developments, promoting transparency, facilitating cooperation). As international soft law, IOSCO's recommendations are not directly binding but provide a common reference point for national regulatory frameworks.

The doctrinal analysis identifies common themes—functional definitions, transparency requirements, conflict management, data governance, proportionality—and divergences in regulatory intensity, enforcement mechanisms, and the balance between prescriptive rules and principles-based guidance.

This Article compares how different legal systems address common regulatory problems, rather than focusing solely on formal legal categories. The method proceeds in four steps:

First, problem identification: what market failures or governance challenges justify regulatory intervention? Section 3 identifies three problems in ESG ratings markets: information asymmetry (rating opacity, data deficiencies), conflicts of interest (incentive misalignment), and market concentration (barriers to entry, reduced competition).

Second, functional equivalence: how do different jurisdictions address these problems? The EU employs a hard-law authorization regime with detailed substantive requirements and centralized supervision by ESMA. Japan relies on a principles-based code of conduct with industry self-regulation and FSA oversight. IOSCO provides soft-law recommendations promoting convergence without imposing binding obligations. These are functionally equivalent responses to similar problems, differing in legal form, enforcement intensity, and institutional design.

Third, comparative evaluation: what are the relative strengths and weaknesses of each approach? The comparison uses four dimensions: (i) regulatory clarity (how clearly are obligations defined?), (ii) enforcement credibility (what mechanisms ensure compliance?), (iii) adaptability (can the framework accommodate market evolution and methodological innovation?), and (iv) proportionality (is regulatory intensity calibrated to risk?). The EU framework scores high on clarity and enforcement credibility but may face challenges in adaptability and proportionality (high compliance costs). Japan's code scores high on adaptability and proportionality but lower on enforcement credibility (no sanctions for non-compliance). IOSCO's principles provide flexibility and promote international coordination but lack enforcement mechanisms.

Fourth, institutional synthesis: what lessons can inform the design of a more coordinated global framework? The comparison suggests that effective regulation requires: (i) functional definitions that capture activities with material market influence regardless of labeling, (ii) process-based oversight that assesses organizational capacity and procedural integrity without dictating methodological outcomes, (iii) calibrated intensity that distinguishes large, systemically important providers from smaller, specialized firms, (iv) transparency requirements that balance disclosure with protection of proprietary methods, and (v) mechanisms for cross-border supervisory cooperation.

Selection Criteria for Comparators. The choice of EU, Japan, and IOSCO reflects three considerations. First, regulatory model diversity: the EU represents a comprehensive hard-law approach with centralized supervision; Japan exemplifies a principles-based, code-of-conduct model with industry self-regulation; IOSCO embodies international soft law promoting convergence without legal bindingness. Second, market significance: the EU and Japan are major financial markets where ESG ratings play an important role in investment decision-making. Third, data accessibility: detailed regulatory texts, official guidance, and public commentary are available for all three sources. Other jurisdictions—including the UK (which completed public consultation on a mandatory authorisation regime in March 2026 but has not yet published final rules as of September 2026), the United States (no comprehensive ESG rating regulation, fragmented oversight under SEC disclosure rules), Hong Kong Special Administrative Region, China (where ICMA published a voluntary code of conduct for ESG ratings and data

products providers in October 2024, developed in collaboration with Hong Kong market participants and with SFC support), and Singapore (no dedicated framework for ESG ratings providers)—are noted in Section 5.1.3 but are not analyzed in depth. While the UK’s proposed regime is at an advanced stage of development with detailed proposals published, Hong Kong Special Administrative Region, China has adopted an international-standard voluntary code facilitated by ICMA, and other jurisdictions have either adopted fragmented approaches (United States) or have not yet established specific measures (Singapore).

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This methodology has two main limitations. First, the analysis is based on regulatory texts and official documents; it does not include empirical assessment of regulatory effectiveness or market outcomes, which would require data on rating quality, market structure, and compliance costs that are not yet available (the EU Regulation enters into force in stages through 2026–2027). Second, the comparison is limited to three sources; a more comprehensive global survey would include additional jurisdictions, but would sacrifice analytical depth for breadth. These limitations are acceptable given the paper’s objectives: to establish the conceptual foundations and institutional design principles for ESG rating regulation, not to evaluate empirical outcomes.

3. Legal Justification for ESG Rating Regulation and the Objective of Sustainable Development

3.1. The Composite Legitimacy Framework

ESG rating regulation is justified by a composite legitimacy framework comprising three dimensions: investor protection, market integrity, and the governance of environmental and social externalities.

Investor Protection. ESG ratings are used by institutional investors to construct portfolios, allocate capital, and manage risks. When ratings are opaque, inconsistent, or distorted by conflicts of interest, investors may make decisions based on misleading information, resulting in suboptimal portfolio performance or exposure to undisclosed risks [25–27]. Information asymmetry between rating agencies and investors is structural: agencies possess detailed knowledge of their methodologies, data sources, and quality-control processes, while investors typically observe only the final rating score or category [9]. This asymmetry creates opportunities for opportunistic behavior, including overstatement of rating precision, concealment of data limitations, or prioritization of commercial relationships over rating independence [6,28].

Investor protection regulation addresses this asymmetry through mandatory disclosure of rating objectives, methodologies, data sources, and limitations. The objective is not to eliminate rating divergence—which may reflect legitimate methodological differences—but to ensure that investors can assess what a rating measures, how

it is constructed, and what uncertainties or limitations it carries. Disclosure enables investors to evaluate whether a rating is fit for their purposes and to compare ratings across agencies on a like-for-like basis.

Market Integrity. ESG ratings influence not only individual investment decisions but also the structure and functioning of capital markets. Ratings are embedded in the construction of ESG indices, the classification of sustainable investment products, and the assessment of portfolio alignment with climate targets or sustainability objectives [29,30]. When ratings lack transparency or are subject to conflicts of interest, market integrity is undermined: products marketed as “sustainable” may not reflect genuine ESG performance, index construction may favor companies with strong ESG marketing rather than substantive performance, and regulatory frameworks relying on third-party assessments (e.g., green bond standards) may be vulnerable to manipulation [31–33].

Market integrity regulation establishes minimum standards for rating independence, methodological rigor, and operational transparency. It seeks to ensure that ESG ratings serve as reliable information signals rather than marketing instruments, and that rating agencies are accountable for the quality of their assessments.

The Governance of Environmental and Social Externalities. The third dimension of regulatory legitimacy concerns the role of ESG ratings in the governance of environmental and social externalities. This dimension is indirect but necessary to understand the full justification for ESG rating regulation.

Environmental and social externalities arise when the costs or benefits of corporate activities are not fully borne by the firm or reflected in market prices. Examples include greenhouse gas emissions (climate externality), water pollution (ecological externality), labor rights violations (social externality), and corruption (governance externality) [12,24]. Traditional regulatory instruments for addressing externalities include Pigouvian taxes, cap-and-trade systems, command-and-control standards, and liability rules. ESG ratings are not direct instruments of this kind: they do not impose taxes, set emissions caps, or mandate specific corporate conduct.

However, ESG ratings can serve as an indirect governance mechanism by transmitting information about corporate externalities into financial decision-making. The transmission operates through three channels:

First, the cost-of-capital channel: when ESG ratings identify firms with poor environmental or social performance, investors may demand higher returns to compensate for associated risks (regulatory risk, reputational risk, litigation risk, or physical climate risk), increasing the firm’s cost of equity or debt capital [12–29]. This creates a financial incentive for firms to improve ESG performance in order to access cheaper capital.

Second, the exclusion channel: institutional investors subject to ESG mandates, fiduciary duties incorporating sustainability considerations, or product classifications (e.g., EU Sustainable Finance Disclosure Regulation Article 8 or 9 products) may exclude firms with low ESG ratings from their investment universe [26,34]. This reduces demand for the firm’s securities, potentially lowering valuations and increasing capital costs.

Third, the engagement channel: ESG ratings are widely used by institutional investors to identify targets for shareholder engagement on sustainability issues [25,35]. Investors may use poor ratings as a basis for dialogue with management, proxy voting on ESG resolutions, or collective engagement initiatives such as Climate Action 100+ [20].

These transmission channels depend critically on the quality, transparency, and reliability of ESG ratings. If ratings are opaque, users cannot assess whether a low rating reflects genuine environmental harm or merely differences in disclosure practices. If ratings are distorted by conflicts of interest, they may systematically favor firms that purchase consulting services from the rating agency, undermining the linkage between ESG performance and financial consequences. If data quality is poor—with extensive use of undisclosed estimates or outdated information—ratings may fail to capture material sustainability risks, enabling firms with significant negative externalities to obtain favorable assessments (greenwashing) [31,33].

Thus, while ESG rating regulation does not directly mandate reductions in carbon emissions, improvements in labor conditions, or changes in corporate governance, it supports the effectiveness of market-based mechanisms for internalizing externalities. By ensuring that ESG ratings are transparent, methodologically sound, and free from distorting conflicts, regulation enhances the capacity of capital markets to reward sustainable corporate behavior and penalize harmful externalities. This constitutes an indirect but important dimension of regulatory legitimacy, complementing the direct objectives of investor protection and market integrity.

It is important to clarify the boundaries of this regulatory justification. ESG rating regulation cannot and should not impose specific sustainability outcomes on rated companies. Regulators may not instruct rating agencies to downgrade firms based on carbon intensity, labor practices, or governance structures, as this would transform ratings from independent assessments into policy instruments and undermine rating credibility. The role of regulation is to ensure that the rating process is transparent, data-driven, and procedurally sound, such that ratings can serve as reliable inputs to investment decisions, which in turn influence corporate incentives. The governance of externalities operates through market mechanisms, not regulatory fiat.

3.2. Rating Divergence

A central challenge in ESG rating regulation is distinguishing legitimate methodological pluralism from problematic rating divergence. ESG ratings exhibit far greater divergence than credit ratings: the average pairwise correlation among major ESG rating agencies is approximately 0.50, compared to over 0.92 for credit ratings [6,23,28]. This divergence has been decomposed into three sources: (i) differences in scope (which ESG issues are measured), (ii) differences in measurement (how issues are assessed), and (iii) differences in weighting (how issues are aggregated into an overall score) [23].

Methodological pluralism is both inevitable and desirable in ESG rating markets. It is inevitable because there is no universally agreed definition of “ESG performance”, no standardized measurement framework comparable to financial accounting standards, and no single correct weighting of environmental, social, and governance factors [36,37]. Different rating agencies serve different user needs: some focus on financial materiality (ESG factors that affect enterprise value), others on impact materiality (corporate impacts on society and the environment), and still others on norms-based assessments (compliance with international standards such as the UN Global Compact) [24,38,39]. These differences reflect legitimate professional judgments.

Methodological pluralism is also desirable because it promotes competition, innovation, and adaptation to evolving sustainability challenges. If regulation mandates a single methodology, it risks entrenching outdated approaches, stifling methodological innovation, and reducing the diversity of perspectives available to investors. Investors with different objectives—some seeking to minimize climate risk, others to maximize positive social impact, still others to avoid exposure to governance failures—benefit from access to ratings that reflect these varied priorities.

However, not all rating divergence is benign. Three categories of divergence can be distinguished:

Category 1: Transparent Methodological Differences. This represents legitimate pluralism. Two agencies may rate the same company differently because they have different objectives (financial risk vs. sustainability impact), different materiality judgments (whether a given issue is financially material in a specific industry), or different normative weightings (whether environmental performance is more important than social performance). Provided that each agency clearly discloses its objective, materiality framework, indicator selection, data sources, and weighting scheme, divergence of this kind is not a regulatory problem. Investors can select the rating that best matches their purposes and understand why ratings differ.

Category 2: Opacity-Driven Divergence. This arises when rating agencies do not disclose sufficient information for users to understand what a rating measures or how it is constructed. Examples include: (i) failure to specify whether the rating assesses financial materiality, impact materiality, or both; (ii) use of proprietary “black-box” algorithms without explanation of key variables or decision rules; (iii) inconsistent application of disclosed methodologies across rated entities; (iv) failure to disclose the proportion of data that is estimated, modeled, or imputed rather than directly reported by companies; or (v) lack of clarity about the time period covered by the rating or the frequency of updates. Opacity prevents investors from assessing rating fitness-for-purpose and from comparing ratings on a like-for-like basis. This type of divergence justifies regulatory intervention to mandate disclosure of rating objectives, methodologies, data sources, and limitations.

Category 3: Conflict-Driven or Quality-Deficient Divergence. This occurs when ratings are distorted by conflicts of interest or produced through methodologies so deficient that they cannot reasonably yield meaningful assessments. Examples include: (i) systematically higher ratings for companies that purchase consulting services from the rating agency; (ii) reliance on materially false or outdated data without disclosure; (iii) application of methodologies that ignore core indicators (e.g., a climate rating that does not consider greenhouse gas emissions); or (iv) frequent, unexplained rating reversals unrelated to changes in corporate performance or public information. This type of divergence reflects market failure—rating agencies failing to perform their information intermediation function—and justifies regulatory intervention through conflict-management rules, data-quality requirements, and supervisory oversight of methodological adequacy.

Regulatory policy should aim to eliminate Category 3 divergence, reduce Category 2 divergence through transparency requirements, and preserve Category 1 divergence as a feature of a healthy, competitive market. The challenge lies in enforcement: distinguishing procedural deficiencies (failure to disclose, inconsistent application of stated methodology, unmanaged conflicts) from substantive disagreements (different professional judgments about materiality or indicator weights). Reflexive law theory suggests that regulators should prioritize procedural integrity, encompassing transparency and internal consistency, over the re-evaluation of substantive rating outcomes. Notwithstanding this deference, supervisory intervention is warranted when methodologies are sufficiently deficient to reduce procedural compliance to a mere formality.

3.3. The Limits of Harmonization

Given the inevitability and desirability of methodological pluralism, regulatory harmonization should prioritize process over outcomes. Attempts to mandate uniform rating methodologies, such as specifying which ESG factors to measure, how to weight them, or what rating scales to use, would require regulators to resolve contested normative and technical questions that are better left to professional judgment and market competition. Furthermore, such mandates would necessitate continuous updates as sustainability challenges evolve, including new climate science, emerging social issues, and changes in corporate disclosure practices. This creates a dynamic inconsistency problem where regulation lags behind market needs [36,40].

Instead, harmonization should establish a common procedural foundation. This begins with functional definitions of rating activities that capture services with material market influence regardless of labeling. It also includes authorization or registration requirements that assess organizational capacity and governance structures without approving specific methodologies. Essential to this foundation is the mandatory disclosure of rating objectives, materiality perspectives, methodologies, data sources, and limitations. Robust conflict-of-interest management rules are also critical, including restrictions on providing consulting services to rated entities and transparency about commercial relationships.

To ensure integrity and accountability, the framework must incorporate data governance requirements, such as version control, traceability, and documentation of estimates and models. It should also feature complaint-handling procedures that allow rated entities to challenge factual errors while preserving rating independence. Finally, supervisory mechanisms should monitor procedural compliance and investigate suspected conflicts or fraud without dictating substantive rating outcomes.

This procedural foundation preserves methodological diversity while ensuring that ratings are produced through transparent, accountable, and conflict-free processes. It allows jurisdictions to calibrate regulatory intensity to local market conditions. For instance, regulators can impose comprehensive authorization requirements on large agencies with systemic influence while subjecting smaller providers to lighter registration and disclosure obligations. This approach maintains a common baseline of transparency and integrity across the market.

4. Institutional Deconstruction of the EU Regulation

The EU ESG Rating Regulation represents the first comprehensive legislative framework for ESG ratings globally. Its structure reveals both the potential and the limitations of hard-law approaches to rating oversight. This section examines the Regulation's core components: functional scope definition, authorization and organizational requirements, conflict-of-interest management, and transparency obligations. It then addresses two critical gaps: the absence of explicit civil liability provisions and the need for clearer guidance on materiality disclosure, particularly the distinction between financial and impact materiality.

4.1. Functional Definition and Regulatory Scope

The Regulation adopts a functional approach to defining ESG rating activities, focusing on the economic substance of the service rather than formal labeling. Article 3(1) defines an ESG rating as “an opinion, a score or a combination of both, regarding an entity’s, a financial instrument’s or a financial product’s ESG profile, characteristics or exposure to ESG risks, or an entity’s impact on people or the environment” that is “based on an established methodology and defined ranking system of rating categories” and “provided to third parties, whether for free or for a fee” [21].

From a functional perspective, ESG ratings typically comprise three elements: an assessment or opinion on the ESG performance of companies, sovereign states, financial instruments, or financial products, based on a relatively stable methodology, and provided to third parties through commercial arrangements. This definition brings rating activities that genuinely influence financial decision-making within the scope of regulation while avoiding the inclusion of all ESG-related information services within the licensing framework.

The Regulation excludes several categories of services from its scope. Credit ratings subject to the Credit Rating Agencies Regulation remain under that framework, avoiding duplicative oversight even when credit ratings incorporate ESG factors (Article 2(2)(f), [21]). Services providing raw ESG data without evaluative aggregation, ad hoc research, internal assessments not disseminated externally, and general advisory services also fall outside the regulatory perimeter (Article 2(2), [21]). These boundaries prevent over-regulation of general information services while capturing activities that materially influence capital allocation.

The most significant exclusion concerns second-party opinions on green bonds and sustainability-linked instruments. These opinions assess whether a bond’s use of proceeds or an instrument’s sustainability targets comply with standards such as the EU Green Bond Standard or the International Capital Market Association’s Green Bond

Principles. While functionally similar to ratings, second-party opinions are currently excluded to avoid disrupting established market practices during the Regulation's initial implementation. However, Article 2(2)(g) subjects this exclusion to review, and ESMA must report on whether second-party opinions should be brought within the regulatory scope [21]. This staged approach reflects regulatory pragmatism: establishing the core framework first, then extending it to adjacent services once institutional capacity and market understanding develop.

4.2. Authorization, Organizational Requirements, and Supervision

The Regulation establishes a centralized authorization regime administered by ESMA. Providers may not offer ESG rating services without prior authorization, and unauthorized provision constitutes a criminal or administrative offense subject to penalties under national law (Articles 4, 29, [21]). Authorization requires demonstration of organizational capacity, governance structures, and resource adequacy rather than approval of specific rating methodologies. ESMA assesses whether the applicant has sufficient personnel with appropriate expertise, adequate IT systems and data management infrastructure, internal control mechanisms for quality assurance, and governance arrangements ensuring independence from undue commercial or political influence (Article 5, [21]).

This process-based authorization model differs fundamentally from product approval regimes. ESMA does not evaluate whether an applicant's methodology is "correct" or whether its ratings align with regulatory preferences. The assessment focuses on institutional capacity: Can this organization consistently apply the methodology it has disclosed? Does it have systems to manage conflicts of interest? Can it maintain data quality and respond to complaints? This approach implements the reflexive law principle that regulation should structure organizational environments without dictating substantive professional judgments.

Ongoing supervision follows the same logic. ESMA conducts periodic reviews of authorized providers, examining procedural compliance rather than rating accuracy. Supervisory inquiries may address whether an agency applies its disclosed methodology consistently across rated entities, whether conflicts of interest are identified and managed according to the agency's stated policies, whether data governance procedures are followed, and whether complaints receive appropriate investigation (Articles 22–24, [21]). ESMA may not, however, instruct an agency to change a specific rating or adopt a particular methodological approach, except where the methodology is so deficient that it cannot plausibly produce meaningful assessments or where procedural violations are so severe that authorization should be suspended or withdrawn.

Authorized providers must establish internal governance structures separating rating functions from commercial and marketing activities, appoint compliance officers responsible for monitoring adherence to regulatory requirements, implement quality control procedures including periodic methodology reviews, maintain audit trails documenting rating production processes, and establish complaint-handling mechanisms accessible to rated entities and rating users (Articles 6–8, [21]). These requirements operationalize organizational independence and procedural accountability without prescribing substantive rating approaches.

4.3. Conflicts of Interest and Independence

Conflict-of-interest management constitutes the Regulation's most interventionist dimension, reflecting lessons from credit rating agency failures during the 2008 financial crisis. The core principle is structural separation: activities that create incentives to distort ratings must be either prohibited or subject to stringent safeguards.

The Regulation prohibits ESG rating providers from offering consulting or advisory services to entities they rate (Article 9(1), [21]). This prohibition addresses the most direct conflict: an agency might be tempted to award favorable ratings to companies that purchase consulting services, or companies might purchase consulting services with the expectation of improved ratings. The prohibition applies not only to direct consultancy but also to any service that could reasonably be perceived as influencing the rated entity's ESG performance or disclosure practices. Limited exceptions exist for technical assistance on data provision—helping a company understand what information the agency requires—but such assistance must be clearly distinguished from consulting on ESG strategy or performance improvement (Article 9(2), [21]).

Additional conflict-management rules address ownership structures, employee incentives, and fee arrangements. An ESG rating provider may not be owned or controlled by a rated entity, and rated entities may not hold significant stakes in rating providers (Article 9(3), [21]). Employees involved in rating production may not receive compensation directly linked to the commercial success of ratings or the revenue generated from specific rated entities (Article 9(4), [21]). Fee structures must be transparent and may not create incentives for favorable ratings, such as higher fees for better scores (Article 9(5), [21]).

Where conflicts cannot be entirely eliminated—for example, when a provider's parent company has business relationships with rated entities—the Regulation requires disclosure of the conflict and implementation of

mitigation measures such as information barriers, separate reporting lines, and independent review of affected ratings (Article 10, [21]). The burden lies on the provider to demonstrate that identified conflicts do not compromise rating independence.

4.4. Transparency, Disclosure, and Methodological Accountability

Transparency obligations form the substantive core of the Regulation, operationalizing the principle that process-based regulation requires comprehensive disclosure to enable external scrutiny.

Article 12 mandates publication of detailed methodological documentation covering: (i) the objective and intended use of the rating (e.g., assessing climate risk for portfolio management, evaluating social impact for ethical investment funds); (ii) the scope of ESG factors considered and the rationale for inclusion or exclusion; (iii) definitions of key terms and concepts used in the methodology; (iv) data sources, including the proportion of company-reported data versus estimated or modeled data; (v) the analytical process through which data is transformed into ratings, including any algorithms, scoring models, or expert judgment procedures; (vi) the weighting or aggregation method used to combine individual indicators into overall scores; (vii) the rating scale and the criteria for assigning entities to rating categories; (viii) the frequency of rating updates and the circumstances triggering ad hoc reviews; and (ix) the limitations of the methodology, including uncertainties, data gaps, or factors not captured by the rating (Article 12, [21]).

A critical transparency gap concerns the concept of materiality. The EU's Corporate Sustainability Reporting Directive (CSRD), which came into force in January 2023 and applies to large companies and listed SMEs from fiscal year 2024 onward, mandates disclosure based on "double materiality" [24,41]. Under this principle, companies must report information that is material in either of two senses: financial materiality, where sustainability matters affect the company's financial position, performance, or cash flows (outside-in perspective); or impact materiality, where the company's activities have significant positive or negative impacts on people or the environment (inside-out perspective) (Article 19a; ESRS 1, Section 3.2, [24]). The European Sustainability Reporting Standards (ESRS), adopted by the European Commission in July 2023, operationalize double materiality through sector-agnostic standards (ESRS 1 and 2) and topic-specific standards covering climate change (E1), pollution (E2), water and marine resources (E3), biodiversity and ecosystems (E4), resource use and circular economy (E5), own workforce (S1), workers in the value chain (S2), affected communities (S3), consumers and end-users (S4), and business conduct (G1) [42].

Each ESRS standard specifies disclosure requirements organized by topics, sub-topics, and metrics [43]. For example, ESRS E1 (Climate Change) requires disclosure of: (i) transition plans for climate change mitigation, including GHG emission reduction targets and pathways; (ii) Scope 1, 2, and 3 greenhouse gas emissions in absolute terms and intensity metrics; (iii) energy consumption and mix; (iv) exposure to climate-related physical risks (acute and chronic) and transition risks (policy, technology, market, reputation); (v) anticipated financial effects of climate risks and opportunities; and (vi) internal carbon pricing mechanisms if used (ESRS E1, [42]). Similarly, ESRS S1 (Own Workforce) requires disclosure of workforce composition, working conditions, equal treatment and opportunities, collective bargaining coverage, work-life balance, health and safety metrics including injury and fatality rates, and training and skills development (ESRS S1, [42]).

The materiality principle operates at two levels. At the entity level, companies must conduct a materiality assessment to identify which sustainability matters are material—either financially or by impact—for their specific circumstances, considering industry, geography, business model, and stakeholder context [ESRS 1, Sections 3.3 and 3.4]. At the metric level, for each material topic, companies must disclose the metrics specified in the relevant ESRS standard, supplemented by entity-specific metrics if necessary to provide a complete picture [ESRS 1, Section 4.1].

ESG rating agencies that assess companies subject to CSRD face a methodological choice: do they evaluate financial materiality (how sustainability issues affect company value), impact materiality (how the company affects sustainability), or both? Different choices lead to potentially divergent ratings for the same company. A manufacturing firm with excellent environmental management systems reducing regulatory risk and operational costs (strong financial materiality performance) might simultaneously have significant absolute carbon emissions and water consumption creating negative environmental impacts (weak impact materiality performance). A rating focused on financial materiality would likely score this company favorably, while a rating focused on impact materiality might score it unfavorably.

The EU ESG Rating Regulation requires disclosure of rating "objective and main contents" (Article 12(1)(a), [21]), but does not explicitly mandate disclosure of the materiality perspective. This creates ambiguity: investors may assume a rating labeled "ESG rating" assesses both financial and impact materiality, when in fact the agency may focus exclusively on one or use an undisclosed weighting between the two. ESMA's technical standards should

clarify that methodological disclosure must specify: (i) whether the rating assesses financial materiality, impact materiality, or both; (ii) if both, how the two perspectives are weighted or integrated; (iii) which ESRS topic areas are covered (e.g., does the rating include all environmental standards E1-E5, or only climate and biodiversity?); and (iv) whether the rating relies on company disclosures made under CSRD/ESRS, and if so, how data gaps or materiality exclusions in company reports are handled.

Beyond disclosure requirements, a significant gap in the Regulation concerns civil liability. Article 29 establishes administrative sanctions for violations, including fines up to 5% of annual turnover for serious breaches such as unauthorized provision of rating services, failure to manage conflicts of interest, or deliberate provision of false or misleading information (Article 29(2), [21]). However, the Regulation does not create a private right of action for investors or rated entities harmed by deficient ratings. This contrasts with credit rating regulation in some jurisdictions, where investors may sue rating agencies for damages resulting from fraudulent or grossly negligent ratings [9].

The absence of civil liability reflects a deliberate policy choice balancing several concerns. On one hand, liability exposure could incentivize rating agencies to invest in data quality, methodological rigor, and conflict management, as agencies would internalize the costs of rating failures. It could also provide compensation to harmed parties and deter willful misconduct or gross negligence. On the other hand, excessive liability risk could have chilling effects: agencies might refuse to rate certain entities or sectors to avoid litigation exposure, reduce rating differentiation to minimize the chance of being proven “wrong”, or exit the market entirely if liability insurance becomes prohibitively expensive. Liability for professional judgment—where reasonable experts can disagree—is particularly problematic: how should courts determine whether a rating was “wrong” when no objective standard exists for correct ESG performance measurement?

A balanced approach would introduce limited civil liability confined to cases of fraud or gross negligence. Fraud includes knowingly relying on false data, deliberately misrepresenting methodologies, or intentionally favoring clients in exchange for commercial benefits. Gross negligence might include applying a methodology that egregiously deviates from disclosed procedures, ignoring readily available material information, or failing to implement basic conflict-management safeguards. Liability should not extend to good-faith professional judgments about materiality, indicator weights, or scoring criteria, even if such judgments later prove controversial or are contradicted by other agencies. Procedural safeguards could include requiring plaintiffs to demonstrate reliance on the rating, actual financial harm, and proximate causation; capping damages at reasonable levels; and providing safe harbors for agencies that comply with disclosure and conflict-management requirements. Such a framework would hold agencies accountable for serious misconduct without deterring legitimate rating activities or second-guessing professional judgment through hindsight litigation.

These gaps—materiality disclosure and civil liability—represent areas where the Regulation could be strengthened through implementing acts or future amendments. Clearer guidance on materiality disclosure would reduce investor confusion and enable more meaningful comparison across ratings. A carefully designed liability framework would enhance accountability without creating perverse incentives or chilling effects.

5. Comparative Analysis and Pathways for Global Coordination

5.1. Comparative Frameworks: Japan and IOSCO

5.1.1. Japan’s Code of Conduct

Japan’s Financial Services Agency published the Code of Conduct for ESG Evaluation and Data Providers in December 2022, following deliberations by the Expert Panel on Sustainable Finance and a Technical Committee involving global and domestic rating agencies [44]. The Code adopts a principles-based structure organized around five core principles, each accompanied by guidelines specifying expected conduct. Unlike the EU’s hard-law authorization regime, Japan’s approach relies on voluntary adoption combined with FSA monitoring and industry self-regulation.

Principle 1 addresses quality and integrity of ESG evaluations and data. The guidelines expect providers to establish and disclose methodologies, ensure consistency in methodology application, implement quality control processes, and maintain appropriate documentation. Providers should disclose the purpose and scope of evaluations, definitions of ESG factors, data sources and their reliability, analytical frameworks and rating criteria, limitations and uncertainties, and the frequency of updates (Principle 1, [44]). This principle parallels the EU’s transparency requirements but expresses them as expectations rather than binding obligations.

Principle 2 concerns conflicts of interest. Providers should identify potential conflicts arising from ownership structures, commercial relationships, or provision of ancillary services; establish policies and procedures to manage conflicts; and disclose material conflicts to users (Principle 2, [44]). The Code does not absolutely prohibit consulting services to rated entities—unlike the EU Regulation—but expects providers to implement safeguards

such as information barriers, separate personnel, and independent review when conflicts exist. This reflects Japan's preference for disclosure and management over categorical prohibition, allowing for greater flexibility but potentially reducing conflict-prevention effectiveness.

Principle 3 focuses on transparency. Beyond methodological disclosure, the Code expects providers to explain the basis for rating changes, provide channels for rated entities to communicate their views and correct factual errors, and clarify the distinction between quantitative data and qualitative judgments (Principle 3, [44]). The emphasis on dialogue with rated entities—without compromising rating independence—reflects Japanese corporate governance culture, which values consensus-building and stakeholder communication.

Principles 4 and 5 address information security and organizational capacity. Providers should protect confidential information obtained from rated entities, implement cybersecurity measures, ensure staff possess appropriate expertise and training, and establish governance structures supporting rating independence (Principles 4–5, [44]). These requirements resemble the EU's organizational standards but are articulated as aspirational guidelines rather than authorization criteria.

The enforcement model distinguishes Japan's approach from the EU's. The Code is voluntary: providers choose whether to adopt it and publicly disclose their adoption status. The FSA monitors adherence through dialogue with providers and market participants, publishes aggregated information on adoption rates and implementation practices, and may escalate to formal supervisory action if serious misconduct emerges. However, non-adoption or non-compliance does not trigger automatic sanctions. This voluntary, principles-based model reduces the need for prescriptive rules and leaves providers greater flexibility in explaining how they implement the Code, but may also reduce accountability if market discipline proves insufficient to incentivize compliance.

Japan's approach reflects broader characteristics of its financial regulatory philosophy: emphasis on self-regulation and industry responsibility, preference for principles over detailed rules, reliance on dialogue and persuasion rather than coercive enforcement, and attention to stakeholder relationships and consensus. These features align with domestic institutional culture but raise questions about effectiveness in a globalized market where rating agencies operate across multiple jurisdictions with varying regulatory expectations.

5.1.2. IOSCO Principles

IOSCO's November 2021 report on ESG ratings and data products establishes international soft-law standards addressing providers, users, and regulators [8]. As recommendations rather than binding rules, IOSCO's principles serve primarily as a coordination mechanism, promoting convergence around common objectives while leaving implementation modalities to national authorities.

For providers, IOSCO recommends transparency about methodologies, including objectives, scope, data sources, analytical processes, and limitations; governance structures ensuring independence from commercial pressures; conflict-of-interest identification, management, and disclosure; data quality controls including verification procedures and correction mechanisms; and adequate resources and expertise to produce reliable assessments (Recommendations 1–4, [8]). These recommendations substantially overlap with both the EU Regulation and Japan's Code, suggesting broad international consensus on core principles despite divergent enforcement approaches.

For users—primarily institutional investors and asset managers—IOSCO recommends conducting due diligence on rating methodologies before relying on ratings, understanding rating limitations and uncertainties, avoiding mechanical application of ratings without independent judgment, and using multiple rating sources to cross-check assessments (Recommendation 5, [8]). These user-focused recommendations acknowledge that even with improved provider transparency, ratings remain one input among many in investment decision-making and should not substitute for investor analysis.

For regulators, IOSCO recommends monitoring market developments and potential risks, promoting transparency through guidance or requirements, facilitating international cooperation and information exchange, and considering whether regulatory intervention is appropriate given market maturity and institutional capacity (Recommendation 6, [8]). This recommendation reflects IOSCO's coordinating role: it cannot impose binding rules on member jurisdictions but can encourage consistent approaches and provide forums for supervisory dialogue.

The practical impact of IOSCO's principles depends on national implementation. Jurisdictions with comprehensive ESG rating regulation—like the EU—can point to IOSCO principles as validation of their approach and as a basis for third-country equivalence assessments. Jurisdictions without dedicated regulation—like the United States—may reference IOSCO principles in guidance to market participants or as justification for future rulemaking. The principles also provide a common vocabulary for cross-border supervisory cooperation, enabling regulators to discuss rating oversight even when their domestic frameworks differ significantly.

5.1.3. Other Jurisdictions: Emerging Approaches

Beyond the EU and Japan, several major financial markets are developing or considering ESG rating oversight frameworks, though most remain at earlier stages of implementation.

The United Kingdom has established the legislative basis for bringing certain ESG ratings activities within the FCA's regulatory perimeter and is developing the detailed regulatory framework through CP25/34. In December 2025, the Financial Conduct Authority (FCA) published a detailed consultation paper (CP25/34) proposing a mandatory authorisation regime for both ESG ratings providers and ESG data products providers [36]. The consultation period closed on 31 March 2026, and the FCA indicated it expected to publish a policy statement and final rules in late 2026 [11]. As of September 2026, final rules have not yet been published, though the detailed proposals in CP25/34 provide a clear indication of the UK's regulatory approach.

The proposed framework establishes: (a) a regulatory perimeter capturing providers of ESG ratings and data products that are used by UK financial market participants for investment decision-making, risk management, or regulatory reporting; (b) a mandatory FCA authorisation process requiring providers to demonstrate adequate governance, systems and controls, and financial resources before commencing operations; (c) ongoing requirements for conflicts of interest management, including organisational measures, disclosure obligations, and policies to prevent commercial considerations from compromising rating integrity; (d) transparency requirements covering methodologies, data sources, key assumptions, limitations, and the proportion of estimated versus reported data; (e) mechanisms for stakeholder engagement, including procedures for rated entities to identify factual errors and request corrections; and (f) supervisory powers enabling the FCA to conduct inspections, require information, investigate misconduct, and impose sanctions including fines and authorisation withdrawal [11].

Critically, the FCA's proposed approach explicitly preserves methodological pluralism. The consultation paper states: "We do not intend to prescribe the specific methodologies that firms should use to produce ESG ratings or data products. We recognise that diversity of approaches can benefit users by providing different perspectives on ESG matters" [11]. This process-oriented regulatory philosophy aligns with the approach advocated in this Article: supervision focuses on ensuring transparency, managing conflicts of interest, and establishing accountability mechanisms, rather than standardising the substance of ESG assessments.

The UK's proposed regime closely resembles the EU's Regulation 2024/3005 in its structural architecture—both establish mandatory authorisation, ongoing supervision, and detailed requirements for governance, conflicts management, and transparency. However, the UK proposals indicate potential differences in certain areas, including proportionality provisions for smaller firms and the regulatory treatment of cross-border service provision [11]. The FCA explicitly built upon IOSCO's 2021 Recommendations and consulted extensively with industry participants, indicating a commitment to international regulatory convergence while tailoring requirements to UK market characteristics [11].

The United States has not adopted comprehensive ESG rating regulation. ESG rating agencies are not subject to SEC authorization or ongoing supervision comparable to credit rating agencies under the Credit Rating Agency Reform Act. However, fragmented regulation exists through several channels. First, investment advisers relying on ESG ratings in managing client assets owe fiduciary duties requiring reasonable due diligence on rating methodologies and data quality [45]. Second, ESG ratings used in marketing investment products are subject to general anti-fraud provisions prohibiting materially misleading statements [46]. Third, rating agencies providing ESG assessments alongside credit ratings may be subject to SEC oversight of their credit rating activities, creating indirect incentives for quality control [47]. Fourth, proxy advisory firms that incorporate ESG factors—such as ISS and Glass Lewis—face SEC regulation as proxy advisors, though this regime focuses on voting recommendations rather than ratings per se [48]. This fragmented landscape reflects longstanding U.S. regulatory philosophy favoring market discipline and disclosure over ex ante authorization, but also creates gaps where pure ESG rating providers operate without dedicated oversight.

Several U.S. policymakers and commentators have called for more comprehensive ESG rating regulation. Proposals include requiring ESG rating agencies to register with the SEC, subjecting them to standards for methodological disclosure and conflict management similar to credit rating agencies, mandating disclosure of data sources and the proportion of estimated versus reported data, and establishing complaint-handling procedures for rated companies [49,50]. However, political polarization around ESG investing—with some viewing it as essential for risk management and others criticizing it as politically motivated capital allocation—has impeded legislative progress. The SEC has focused on disclosure requirements for investment funds using ESG strategies rather than regulating rating providers directly [51].

In Asia-Pacific, regulatory approaches to ESG ratings providers vary significantly. Singapore has not established a dedicated regulatory framework for ESG ratings or data products providers as of September 2026.

The Monetary Authority of Singapore (MAS) has emphasized that financial institutions using ESG ratings should conduct appropriate due diligence, understand methodological limitations, and avoid over-reliance on third-party assessments [52]. This approach places primary responsibility on rating users rather than regulating providers themselves, consistent with Singapore's principles-based regulatory philosophy.

Hong Kong Special Administrative Region, China has adopted a distinctive model: an international-standard voluntary code facilitated by a global industry association. In October 2024, the International Capital Market Association (ICMA), in collaboration with a Voluntary Code of Conduct Working Group (VCWG) comprising Hong Kong market participants including major ESG ratings providers (MSCI, S&P Global, Moody's, Morningstar, Bloomberg), asset managers, and banks, published the Hong Kong Code of Conduct for ESG Ratings and Data Products Providers [53]. The Securities and Futures Commission (SFC) of Hong Kong Special Administrative Region, China participated as an observer in the VCWG and expressed support for the initiative [53], but the Code is not a regulatory instrument and adoption remains voluntary [53].

The Hong Kong Code establishes six principles addressing governance, quality assurance, conflicts of interest management, transparency, confidentiality, and stakeholder engagement [53]. Critically, the Code adopts a process-oriented approach that preserves methodological diversity. Principle 4 (Transparency) requires providers to disclose the "key elements, assumptions, and limitations" of their methodologies, but explicitly states that "transparency does not require Providers to disclose proprietary information or the detailed inner workings of their methodologies" [53]. This approach aligns with the regulatory philosophy advocated in this Article: supervision focuses on ensuring process integrity—transparency about what methodologies do and their limitations—rather than prescribing what methodologies should conclude or how ESG factors should be weighted.

The Hong Kong Code's substantive requirements closely parallel those in other jurisdictions' frameworks. Its governance and conflicts principles mirror requirements in the EU Regulation and UK proposals. Its transparency requirements—disclosure of methodologies' key elements, data sources, and the distinction between estimated and reported data—correspond to similar provisions in the EU, UK, and Japan frameworks [54]. Its stakeholder engagement principle, requiring mechanisms for rated entities to identify factual errors, parallels the EU's Article 12 and UK CP25/34's engagement proposals. This convergence demonstrates that voluntary codes, when developed through multi-stakeholder processes and aligned with international standards (IOSCO's 2021 Recommendations), can achieve substantive alignment with mandatory regimes on core regulatory objectives—governance, conflicts management, transparency—without requiring governmental enforcement.

However, the voluntary nature of the Hong Kong Code presents limitations. Unlike mandatory authorisation regimes (EU, UK), there is no regulatory mechanism to compel adoption, monitor compliance, or sanction non-adherence. The Code includes a self-attestation template (Annex 2) that providers may use to declare their adherence, but as of September 2026, neither ICMA nor the SFC has published information on how many providers have adopted the Code or whether any public register of adherents will be maintained [53,55]. The effectiveness of this model thus depends entirely on market discipline: whether investors and rated entities reward adherent providers and penalise or avoid non-adherent ones, and whether reputational incentives prove sufficient to ensure widespread adoption and meaningful compliance.

The SFC has also addressed ESG ratings indirectly through regulation of rating users. In June 2021, the SFC issued guidance requiring fund managers of ESG-related investment products to ensure that ESG claims are accurate, that fund strategies align with stated ESG objectives, and that ESG ratings or data are properly understood and contextualized [55]. This user-focused regulation creates demand-side incentives for ratings quality, complementing the supply-side incentives embedded in the voluntary Code.

China presents a distinctive case. ESG rating and evaluation services are provided by domestic agencies including SynTao Green Finance, China Securities Index Company, and Wind Information, as well as international agencies operating through partnerships or data licensing arrangements. Chinese financial regulators have issued guidance on green finance and sustainable investment emphasizing ESG integration by institutional investors, but have not established a comprehensive regulatory framework specifically for rating providers [56]. China's approach reflects its state-directed financial system: ESG ratings are viewed as tools supporting policy objectives such as carbon neutrality and common prosperity, rather than purely market-driven information services. Regulatory development is likely to align ESG rating standards with national sustainability goals, potentially creating tensions with international frameworks emphasizing methodological pluralism and rating independence.

5.2. Identified Deficiencies in the Current Global Landscape

The current fragmented regulatory landscape creates several systemic problems that undermine the effectiveness of ESG ratings as information intermediaries. First, divergent regulatory definitions create perimeter

uncertainty. An agency providing ESG assessments might constitute a regulated “ESG rating provider” in the EU but operate as an unregulated data vendor in the United States or a voluntary code participant in Japan. This definitional fragmentation enables regulatory arbitrage: agencies can structure their services to avoid the most stringent requirements, potentially by labeling ratings as “data” or “research” or by providing services through subsidiaries in less-regulated jurisdictions. Investors using such ratings may be unaware that providers face different oversight standards depending on domicile and service structure.

Second, inconsistent conflict-of-interest rules create competitive distortions. The EU prohibits rating providers from offering consulting services to rated entities, while Japan’s Code permits such services subject to disclosure and management. An agency prohibited from consulting in the EU might establish a Japanese subsidiary to offer those services, creating organizational complexity and potential leakage of rating-relevant information across corporate boundaries. Conversely, agencies operating solely in Japan face less stringent conflict restrictions than EU competitors, potentially gaining commercial advantages through integrated service offerings that EU providers cannot match. These asymmetries distort competition based on regulatory arbitrage rather than service quality.

Third, transparency standards vary in specificity and enforceability. The EU Regulation mandates detailed methodological disclosure enforceable through ESMA supervision and sanctions. IOSCO recommends transparency but leaves enforcement to national authorities. Japan’s Code expects transparency but relies on voluntary compliance without coercive mechanisms. An agency disclosing minimal methodological information might face enforcement action in the EU, remain compliant with IOSCO recommendations (which are not binding), and be considered non-compliant with Japan’s Code but suffer no formal consequences. This variability creates uncertainty for rating users attempting to assess whether disclosed information is adequate, and reduces accountability for providers operating primarily in jurisdictions with weaker enforcement.

Fourth, cross-border supervision faces institutional obstacles. Major rating agencies operate globally, producing ratings used simultaneously by investors in multiple jurisdictions. When methodological deficiencies or conflicts of interest emerge, which regulator has authority to investigate? If a rating produced by a U.S.-domiciled agency using data from European companies misleads Japanese investors, coordination among the SEC, ESMA, and FSA becomes necessary but lacks clear protocols. IOSCO facilitates information exchange through multilateral memoranda of understanding, but these primarily address securities fraud rather than rating oversight. The absence of dedicated supervisory cooperation mechanisms for ESG ratings creates gaps where multinational agencies exploit coordination failures to avoid effective oversight.

Finally, the lack of common standards for third-country equivalence impedes market access. The EU Regulation allows non-EU rating agencies to provide services in the Union if their home jurisdiction is deemed equivalent or if they establish an EU subsidiary. However, equivalence determinations require assessing whether third-country frameworks achieve “comparable outcomes” to the EU’s, a standard that is neither clearly defined nor consistently applied (Article 4(3), [21]). Agencies domiciled in Japan might argue that the Code of Conduct is equivalent because it addresses the same issues—transparency, conflicts, governance—even though its voluntary nature and lack of sanctions differ fundamentally from the EU’s mandatory regime. Without agreed criteria for equivalence, third-country access becomes uncertain, creating barriers to cross-border service provision and potentially fragmenting global ESG rating markets.

5.3. Institutional Benefits of Coordinated Reform

Coordinated global reform addressing these deficiencies could yield significant institutional benefits without requiring full harmonization of regulatory models. The objective is not to impose the EU’s authorization regime universally—such an approach would be neither feasible nor desirable given varying market structures and institutional capacities—but to establish a common procedural foundation ensuring minimum standards across jurisdictions [22].

A coordinated framework should include functionally equivalent definitions of rating activities capturing services with material market influence regardless of labeling, ensuring that providers cannot escape oversight through nominal recharacterization. Jurisdictions can calibrate regulatory intensity—comprehensive authorization for large systemically important providers, lighter registration for smaller specialists—while applying common baseline standards to all providers within the functional perimeter. This preserves regulatory flexibility while preventing race-to-the-bottom dynamics where agencies domicile in the least regulated jurisdiction.

Common minimum standards for conflict management should prohibit or mandate disclosure of the most problematic conflicts. A primary concern is the combined provision of ratings and consulting services to the same entity. While jurisdictions should be permitted to adopt stricter rules if domestic conditions warrant, a baseline prohibition or disclosure requirement is essential. Transparency requirements should converge around core elements. These include disclosure of the rating purpose and materiality perspective, definitions of ESG factors,

data sources and estimation methods, weighting and aggregation logic, and methodological limitations. Jurisdictions may require additional disclosures reflecting local priorities, but all should enforce minimum transparency as a condition of market access.

Supervisory cooperation mechanisms should enable cross-border information sharing, coordinated investigations of multinational providers, and mutual recognition arrangements facilitating market access. IOSCO provides an existing institutional platform for developing such mechanisms through its Committee on Sustainable Finance or through expansion of existing multilateral memoranda. Coordination need not require formal treaties or supranational authorities; enhanced information exchange and regular supervisory dialogue can significantly improve oversight effectiveness.

The benefits of such coordination extend to all market participants. Rating providers gain regulatory clarity and a level competitive playing field where service quality rather than regulatory arbitrage determines success. Investors benefit from greater confidence in rating reliability and improved ability to compare ratings across providers operating under comparable standards. Rated companies face more predictable expectations and reduced burden from duplicative compliance with inconsistent requirements. Regulators enhance oversight effectiveness through cooperation and avoid unilateral action that might disadvantage domestic market participants. Most fundamentally, coordinated reform supports the broader objectives of sustainable finance: improving capital allocation efficiency, enhancing transparency about corporate sustainability performance, and strengthening market-based mechanisms for internalizing environmental and social externalities [16].

6. Conclusions

The regulation of ESG rating agencies represents a critical juncture in the evolution of sustainable finance governance. As capital markets increasingly integrate environmental, social, and governance considerations into investment decision-making, the quality, transparency, and reliability of ESG ratings become matters of systemic importance. This paper has demonstrated that effective regulation requires navigating a complex terrain where investor protection, market integrity, and the governance of environmental and social externalities intersect.

The EU ESG Rating Regulation offers the most comprehensive legislative template to date, establishing an authorization regime administered by ESMA and imposing detailed requirements for organizational governance, conflict management, and methodological transparency. Its strength lies in regulatory clarity and enforcement credibility: providers face unambiguous obligations backed by supervisory powers and meaningful sanctions. However, the framework also reveals tensions inherent in regulating knowledge-intensive professional services. The Regulation wisely refrains from mandating specific rating methodologies, recognizing that methodological pluralism serves legitimate purposes and that substantive standardization would stifle innovation. Yet the boundary between permissible procedural oversight and impermissible substantive direction remains uncertain in practice, particularly where disclosed methodologies appear so deficient that they cannot plausibly produce meaningful assessments.

Two critical gaps warrant attention in future implementation. First, the Regulation should more explicitly require disclosure of materiality perspectives—whether ratings assess financial materiality, impact materiality, or both, and how they align with the double materiality framework embedded in the CSRD and ESRS. This disclosure is essential not only for investor understanding but also for the effective functioning of market-based mechanisms for internalizing externalities. When investors cannot determine what a rating measures, its capacity to transmit sustainability information into capital allocation decisions diminishes. Second, the absence of civil liability provisions limits accountability for serious misconduct. A carefully designed liability framework—confined to fraud or gross negligence, excluding good-faith professional judgments, and incorporating procedural safeguards—would strengthen deterrence without chilling legitimate rating activities.

Comparative analysis reveals that different jurisdictions pursue similar objectives through divergent institutional means. Japan's principles-based Code of Conduct emphasizes self-regulation, industry dialogue, and voluntary adoption, reflecting domestic regulatory culture but raising questions about enforcement effectiveness in the absence of mandatory compliance mechanisms. IOSCO's soft-law recommendations provide a coordination platform promoting convergence without imposing binding obligations, enabling jurisdictions to maintain regulatory autonomy while working toward common standards. The fragmented global landscape—with comprehensive hard law in the EU, voluntary codes in Japan, fragmented oversight in the United States, and monitoring-focused approaches in Asia-Pacific financial centers—creates perimeter uncertainty, enables regulatory arbitrage, and complicates cross-border supervision of multinational rating agencies.

Effective global coordination does not require uniform regulatory models. Jurisdictions differ in market structures, institutional capacities, legal traditions, and policy priorities; imposing a single approach would be neither feasible nor desirable [16,57,58]. Instead, coordination should establish a common procedural foundation

built on functionally equivalent definitions of rating activities, minimum standards for conflict management and transparency, calibrated regulatory intensity distinguishing large systemically important providers from smaller specialists, and supervisory cooperation mechanisms enabling information exchange and coordinated oversight of cross-border providers. This foundation preserves national flexibility while preventing race-to-the-bottom dynamics and ensuring that rating users worldwide can rely on minimum standards of transparency and integrity.

The analytical framework developed in this paper—combining reflexive law theory and proportionality principles—offers guidance for regulatory design that transcends ESG ratings. When regulating knowledge-intensive professional services where substantive outcomes depend on specialized expertise and evolving knowledge, process-based oversight focusing on transparency, conflict management, and procedural integrity proves more effective than prescriptive rules dictating outputs. Proportionality requires calibrating regulatory intensity to risks posed: comprehensive authorization and ongoing supervision for activities with systemic influence, lighter registration and disclosure obligations for smaller-scale services. These principles apply equally to credit rating agencies, audit firms, proxy advisors, and other information intermediaries whose independence and methodological soundness affect market functioning.

Looking forward, several issues warrant continued attention. First, as corporate sustainability disclosure improves—particularly in jurisdictions implementing mandatory reporting under frameworks like CSRD—rating agencies will face both opportunities and challenges. Richer data enables more granular assessments, but also increases methodological complexity and the risk that users misunderstand what ratings capture. Regulators should monitor whether improved disclosure translates into more reliable ratings or merely shifts the locus of uncertainty from data availability to analytical choices. Second, the interaction between ESG ratings and other elements of sustainable finance infrastructure—taxonomy regulations, disclosure regimes, fiduciary duty standards—requires holistic governance. Ratings influence how taxonomies are applied, how disclosure is interpreted, and how fiduciary duties are discharged; fragmented regulation of these interconnected elements creates gaps and inconsistencies. Third, the emergence of artificial intelligence and machine learning in ESG rating methodologies raises novel transparency challenges. Algorithmic models may identify patterns in vast datasets that human analysts would miss, but their opacity complicates disclosure: how can agencies explain methodologies that involve complex neural networks or ensemble models? Regulatory frameworks must balance the benefits of technological innovation against the imperative of user comprehension.

Finally, the normative foundations of ESG rating regulation deserve ongoing scrutiny. This paper has argued that regulation is justified by investor protection, market integrity, and the governance of externalities. However, the third dimension—externality governance—remains contested. Some view ESG ratings as purely financial tools assessing risks to shareholder value, making externality considerations irrelevant to regulatory design. Others see ratings as instruments for steering capital toward sustainable outcomes, implying that regulation should favor methodologies prioritizing impact materiality over financial materiality. This tension reflects deeper disagreements about the purpose of capital markets and corporate governance: are corporations primarily vehicles for maximizing shareholder wealth subject to legal constraints, or do they bear broader responsibilities to stakeholders and society? ESG rating regulation cannot resolve these fundamental debates, but its design inevitably reflects underlying assumptions. Transparency about these assumptions—in both regulatory frameworks and rating methodologies—is essential for democratic accountability and informed public discourse.

The regulation of ESG rating agencies stands at the intersection of financial regulation, environmental governance, and corporate accountability. The frameworks emerging in the EU, Japan, and through international bodies like IOSCO represent important first steps toward ensuring that ratings serve their intended function as reliable information intermediaries. Continued refinement, international coordination, and attention to implementation challenges will determine whether these frameworks succeed in fostering sustainable finance that genuinely allocates capital to support long-term environmental and social objectives while protecting investors and maintaining market integrity.

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Conflicts of Interest

The authors declare no conflict of interest.

Use of AI and AI-Assisted Technologies

During the preparation of this work, the authors used ChatGPT (OpenAI) to assist with the translation of parts of the manuscript and with academic language editing, and Qwen to assist with reading, organizing, and summarizing relevant literature. The authors reviewed and edited all AI-assisted outputs, verified the relevant information and citations, and take full responsibility for the content, originality, and integrity of the published article

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