

First Steps Towards Regulating ESG Ratings Providers: HM Treasury Consults

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Environmental, Social and Governance (“**ESG**”) factors play an increasingly important role in financial markets, as industry participants integrate ESG into their activities, product offerings and investments. Consequently, firms and consumers increasingly rely on providers of data on such factors, including ESG ratings.

The provision of ESG ratings is not currently a regulated activity in the UK. Recognising the risks this may entail, His Majesty’s Treasury (“**HMT**”), on 30 March 2023, published a consultation (the “**Consultation**”)¹ proposing to bring ESG ratings providers within the scope of the UK’s financial services regulatory regime, with eventual regulation being potentially very broad in scope.

This alert memorandum sets out the key points of the Consultation and explores its wider implications.

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¹ The Consultation is accessible [here](#).



I. Context

A. United Kingdom

The first time the question of whether ESG ratings and ESG data providers should become subject to regulatory oversight was raised in the UK was in June 2021, as part of the FCA's consultation paper on climate-related disclosures and ESG in capital markets.²

In October 2021, HMT published its original Greening Finance Roadmap,³ where, amongst other things, it recognised the growing use of ESG ratings and data in the UK, and noted that the government would consider bringing these products into the regulatory perimeter.

In June 2022, the FCA published the feedback statement to its June 2021 consultation. The FCA noted that it saw “*a clear rationale for regulatory oversight of certain ESG data and rating providers – and for a globally consistent regulatory approach informed by the recommendations on ESG data and ratings developed by the International Organization of Securities Commission (IOSCO) in 2021*”, and expressed support for HMT's consideration of bringing ESG data and rating providers within our regulatory perimeter.⁴

On 22 November 2022, the FCA announced the formation of a working group to develop a voluntary code of conduct for ESG data and ratings providers (“**Code of Conduct**”).⁵ The intention underpinning the Code of Conduct initiative is to build trust in the market, protect market integrity and promote effective competition in a timely way (seeing that extending the regulatory perimeter, as

proposed in the Consultation, may involve potentially long lead times).

B. International Developments

In July 2021, the International Organization of Securities Commissions (“**IOSCO**”) published a consultation on ESG ratings and data products providers, with a view to understanding the implications of the increasingly important role of ESG ratings and data products for financial markets.⁶

This consultation was followed by a report (the “**IOSCO Recommendations**”), recommending, amongst other things, that regulators give greater attention to the use of ESG ratings and data products and the activities of ESG rating and data products providers in their jurisdictions.⁷

On 7 November 2022, IOSCO published a call for action to counter greenwashing by asset managers, and ESG rating and data providers. Addressed at voluntary standard setting bodies and financial industry associations, the call for action demands, amongst other things, improved reliability, comparability, and interpretability of ESG ratings and data products, so that investors have access to internationally consistent and comparable sustainability-related information.⁸

In the meantime, the EU has also started to take first steps with a view to regulating this industry. In February 2022, ESMA published a call for evidence on market characteristics for ESG rating providers in the EU.⁹ In April 2022, the EC published a consultation, seeking views on the functioning of the ESG ratings market and the need

² FCA, Consultation paper 21/18 “Enhancing climate-related disclosures by standard listed companies and seeking views on ESG topics in capital markets”, accessible [here](#).

³ The Greening Finance Roadmap is accessible [here](#).

⁴ FCA, Feedback Statement 22/4 “ESG integration in UK capital markets”, accessible [here](#).

⁵ Cleary Gottlieb published an article analysing the implications of such a voluntary code of conduct, accessible [here](#).

⁶ IOSCO's consultation on ESG ratings and data products providers (CR 02/21) is accessible [here](#).

⁷ IOSCO's final report on ESG ratings and data products providers (FR 09/21) is accessible [here](#).

⁸ IOSCO's call for action For financial markets voluntary standard setting bodies and industry associations is accessible [here](#).

⁹ ESMA's call for evidence is accessible [here](#). ESMA communicated the findings of the call for evidence to the European Commission in a letter in June 2022 (accessible [here](#)).

for regulatory intervention.¹⁰ The results of this consultation were published August 2022,¹¹ highlighting that almost all respondents considered intervention necessary, with the vast majority of respondents favouring legislative/regulatory intervention in the form of an authorisation/registration regime. Reflecting this feedback, the EC is now preparing an initiative, with a legislative proposal expected to be published later this year.

II. Scope

A large part of the Consultation sets out HMT's current thinking on the exact scope of regulation that would be introduced.

HMT proposes to create a new regulated activity that would, subject to certain exclusions, cover the "direct" provision by UK or overseas firms of any "assessment" of ESG factors in relation to a "specified investment" to be used by persons in the UK.

A. Key issues

Several aspects of this approach are worth highlighting:

- i. **"assessment"**: HMT intends to regulate not only products labelled "ratings", but also other assessments that involve evaluation or value judgment on the part of the provider (e.g., "scores" or "marks"). This may include both ESG assessments directly produced by analysts, as well as assessments generated through an algorithm. This breadth of scope would be intended to ensure that new products which may be developed in the future would fall within the regulatory scope.

- ii. Importantly, HMT does not currently contemplate regulating the provision of ESG *data* which involves no, or only minimal, processing, i.e., where no assessment or evolution is being provided. This would also mean that estimates and proxy data (such as those which aim to fill gaps in a data set) would be excluded from the regulatory scope. The reason for this is that unprocessed ESG data raises fewer concerns than assessments (for instance, ESG data is inherently more transparent and based on less complex methodologies), and to the extent concerns exist, these will likely be addressed through other initiatives.¹²
- iii. **"direct provision"**: HMT intends to capture situations where an ESG assessment is provided to a UK user who has paid for that rating, either on its own or as part of another service or bundle of products (i.e., assessments provided for free would be out-of-scope). It would appear that such arrangements with a single user would suffice.
- iv. **"by UK or overseas firms"**: HMT intends to capture the direct provision of ESG assessments to users in the UK, by *both UK firms and overseas firms*. This is both to ensure adequate protection for UK users and to ensure a level playing field/avoid firms' moving offshore to evade UK regulation, given that ESG assessments could easily be provided to UK users by a provider located outside the UK. HMT notes that, to the extent other jurisdictions introduce comparable regulation of ESG assessment providers with suitable cooperation mechanisms, HMT will

¹⁰ The EC's April 2022 targeted consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings is accessible [here](#).

¹¹ The EC's summary report on its targeted consultation on the functioning of the ESG ratings market in the EU and on the consideration of ESG factors in credit ratings is accessible [here](#).

¹² As examples of such initiatives, HMT refers to plans to introduce

sustainability-related corporate reporting standards aligned with the International Sustainability Standards Board; the Net-Zero Data Public Utility initiative, which would allow all stakeholders free access to key climate transition-related data; and the voluntary Code of Conduct for ESG rating and data providers is being developed by an industry working group.

consider expanding its regulatory deference framework to provide for the recognition of equivalent overseas regimes. However, where such “substituted compliance” is not available (because a particular overseas jurisdiction does not introduce equivalent legislation – either at all or where the scope or practical requirements are materially different from the UK regime), it remains to be seen how the cross-border provision of assessments will be accommodated. Should the extra-territorial net be cast too widely, there is a risk that UK users’ access to overseas products is significantly restricted (at least in principle, as there may be a risk that the requirements cannot practically be enforced extra-territorially).

- v. Interestingly, HMT does not propose to capture the provision of ESG ratings by any UK or overseas firm to users outside the UK.
- vi. **“in relation to a specified investment”**: HMT intends to capture the provision of ESG assessments when they are “used” in relation to investments that qualify as “specified investments” for the purposes of the Financial Services and Markets Act 2000 (“**FSMA**”) and the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (“**RAO**”), such as shares, debt instruments, or units in a collective investment scheme. HMT’s envisaged concept of “use”, however, is not clearly explored.
- vii. Pertinently, HMT asks ESG ratings providers whether they have the means of knowing when an ESG rating they provide will be used in relation to a specified investment. It envisages that providers may determine this through agreements such as contractual relationships such as licensing agreements (e.g., benchmark indices) or tailored services (e.g., metrics targeted at regulated disclosures).

B. Exclusions

HMT has emphasised that the scope of application of any potential regulation should be targeted and proportionate to the risks that ESG ratings pose. For that reason, HMT is considering excluding smaller firms as well as certain specific activities.

Regarding smaller providers of ESG assessments, HMT highlights that such firms might be disproportionately affected by regulation compared to larger ones, which could harm competition in the market. Accordingly, HMT is contemplating various options to ensure that the regulatory burden for smaller providers is proportionate, including the following:

- a. Bringing ESG assessment providers of all sizes into the regulatory perimeter (including authorization requirements), but subjecting larger providers to enhanced regulatory obligations;
- b. Imposing authorization requirements only on ESG assessment providers of a certain size (and potentially regulating smaller providers in other ways, e.g., through the designated activities regime under the Financial Services and Markets Bill or some other bespoke regime);
- c. Introducing an opt-in mechanism, enabling smaller providers to choose to become subject to the full range of regulatory requirements, thereby demonstrating to their clients that they are meeting the same standards (to avoid competitive disadvantages compared to larger, FCA-regulated providers).

HMT also requests views on how to distinguish between smaller providers and larger ones. This involves understanding the best criteria to measure size – that is, whether it is using one or more of the following: turnover, balance sheet total, number of employees, or another metric. It also involves understanding the appropriate level for these

criteria to be set.

HMT also contemplates that a number of specific activities should be excluded from the regulatory scope, namely the following:

- i. the provision of ESG assessments by not-for-profit entities (e.g., a UK registered charity or a registered not-for-profit entity in another jurisdiction);
- ii. ratings that are created by an entity solely for use by that entity (e.g., asset managers creating their own assessments to inform their investment decisions). HMT is also requesting feedback on whether firms producing ESG assessments to be used by other entities in their group (“intra- group ratings”) should be regulated.;
- iii. credit ratings which consider the impact of ESG factors on creditworthiness (because these products are already subject to requirements under the Credit Ratings Agencies Regulation);
- iv. investment research products, such as equity research reports;
- v. external reviews, including second-party opinions, verifications, and certifications of ESG-labelled bonds (which are more tailored to the provision of assurance-like activities in a non-audit capacity);
- vi. proxy advisor services, such as voting or recommendations to shareholders of firms;
- vii. consulting services, even where these relate to ESG matters (provided they are bespoke and ad hoc reviews; by contrast, where they systematically influence capital allocation, such as when a one-off ESG rating is provided

for the purpose of an Initial Public Offering, this should be subject to regulation);

- viii. academic research or journalism, even where that relates to ESG matters.

C. Potential future expansion of scope

HMT acknowledges that there are certain situations that would not be captured by the currently contemplated scope, but that might warrant regulation.

One example might be ‘indirect’ provision of ESG ratings to UK users, e.g., where an ESG ratings provider does not have a contractual agreement with a UK user, but its ESG ratings become available to UK users anyway (for example via intermediaries), or where a UK investor uses an ESG rating which has been paid for by a rated entity located overseas (i.e., when an ESG ratings provider uses an ‘issuer-pays’ model and that provider, or the rated firm who is the issuer, makes that rating available to UK investors). Another example might be where assessments are used in relation to certain things other than specified investments, such as some voluntary carbon credits.

HMT notes that such situations raise complex regulatory issues and is seeking stakeholder feedback on whether such scenarios should be regulated.

D. Coherence with existing regulations

HMT makes a few interesting observations in this regard:

- i. ESG ratings are sometimes compared to credit ratings, but they are multidimensional, unlike credit ratings which focus on only the creditworthiness of an entity or financial instrument.

- ii. HMT welcomes views from respondents on whether there are areas where new regulation on ESG ratings could overlap with the UK Benchmarks Regulation (or other regulations), and what the effects of this would be. It is particularly interested in the “practical challenges” posed by any such overlap.
 - iii. The Code of Conduct is expected to be in line with the IOSCO Recommendations, and as such may have some similarities with potential FCA regulation. Providers who fall outside the scope of potential regulation, such as providers of pure ESG data products, could adopt this Code of Conduct.
- (ii) **Good governance**, specifically in respect of management of conflicts of interest, internal consistency of methodology within a provider, and resources and personnel competencies;
 - (iii) **Management of conflicts of interest**, including identification, mitigation, management and disclosure of conflicts; and
 - (iv) **Robust systems and controls**, including written policies and procedures and/or internal controls on processes and methodologies, facilities for reporting of complaints and misconduct (incl. on independence, transparency and integrity), and engagement with rated entities.

III. Requirements

The way HMT intends to regulate ESG ratings providers is by bringing the provision of ESG ratings within the scope of the RAO and, as such, FSMA framework. This would require in-scope ratings providers to become FCA-authorized and to meet specified “threshold conditions”.

Specific, firm-facing requirements, would then be set by the FCA in their rules. These requirements are not the focus on the Consultation, but HMT anticipates that, to ensure consistency with international standards and other jurisdictions and avoid the risk of fragmentation, any requirements would be developed taking into account international developments, in particular the IOSCO Recommendations. These recommendations focus on the following key regulatory outcomes:

- (i) **Transparency**, specifically in respect of methodologies (including individual underlying components, measurement objective), data and information sources (including whether public), and procedures for data gaps and the use of averages and estimates;

Furthermore, HMT envisages that whether relevant firms would be required to have a physical presence in the UK in order to obtain authorisation would be left up to the FCA to determine – although this is expected to be informed by the FCA’s existing framework for international firms and based on the nature and scale of the firm’s activities, and the risks of harms the activities could cause. The detail of any such requirements would be subject to FCA consultation.

IV. Next steps

HMT has requested feedback on the Consultation by 30 June 2023. If the proposals are taken forward, further technical consultations will be issued by the FCA on specific firm rules. In the meantime, the working group convened by the FCA will continue with the development of the Code of Conduct, with HMT acting as an observer.

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