FRESHFIELDS

ESG ratings providers to be regulated in the UK

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This month the UK Chancellor of the Exchequer, Rachel Reeves, confirmed as part of her first Mansion House speech the UK Government's plans to move ahead with introducing legislation in early 2025 aimed at regulating ESG ratings providers by placing them under the supervision of the FCA. Draft legislation was published on the same day. The FCA, which supported the announcement of an industry-led voluntary code of conduct in 2023, has welcomed this latest development. The FCA will now develop a new regime to improve the reliability of ESG ratings by encouraging greater transparency and good governance by ratings providers in this space, which is in line with a global trend of enhancing regulatory oversight of ESG ratings providers given the increased prominence of their role in financial markets. In this blog post we consider the latest developments and their broader implications.

Background and lead up to new legislation

The 2021 IOSCO Recommendations

In November 2021, the IOSCO Task Force on Sustainable Finance published a **final report** on '*Environmental, Social and Governance (ESG) Ratings and Data Products Providers*', in which it recommended that regulators and policymakers focus on improving the reliability and transparency of ESG ratings products through increased oversight of ESG ratings providers, where needed, or by supporting the development of industry-led voluntary standards (the ***2021 IOSCO Recommendations***).

The 2023 Voluntary Code of Conduct

In 2022, the FCA appointed the International Capital Market Association (ICMA) and the International Regulatory Strategy Group (IRSG) to work with an industry group to develop a globally consistent voluntary code of conduct for ESG ratings and products providers.

Following a consultation period, the **Code of Conduct for ESG Ratings and Data Products Providers** (the ***Voluntary Code of Conduct*** or ***Code***) was launched in December 2023. The Code is grounded in the 2021 IOSCO Recommendations. It sets out six principles based on the 2021 IOSCO Recommendations and is structured around four key outcomes including good governance, systems and controls, management of conflicts of interest and transparency.

The FCA announced its support for the Voluntary Code of Conduct and encouraged all ESG ratings providers to engage with and sign up to it.

In the first half of 2023, the UK Government also **consulted** on whether to start regulating ESG ratings providers (the ***2023 Consultation***). This followed the launch of the UK Government's Green Finance Strategy, aimed at reinforcing its ambition for the UK to continue as a global leader in green finance.

The new UK policy

Following the Chancellor's announcement that the UK Government will be taking forward proposals to regulate ESG ratings providers, HM Treasury has published its **response** to the 2023 Consultation alongside **draft legislation** for comment.

The consultation response notes that there is '*strong support*' for the proposed regulation of ESG ratings providers, with a preference for the new regime to align with the 2021 IOSCO Recommendations.

The draft legislation is open for technical feedback until 14 January 2025.

In a statement, the FCA said it welcomed this development, which it noted is '*widely supported by industry*'.

Provision of ESG ratings becomes a new regulated activity

The proposed regime will involve an expansion of the current regulatory perimeter to capture the *provision* of ESG ratings as a new regulated activity. The term 'ESG rating provider' will capture an entity that produces and makes available ESG ratings. This includes firms providing standalone ESG ratings, as well as those providing ESG ratings as part of an existing regulated activity. The scope captures UK firms (providing ESG ratings to UK or non-UK users) and overseas firms (providing ESG ratings to UK users by way of a business relationship). Affected ESG ratings providers would need to become FCA authorised.

A 'regulated products and services' exclusion will exclude firms from needing to apply for separate permission where they create ESG ratings as part of the development and delivery of another regulated activity for which they are already authorised. However, FCA rules may include additional requirements for firms wishing to benefit from the exclusion. Further exclusions from the regime will also be available, including where ratings are provided for internal or intra-group use only.

The sole activity of *distribution* of an ESG rating will not be in scope of the regime, provided the rating is made available on its own without any manipulation or alteration of the original rating.

Narrowing the concept of an ESG rating

The definition of an ESG rating for the purposes of the regime has been narrowed from the 2023 Consultation and is defined in the proposals as '*an assessment regarding one or more ESG factors, produced in the form of an ESG opinion, an ESG score or a combination of both, whether or not it is characterised as an ESG rating*'.

Further definitions provide clarity around the concepts of an 'ESG opinion' and an 'ESG score'. Essentially, the idea is that products can be identified by the objective they serve, i.e. to make an assessment (evaluation or value-judgment) of the characteristics of an entity or product in relation to ESG matters.

The regime will capture ratings that are '*likely to influence a decision to make a specified investment*'. This would, for example, include a rating that is likely to be used to inform asset allocation and portfolio construction, as well as a pre-IPO rating, as it is reasonable to expect that these will be likely to influence a decision to make a specified investment.

Impact on overseas ESG ratings providers

As part of its consultation, the FCA will explore the approach to overseas ESG ratings providers. This will include whether overseas ESG ratings providers applying for UK authorisation would be expected to be incorporated in the UK, for example based on their size, significance or market impact in the UK.

As an alternative to full UK authorisation, the government is also exploring the creation of an overseas regime or other access routes into the UK market specifically aimed at overseas providers. This will include an assessment of whether the exclusion for regulated products and services could apply to overseas providers who benefit from existing market access arrangements, in particular in relation to credit ratings, benchmarks and overseas funds.

Next steps

The designing and commencement of the new regulatory regime in the UK is expected to take approximately four years. Once the legislation is introduced, which is expected to take place in early 2025, the FCA will consult with stakeholders, including a range of ESG ratings providers and users, and develop its regulatory regime. The FCA has also said it will continue to engage with other international authorities, including the EU, to support regulatory alignment. In the meantime, it continues to encourage both ESG data and ratings providers to sign up to the Code.

Once finalised, impacted firms will need to apply to the FCA for authorisation, with the new regulatory regime expected to go live at the end of a transition period.

Developments elsewhere

The UK Government is not the only policymaker focusing on increasing the regulatory supervision of ESG ratings providers. The European Council **announced** in November 2024 that it has adopted new legislation aimed at bringing ESG ratings providers under the supervision of the European Securities and Markets Authority (***ESMA***). Under the new rules, providers will need to be authorised and supervised by ESMA and comply with a number of governance requirements and transparency rules in relation to their methodology and sources of information.

What does this mean for the industry?

Obtaining varied ESG ratings from providers who are not transparent about the methodologies used to determine companies' ratings has the potential to: (a) create confusion for investors who rely on those ratings to inform them about investment decisions; (b) create difficulties for companies and financial institutions who rely on their ESG ratings to obtain investment; and (c) undermine overall trust in the market, particularly in circumstances where greenwashing and misleading product information has been on the rise, impacting investor confidence in ESG ratings.

The new regulatory regime aims to mitigate against these issues by improving the reliability of ESG ratings via encouraging increased disclosure and transparency about the methodologies used by ratings providers.

There is some concern, as noted in the responses to the 2023 Consultation, that the new regulatory regime will be overly burdensome, particularly for smaller ratings providers in the market. The FCA has indicated that the new regime will be '*proportionate*', which will include a consideration of the impact on large and small firms. The FCA will need to balance the need for an appropriate level of investor and market protection with a view to promoting continued innovation and competition in this space. However, the precise details of the regime remain to be seen and should be closely monitored by ratings providers and users who may be impacted.