

**MEMO# 35240**

April 14, 2023

# UK Government Consults on Regulatory Regime for ESG Ratings Providers

[35240]

April 13, 2023

TO: ICI Global Members

ESG Task Force

Global Regulated Funds Committee SUBJECTS: ESG

International/Global RE: UK Government Consults on Regulatory Regime for ESG Ratings Providers

On March 30, 2023, the HM Treasury released a consultation paper<sup>[1]</sup> seeking feedback on the initial scope of a potential regulatory regime for ESG ratings providers. The HM Treasury intends to bring ESG ratings providers into the regulatory perimeter, under the oversight of the Financial Conduct Authority (FCA), to improve transparency and promote good conduct in the ESG ratings market.

While the HM Treasury envisions that the regulatory regime will be developed based on the recommendations of the International Organization of Securities Commissions (IOSCO),<sup>[2]</sup> in contrast to the IOSCO recommendations, it proposes to cover only ESG ratings (e.g., where assessments of ESG factors are present) and exclude raw ESG data from the regulatory regime.

The consultation will close on June 30, 2023. If the HM Treasury decides to pursue regulation for ESG ratings providers, the FCA will set out detailed regulatory requirements for further consultation. ICI Global does not intend to submit comments on this consultation but will track the development and assess potential implications on global asset managers.

## **AUTHORIZATION REGIME FOR ESG RATINGS PROVIDERS**

An ESG ratings provider will be required to meet certain conditions and become authorized by the FCA<sup>[3]</sup> if it falls into scope of the regulatory regime.

The HM Treasury is considering two options to ensure a proportionate regulatory regime:

- (i) All ESG ratings providers will be subject to RAO authorization requirements, with further enhanced requirements for "larger" providers;
- (ii) Only ESG ratings providers of a certain size will be subject to RAO authorization

requirements. Unauthorized, smaller providers will be subject to some regulatory requirements through, for example, the forthcoming Designated Activities Regime, or may choose to be subject to the full RAO authorization requirements (i.e., an opt-in mechanism).

The HM Treasury also seeks views on the criteria for determining "small" and "large" ESG ratings providers.

## **SCOPE OF THE AUTHORIZATION REGIME**

An ESG ratings provider will fall into scope if it "directly provides an assessment of environmental, social, or governance factors to a user in the UK, where the assessment is used in relation to a specified investment in the RAO,[\[4\]](#) unless an exclusion applies".

*Assessment of ESG factors.* The HM Treasury proposes a deliberately broad definition of what would constitute an "assessment" of ESG factors. Any evaluation or value judgement of the characteristics of an entity or product as related to ESG matters would be included, regardless of whether the products are labeled as "ratings," "scores," or otherwise. The assessment could be directly produced by analysts or generated through algorithms. Thus, it is possible that a product considered on the market as "data" could be subject to the proposed regulatory regime.

Raw, or minimally processed[\[5\]](#) ESG data will be excluded as the HM Treasury recognizes these data are inherently more transparent than "ratings" which rely on assessment and evaluation. Estimates and proxy data, which aim to fill gaps in a data set, will also be excluded from the proposed regime as long as there is no separate assessment provided.

*Used in Relation to a Specified Investment.* The proposed regulatory regime will primarily capture the direct provision of ESG ratings to users in the UK, i.e., an ESG rating is provided to an institutional or retail UK user who has paid for that rating, either on its own or as part of another service or bundle of products. ESG ratings that UK users could access for free will be excluded. Nevertheless, the HM Treasury will evaluate whether and how indirect provision of ESG ratings, for example, ESG ratings provided by overseas providers become available to a UK user via intermediaries, would be included in the scope.

Further, only ESG ratings that are used in relation to RAO specified investments (e.g., shares, debt instruments, and units in collective investment schemes) will be covered in the proposed regulatory regime. This, in turn, will require ESG ratings providers to understand how their products are being used.

*Exclusions.* The HM Treasury sets out some potential exclusions from the regulatory regime.[\[6\]](#) Notably, ESG ratings created by an entity solely for its internal use, for instance, internal ratings created by asset managers, will be excluded. Yet, such exclusion will not be applicable to cases where the ESG ratings are created for both internal and external use (i.e., these ratings being sold as a standalone product or as part of a bundle of products).

*Potential Extraterritorial Effect.* Both UK and overseas firms will be captured if they directly provide ESG ratings to a user in the UK. The HM Treasury notes that the FCA would consider whether overseas firms need a UK presence in order to obtain authorization. It also indicates the possibility of recognizing equivalent overseas regimes in the future.

## **RELATED INITIATIVE: Voluntary UK Code of Conduct for ESG Ratings and Data Providers**

In parallel to the UK government efforts to develop a regulatory regime for ESG ratings

providers, the FCA is currently working with industry participants to develop a code of conduct for ESG ratings and data providers that could be put in place in advance of a regulatory regime.<sup>[7]</sup> The HM Treasury notes that providers who fall outside the scope of potential regulatory regime, e.g., providers of pure ESG data products, could adopt this voluntary code of conduct, which is expected to have some similarities with the potential regulatory regime. The FCA is expected to consult on the code of conduct in June 2023.

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## Notes

[1] See Future Regulatory Regime for Environmental, Social, and Governance (ESG) Ratings Providers Consultation ("Consultation Paper"), March 2023, available at <https://www.gov.uk/government/consultations/future-regulatory-regime-for-environmental-social-and-governance-esg-ratings-providers>.

[2] See FR09/21 Final Report Environmental, Social and Governance (ESG) Ratings and Data Products Providers, November 2021, available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf>; ICI Memorandum [33922], dated November 24, 2021, available at <https://www.ici.org/memo33922>.

[3] The HM Treasury proposes to amend the Financial Services and Markets Act 2000 (FSMA) (Regulated Activities) Order 2001 (RAO), requiring firms to become FCA authorized and to meet specified Threshold Conditions. Threshold Conditions are the minimum requirements set out in the FSMA that firms must meet to become and remain authorized.

[4] The HM Treasury has defined which activities are regulated activities by specifying them in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO), available at: <https://www.legislation.gov.uk/ukxi/2001/544/contents/made>.

[5] Examples include formatting or summarizing the ESG data, as long as there is no separate assessment provided.

[6] See Consultation Paper, *supra* note 1, at Chapter 3 Exclusions.

[7] See Terms of Reference - ESG Data and Ratings Code of Conduct Working Group (DRWG) - Development of a globally consistent voluntary Code of Conduct for ESG data and ratings providers that fosters an effective, trusted and transparent market. Available at <https://www.fca.org.uk/publication/documents/drwg-terms-of-reference.pdf>.