HM Treasury

Future regulatory regime for Environmental, Social and Governance (ESG) ratings providers

Consultation Response

November 2024

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Foreword

Growth is the number one mission of this government. The government is proud that the UK is recognised as the leading global hub for sustainable finance, but we must ensure that the UK can continue to win the race for the global business that will drive the green transition and deliver economic growth in the UK. Our plans to bring ESG ratings providers into regulation are driven by our support for this growing sector and the role of the global ESG market in influencing billions of pounds worth of investment.

Now more than ever, businesses are being scrutinised by investors looking to align their investment strategies with their customer's values and assess both the risks and opportunities presented by the transition to a net zero, nature positive economy.

With the global ESG market predicted to surpass $40 trillion by 2030[1], investors and markets are making increasing use of ESG ratings to inform investment decisions and capital allocation. Bringing ESG ratings providers into regulation will boost investor confidence, reduce greenwashing, and address the lack of transparency highlighted in responses to the government's consultation. This will help to drive investment, support innovation and ensure that companies in critical sectors are not penalised by opaque ratings.

This consultation response both sets out the government's policy approach to the regulation of ESG ratings and how that approach has been included in draft legislation, which we have also published today.

I would like to thank all those who responded to the original consultation and look forward to bringing forward the final legislation in the first half of next year to deliver a future regulatory regime which will help to develop a robust, transparent ESG ratings sector – placing the UK at the forefront of this crucial, growing market.

Tulip Siddiq MP

Economic Secretary to the Treasury & City Minister

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[1] ESG AUM set to top $40 trillion by 2030, anchor capital markets | Insights | Bloomberg Professional Services

Chapter 1

Introducing regulation for ESG ratings providers

1.1 The previous government published a consultation on the regulation of ESG ratings providers on 30 March 2023, and this closed on 30 June 2023. It sought views on:

- The introduction of regulation for ESG ratings providers
- Description of ESG ratings and their provision
- Activities to exclude from regulation
- Sectoral and territorial scope of regulation
- Making regulation proportionate

1.2 This document is the government's consultation response, summarising views, drawn from 94 written consultation responses. Respondents included[2]:

- 30 ratings providers
- 14 ratings users
- 10 rated entities
- 9 consultancies and advisory bodies
- 31 others, including 22 trade bodies

1.3 In addition, since publishing the proposals, HM Treasury has engaged with a variety of organisations, mostly through a series of workshops and roundtables. The Financial Conduct Authority (FCA) has also run an initial engagement programme in parallel and in anticipation of the provision of ESG ratings becoming an FCA regulated activity.

1.4 This consultation response is accompanied by a draft Statutory Instrument (SI) on which the government would welcome technical comments by **14 January 2025**. Further details on how to provide comments on this draft SI can be found in Chapter 6.

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[2] See Annex 1 for full summary of respondents to this consultation.

1.5 The draft SI focuses on the regulated activity and exclusions, while work continues on other aspects such as transitional provisions, consequential amendments and market access routes for certain overseas providers (explained further within Chapter 4). Drafting notes have been provided where appropriate within the accompanying draft SI to aid readers' understanding of intent and purpose.

Recap on original consultation proposal for regulation

1.6 The consultation proposed that the regulated activity would be the direct provision of an assessment (rating, score, ranking, evaluation) of environmental, social and governance factors to a user within the UK, where the assessment is used in relation to a specified investment as per the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO), unless an exclusion applies.

1.7 The proposal was for entities which produce ESG ratings and are identified as being in scope of the regulatory perimeter, to be required to obtain authorisation from the FCA to carry on this activity. Compliance with future FCA rules would be a mandatory requirement for entities within scope. The government expects future FCA rules to be informed by the International Organisation of Securities Commissions (IOSCO) 2021 recommendations, with the regulatory outcomes focused on promoting transparency, good governance, management of conflicts of interest and robust systems and controls.[3]

Question 1

Do you agree that regulation should be introduced for ESG ratings providers?

1.8 HM Treasury received 91 responses overall to this question. See Table 1.A. below for a breakdown of these specific respondents:

Table 1.A.

Respondent Type	Yes (86)	No (5)
ESG ratings providers	26	4
ESG ratings users	14	
ESG rated body	10	
ESG consultants	8	
Other	28	1
Total	**86**	**5**

[3] FR09/2021 Environmental, Social and Governance (ESG) Ratings and Data Products Providers (iarticleosco.org)

1.9 95% of respondents were in favour of regulation, citing the need to address a number of perceived harms within the ESG ratings market. Views in favour reflected core requirements to improve transparency in the methodology used to create ESG ratings and to address conflicts of interest, for example where providers are providing an ESG rating service (for a fee) to an entity, then proceeding to advise (for a fee) that same rated entity on how to improve its ESG score.

1.10 5% of respondents did not support the introduction of regulation for ESG ratings provision, with the following reasoning provided:

- Concern that regulation could stifle the nascent ESG ratings market, by creating a barrier to entry for new ESG ratings providers. This would have the effect of reducing competition in the market.
- The increase in costs for firms, including both the initial cost of authorisation (legal and compliance functions) and the ongoing cost of meeting FCA requirements, such as needing to maintain and update internal systems and reporting lines to monitor and document compliance. Respondents noted the strong possibility that these costs may be passed down from providers to users of ESG ratings.
- The potential for smaller ESG ratings providers to be disproportionately affected by the proposals.
- A preference for a guidance-based approach, for example through the adoption of a government code of best practice, or adherence to the voluntary code of conduct developed by the ESG Data and Ratings Working Group (DRWG)[4], now hosted by the International Capital Market Association (ICMA)[5], rather than the proposed regulatory approach. Some respondents felt that a guidance-based and voluntary approach would allow the ESG ratings market to better grow and evolve.

1.11 These concerns have been considered and, where appropriate, addressed as part of the government's responses contained throughout this document.

[4] Code of Conduct for ESG Ratings and Data Products Providers (irsg.co.uk)

[5] Code of Conduct for ESG Ratings and Data Products Providers » ICMA (icmagroup.org)

Question 2

(For ESG ratings providers) If your firm were subject to regulation in line with IOSCO's recommendations, and aimed at delivering the four key regulatory outcomes in Figure 1.A, how would this impact your business? Please provide information on the size of your business when answering this question.

Figure 1.A IOSCO's recommended key regulatory outcomes

Transparency	Good governance	Management of conflicts of interest	Robust systems and controls
• Methodologies (incl. individual underlying components, measurement objective) • Data and information sources (incl. whether public) • Procedures for data gaps, and the use of averages and estimates	• Enabling good management of conflicts of interest • Internal consistency of methodology within a provider • Sufficient resources and competent personnel	• Identification, mitigation, management and disclosure of conflicts of interest	• 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) • Engagement with rated entities

1.12 HM Treasury received 32 responses to this question, comprised of representatives of ESG ratings providers and a selection of trade bodies and consultancies. 63% of respondents anticipated some form of impact on their business. Of those respondents, 65% envisioned that impact to be of a significant or severe nature. Two of the prevalent concerns highlighted included the ongoing costs related to being FCA authorised and regulated and the potential need to secure additional resourcing to ensure compliance. 22% of respondents also noted a practical challenge for the government in safeguarding against a regulation that inadvertently inhibited innovation and growth. These same respondents cautioned against a rise in transparency requirements, potentially to the detriment of product development and protection of a firm's intellectual property.

1.13 Some respondents cited concerns regarding future FCA rules, including the possible requirement for business restructuring if, for

example, regulatory rules required a separation between ratings activities and advisory services to address any conflict-of-interest issues.

1.14 There was also some concern raised by smaller firms that felt more vulnerable to the possible disproportionate impacts that a future regulatory regime could bring.

Question 3

Are there any practical challenges arising from overlap between potential regulation for ESG ratings providers and existing regulation?

1.15 HM Treasury received 56 responses to this question. The main areas of potential overlap identified were the government's Sustainability Disclosure Requirements (SDR) framework; (specifically, the FCA's SDR and investment labels regime[6]) noting that FCA authorised firms will already be subject to the FCA's anti-greenwashing rule. The International Sustainability Standards Board (ISSB) standards[7] were also identified as a possible cause of regulatory overlap, together with the UK Benchmarks Regulation (BMR)[8] and Credit Ratings Agencies Regulation (CRAR)[9].

1.16 Respondents were also concerned that if the regulation were entity-focussed rather than activity-focussed, the scope would be hard to define. This consideration is addressed within Chapter 3 of this document.

Question 4

Are there any other practical challenges to introducing such regulation?

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6 PS23/16: Sustainability Disclosure Requirements (SDR) and investment labels (fca.org.uk)

7 ISSB-2023-A – Issued IFRS Standards ISSB-2023-B – Issued IFRS Standards

8 The Financial Services and Markets Act 2000 (Benchmarks) Regulations 2018

9 The Credit Rating Agencies Regulations 2010

1.17 HM Treasury received 60 responses to this question. Some respondents noted the possible challenge of ensuring interoperability with current international codes and regulations, including the European Union's (EU) Sustainable Finance Disclosure Regulations (SFDR)[10], Corporate Sustainability Reporting Directive (CSRD)[11], the EU Green Taxonomy[12], as well as any future regulatory developments in the US and Japan. Respondents suggested that the government should therefore adopt a definition of an ESG rating which aligns with existing regimes and other international policy initiatives. Respondents noted that this could alleviate interoperability issues and help better facilitate cross-border operations for UK-based ESG ratings providers.

1.18 Some respondents suggested that it would be challenging to achieve a proportionate scope for a regulatory regime. In particular, respondents highlighted the risk that smaller providers could experience a disproportionate burden under regulation and suggested that any regulatory regime should look to mitigate against unnecessary and overly burdensome financial or operational costs.

1.19 Some respondents were keen that regulation should account for differing ESG ratings methodologies and protect the existing competitive market. Other respondents also emphasised the importance of regulation not negatively impacting (via any transparency requirements) a provider's intellectual property or competitive advantage within the market.

1.20 Respondents also noted the potential for overlap with the work of the DRWG and its voluntary code of conduct.

1.21 Whilst representative respondents from the defence and security sectors noted the negative impact of current exclusionary practices by some investment funds managers and welcomed regulation of ESG ratings providers as a route to provide some transparency on this issue.

Government Response

1.22 All consultation responses have now been considered and analysed. As outlined in paragraph 1.4, the positions arrived at and outlined throughout the government response sections of this document are presented in conjunction with a corresponding draft SI.

1.23 There is strong support for the proposed introduction of regulation for the provision of ESG ratings. As confirmed by the Chancellor on 8 August 2024, the government intends to introduce

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10 Regulation - 2019/2088 - EN - sfdr - EUR-Lex (europa.eu)

11 Directive - 2022/2464 - EN - CSRD Directive - EUR-Lex (europa.eu)

12 Regulation - 2020/852 - EN - taxonomy regulation - EUR-Lex (europa.eu)

legislation to meet the demand for regulatory oversight of ESG ratings provision.

1.24 It is worth highlighting that the overall tone of responses received was positive, with a preference from respondents for regulatory alignment with the recommendations set out by IOSCO.

1.25 The government's response and the draft SI frame how the regulatory perimeter for ESG ratings provision will be established. Once legislation is passed, the FCA will develop the standards and regulatory requirements that will need to be met by ESG ratings providers. Draft rules and guidance will be published for consultation by the FCA prior to the regulatory regime being finalised and implemented.

Regulatory regime operation and supervision

1.26 The UK's general approach to financial services regulation is founded upon the Financial Services and Markets Act 2000 (FSMA) and is sometimes referred to as the "FSMA model".[13] The FSMA model delegates the setting of regulatory standards to the expert, operationally independent regulator, the FCA – within an overall accountability framework set by government and Parliament.

1.27 FSMA establishes a framework whereby any person (whether an individual or firm) can only carry out a regulated activity if they are authorised by the appropriate regulator (i.e., they are an "authorised person") or are exempt from the authorisation requirement. Under this framework, the government determines which activities are regulated activities, by specifying them in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO).[14]

1.28 The government intends to introduce secondary legislation to amend and expand the regulatory perimeter to capture the activity of providing ESG ratings, including ratings produced in the UK and ratings produced overseas which are made available to UK users by way of a business relationship. This perimeter extension will be delivered via an amendment to the RAO, which will require affected ESG ratings providers to become FCA authorised and to meet the Threshold Conditions at all times.[15]

1.29 Prior to the FCA's authorisation gateway opening, and following their policy development processes, the FCA will consult on draft rules and guidance for ESG ratings providers. This will include additional rules

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13 Financial Services and Markets Act 2000

14 The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001

15 Which includes assessment of the standards of a providers' supervisory effectiveness, suitability, business model, access to appropriate resources, and other requirements deemed minimum conditions to satisfy FCA authorisation. Financial Services and Markets Act 2000

for those existing authorised firms who wish to benefit from the regulated products and services exclusion set out in Chapter 3. While these firms will not require a separate permission to provide ESG ratings as part of an existing regulated product or service, the FCA will assess whether existing standards need to be enhanced, to help ensure a level playing field between all firms producing ESG ratings. The consultation will include a cost benefit analysis to assess their impact before being finalised.

1.30 Once the regulatory framework is in place and the FCA's authorisation gateway is opened, the extent to which ESG ratings providers meet FCA rules – including the Threshold Conditions – will be assessed individually at the FCA's authorisation gateway and ongoing supervision. It is for the FCA to develop their approach to authorisation and consider how to provide an appropriate level of support to firms through the application process.

1.31 Considering international momentum, consistency with international standards and other jurisdictions is vitally important to avoid the risk of fragmentation. Therefore, the government expects that any requirements developed will take account of international policy initiatives, in particular the recommendations provided by IOSCO.

1.32 As part of the design of the future regulatory framework for ESG ratings provision, the FCA is considering its approach to overseas ESG ratings providers applying for UK authorisation. This includes exploring whether, according to size, significance, or market impact in the UK, an ESG ratings provider would be expected to be incorporated in the UK. This will form part of the FCA's consultation on the ESG ratings regulatory regime.

1.33 In addition, the government is exploring creating overseas regimes and other access routes into the UK market for overseas providers (as an alternative to requiring full UK authorisation). This includes a possible market access or overseas regime for ratings issued in overseas jurisdictions, and the government will reflect on whether and when these could be introduced for overseas providers. This topic is discussed further in Chapter 4.

Timeline for the introduction of a regulatory regime for ESG ratings providers

1.34 The overall process of designing, developing and commencing the ESG ratings regulatory regime (as outlined above) is expected to take approximately four years, with the government aiming to lay the requisite secondary legislation before Parliament in early 2025 (subject to Parliamentary time). Following this, the FCA will develop and consult on policy proposals, building in feedback to finalise the ESG ratings regime. Affected firms will then go through the authorisations process, with the regime ultimately going live at the end of the authorisation gateway. This timeline is subject to various factors, including the number of firms in scope of the regime.

Regulatory Impact

1.35 The government expects the FCA to create a proportionate regulatory regime that primarily addresses the risks of harm related to conflicts of interest, governance, systems and controls and transparency, with reference to the IOSCO recommendations. This topic is discussed in greater detail in Chapter 5 of this document.

1.36 As outlined above, the FCA will carry out a cost-benefit analysis of the rules and guidance it proposes. This process will be vital to the development of a proportionate regulatory regime as it will assess the potential net impact of regulation (including the impact on large and small firms), with a view to fostering competition and continued innovation whilst maintaining an appropriate level of investor and market protection in this nascent market.

1.37 The government recognises that there is a possible risk of creating a system of disproportionately burdensome dual regulation for certain ESG ratings providers. These potential overlaps are considered within Chapter 3 of this consultation response document.

1.38 The government is seeking to secure an appropriate level of investor and market protection by addressing risks of harm, whilst not stifling innovation or impairing a competitive environment through a disproportionate regulatory regime.

Chapter 2

Description of ESG ratings and their provision

Recap on original proposals from the Consultation

2.1 HM Treasury's original proposal was to capture the range of ESG ratings provision to financial markets, regardless of how this was named or marketed. HM Treasury therefore proposed that the regulated activity should cover an assessment regarding one or more environmental, social and governance factors, whether or not it is labelled as an ESG rating.

2.2 HM Treasury's proposed scope excluded data on ESG matters where no assessment is present.

2.3 The proposals sought to address risks raised by the material influence of unregulated ESG ratings provision on decisions related to financial services in the UK. As such, it was proposed that regulation would capture the provision of ESG ratings when used for a broad range of activities which relate to financial services. This included, but was not limited to, investments such as shares, debt issued by firms, governments, and other public sector bodies as well as other types of financial products such as loans, units in a collective investment scheme and contracts of insurance.

2.4 HM Treasury therefore proposed that the new regulated activity would cover the provision of an ESG rating to be used by persons in the UK in relation to an RAO specified investment. The full list of specified investments can be found in Part III of the RAO.

Question 5

Do you agree with the proposed description of an ESG rating?

2.5 HM Treasury received 79 responses to this question. 74% of respondents agreed or broadly agreed with the proposed description as presented within the consultation: *"An ESG rating in the context of a*

new regulated activity would cover an assessment regarding one or more environmental, social and governance factors, whether or not it is labelled as such."

2.6 25% of respondents to this question disagreed with the proposed description. These respondents were concerned that the proposed description deviated too much from the IOSCO definition and was too broad, risking capturing too wide a range of ESG products (data, for example). 1% of respondents neither agreed nor disagreed with the proposed description.

2.7 Among some of those that were generally in agreement with the proposed description, there were some concerns raised around the use of the term "assessment"; in particular, that this term would require some further explanation in understanding what, in practice, a "rating" means when compared to an "assessment".

2.8 One respondent voiced concerns related to the defence sector, suggesting that as well as environmental, social and governance considerations, HM Treasury should also reflect upon the addition of "security" to these factors to help address exclusionary practices developed from ESG concerns, which could curtail interest in defence-related company shares.

It is important to note here that whilst a future regulatory regime for ESG ratings is not intended to dictate investment decisions, requirements for transparency in the methodology used to produce the ESG rating will support greater investor awareness of the defence industry's role.

Question 6

Do you agree that ESG data, where no assessment is present, should be excluded from regulation?

2.9 HM Treasury received 76 responses to this question. 64% of respondents agreed that data, where no assessment is present, should be excluded from regulation. Table 2.A. below illustrates a granular breakdown of question 6 responses:

Table 2.A

Respondent Type	**Yes** (49)	**No** (27)	**N/A** (18)
ESG ratings provider	17	8	5
ESG ratings user	9	5	
ESG rated body	5	3	2
ESG consultants	4	3	2
Other bodies	14	8	9
Total	**49**	**27**	**18**

2.10 Some respondents who were generally supportive of excluding data (where no assessment is present) disagreed with part of HM Treasury's proposal and noted that there were instances where the explicit inclusion of data could be appropriate. Examples put forward were: minimally processed data, proxy data, the use of data assumptions, data estimates and forecasts (e.g. climate value at risk based on certain climate scenarios). Some respondents noted that even raw data can, at times, partially rely on some value judgement or form of estimation that would constitute human manipulation and consequently deviate from the status of pure, raw data.

2.11 In circumstances where ESG data providers are producing such estimates, some respondents called for their inclusion within the scope of regulation of ESG rating provision. Some respondents also called for the government to define what constitutes proxy data and minimally processed data.

2.12 A number of respondents highlighted that, when considering data and whether an assessment has been made, reference could be made to IOSCO's definition, which includes an 'opinion' that is based upon a 'defined ranking system of ratings categories'. Those respondents noted HM Treasury's definition of an ESG rating may otherwise be too broad in its scope.

2.13 Several respondents put forward that controversy reports (identifying companies involved in ESG-related incidents such as bribery, corruption, workplace discrimination or environmental incidents) should be included within the scope of regulation, as they typically provide an assessment of one or more environmental, social or governance factors and require final analysis.

2.14 36% of respondents disagreed with the proposal to exclude data. Some of these respondents said that excluding data from the

regulatory perimeter would increase the risk that the data was unreliable. Respondents also noted that any subsequent rating produced from unregulated data might be unfit for purpose.

2.15 Some respondents also highlighted that, as per recommendations made by IOSCO, there should be no difference in regulatory priorities between ESG ratings providers and ESG data providers, given that there is such significant interaction between the two.

Question 7

Do you agree with the proposal to regulate the activity of providing ESG ratings to be used in relation to RAO specified investments?

2.16 HM Treasury received 57 responses to this question. Of those respondents, 82% agreed with the proposal, 14% disagreed and 4% offered mixed views in their response.

2.17 Respondents who were generally supportive of the proposal highlighted that a definition of the activity of producing an ESG rating could complement and clarify this proposal. These respondents also felt that the list of specified investments included within the RAO comprehensively covered the financial activities where provision of an ESG rating is currently applied.

2.18 11% of the 57 respondents also suggested that 'loan books' (a record of the loans held by a bank or finance company), and voluntary carbon credits should be added to the list of in-scope specified investments. In terms of the RAO however, a loan book is not a separate category of investment. It is a collection of individual investments, and the regulatory status of each individual investment may differ. These suggested additions are explored further in Chapter 3.

2.19 Whilst some respondents recognised the logic behind the proposal, there were some who questioned the proportionality of this approach, given the significant breadth of specified investments contained in the RAO.

2.20 Of the respondents who disagreed with HM Treasury's proposal, there was some concern that this approach would require ESG ratings providers to precisely understand what their ratings are used for, something that is not common practice in the provision of ESG ratings. An alternative view was that the government should look to regulate the provision of all ESG ratings provided in the United Kingdom, rather than ESG ratings used in specified ways.

Question 8

(For ESG ratings providers) Do you know when an ESG rating you provide will be used in relation to a specified investment?

2.21 HM Treasury received 24 responses to this question. 75% of respondents indicated that there was either a lack of clarity, or it was unknown, as to what the provided ESG rating was used or intended to be used for. 25% of respondents confirmed that they were generally aware when an ESG rating they were providing was being used in relation to a specified investment.

2.22 Amongst the respondents who were unclear as to the intended use of the rating provided, there was consensus that a ratings provider often has limited visibility of how the rating provided will ultimately be used. This could be due to a variety of reasons, for example, users combining elements of one ESG rating with another. These respondents also highlighted that, despite the existence of licence agreements and contracts between the provider and user, they could not guarantee that a rating would not be used beyond the understanding of the originating rating provider and user.

2.23 Amongst those respondents who felt they were generally aware of the use of their ratings, this clarity was ascertained via a number of avenues, such as regular user contact through surveys (caveated by response rate variation), bespoke provider/user contracts or, where a provider has a relatively small user base and closer working relationships with their users.

Question 9

Are there ESG ratings used in relation to anything other than an RAO specified investment which also should be included in regulation?

2.24 HM Treasury received 35 responses to this question. 49% of respondents felt that there were additional areas beyond RAO specified investments which relied upon ESG ratings, and which should therefore be included within future regulation.

2.25 There was a wide range of additional areas suggested, each with no more than 18% of support from respondents. Voluntary carbon credits were suggested for inclusion as it was seen to be important that any regulatory framework should be future-facing and able to tackle any emerging products within the ESG ratings market. Other specific

suggestions for inclusion (some of which are already designated specified investments under the RAO) were: regulatory reporting, risk management reporting, portfolio construction, conventional loans, 'loan-books', ratings utilised by banks, insurers, asset owners and ratings used for private market infrastructure, real estate, commodities, Sustainability Linked Loans (SLLs) and Money Market Funds (MMFs). Some respondents suggested that any addition beyond RAO specified investments should only be included where both the nature and use of the ESG rating would influence capital allocation.

2.26 34% of respondents did not think that anything beyond RAO specified investments should be included in regulation. 17% of respondents were unsure as to whether the proposed regulation would be precise enough to capture all ESG ratings in relation to an RAO specified investment.

2.27 Some respondents suggested that any regulatory status of an entity/provider should be determined by 'end user' rather than 'use case', or that all ESG ratings provision should be regulated, rather than limiting the regulatory scope to those ratings used within the financial services sector.

Government Response

2.28 The government has reflected on the consultation responses suggesting that the proposed approach to the ESG rating definition was too broad a description and could be open to interpretation. The government has narrowed and clarified the definition as set out in the accompanying draft SI and summarised below.

Definition of an ESG rating

2.29 Through a process of response analysis and further industry engagement, the definition of an ESG rating for the purposes of the regulatory regime has been developed 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"*** (see inserted article 63ZB of the draft SI).

2.30 An ESG opinion is defined as "*an ESG rating involving substantial analytical input from an analyst, whether or not it is characterised as an ESG opinion*". An ESG score is defined as "*an ESG rating derived from data and a pre-established statistical or algorithmic system or model, without additional substantial analytical input from an analyst, whether or not it is characterised as an ESG score*".

2.31 As noted in the original consultation, there is a broad range of terminology currently utilised within this space – not all ESG ratings use the term "rating", and they can also be called a score, mark, assessment, opinion or solution. However, these products can be identified by the objective they serve, which is to make an assessment – an evaluation, or value-judgment - of the characteristics of an entity or product as

related to ESG matters. Hence the definition, for regulatory purposes, as presented in the draft SI.

2.32 The government considers this definition to be a proportionate approach to defining an ESG rating. It is consistent with the intention of addressing recognised risks posed by the material influence of unregulated ESG ratings.

2.33 In proceeding as proposed within the consultation paper and continuing to utilise the phrase *"regarding one or more ESG factors",* the government intends to create a future-proof regulatory regime by not delineating between certain categories in scope. This reflects the government's intention to capture both general ESG ratings products (e.g. aggregate ESG ratings on corporates or funds) and specific ones (e.g. biodiversity or controversy scores).

ESG Data

2.34 As set out in Chapter 1, the government intends to proceed as proposed within the consultation paper and include within regulation ESG ratings provision only.

2.35 The decision to exclude the provision of ESG data at this stage aligns with the wider position on financial data (which is not regulated) and reflects the majority of respondents' views that the biggest risk of harm is from the assessment that constitutes the ESG rating. There are other targeted proposals which could support the ESG data market, for example, the implementation of the International Sustainability Standards Board (ISSB) standards. The government also continues to support the voluntary code of conduct for ESG data and ratings providers, which includes best practice for data products provision, data sources and analysis, serving as a useful complement to a future ESG ratings regulatory regime.

2.36 It is also relevant that the EU's proposed ESG regulatory regime have also excluded ESG data at this stage.

2.37 The government recognises the issues raised by respondents concerning ESG data and will continue to monitor the ESG data market and international developments to assess whether further regulatory action is required.

The activity of providing an ESG rating

2.38 The government intends to proceed to expand the regulatory perimeter to capture ESG ratings which are "*likely to influence*" a decision to make an RAO-specified investment. This approach was informed by analysis of responses to the consultation question of whether an ESG rating provider is aware of their ratings' end use.

2.39 The original consultation proposal was to regulate the activity of providing an ESG rating when used in relation to an RAO specified investment. However, given that 75% of ESG ratings provider respondents to Question 8 of the consultation stated that they do not have sight of end-use, including whether the rating they provide will be

utilised in relation to an RAO specified investment, the government's approach is no longer reliant on a provider having detailed sight and knowledge of a rating's use.

2.40 The government's new approach is to capture any ratings which are "*likely to influence a decision to make a specified investment*". For example, a rating that is likely to be used to inform asset allocation and portfolio construction would be captured (except where the ESG rating provider could not reasonably have expected the rating to influence a decision to make a specified investment). Another example could be pre-initial public offerings (IPO) ratings, as it is reasonable to expect that these ratings will be likely to influence a decision to make a specified investment. It would also be considered reasonable to expect that a provider's knowledge of a link between its ESG rating provision and its use in specified investments or financial services decision making would be ensured by best and sensible endeavour. Contractual relationships between provider and user could be one option for providers to consider.

2.41 The government intends to capture ratings made available to UK users, both by providers located in the UK as well as providers based overseas. However, overseas providers will only be captured when providing an ESG rating to a person located in the UK by way of a business relationship (see Chapter 4).

2.42 Following response analysis and further engagement with industry, the government is defining the provision of an ESG rating as a specified kind of activity where an ESG rating is:

(a) produced using an established methodology and a defined ranking system of rating categories,
(b) made available in accordance with paragraph (2), and
(c) likely to influence a decision to make a specified investment, unless the ESG rating provider could not reasonably have expected the ESG rating to influence a decision to make a specified investment.

(2) This paragraph applies where—
(a) a rating is made available by an ESG rating provider located in the UK by any means;
(b) a rating is made available by an ESG rating provider not located in the UK by way of a business relationship, including but not limited to a subscription or any other contractual relationship, with a person located in the UK.

(3) For the purposes of paragraph (2)(b), the circumstances in which an ESG rating is made available by an ESG rating provider include where—
(a) the rating is made available by the ESG rating provider to another person;
(b) the rating is made available by that person or via one or more third parties to a person located in the UK;
(c) the ESG rating provider could reasonably have expected the ESG rating to be made available to a person located in the UK.

(4) For the purposes of paragraph (1), it is immaterial whether the rating is solicited or unsolicited.

2.43 In alignment with IOSCO's definition, the activity captures those ESG ratings that are "*based on a defined ranking system of rating categories*".

2.44 The government also sees it as sensible to explicitly define a "rating category" as including, but not being limited to, *"a variable or division within a system, such as a letter, number, symbol, colour or temperature, that provides a relative measure to distinguish one or more characteristics of various rated items"*. The government's expectation is that the inclusion of this explicit demarcation will provide clarity to all users and providers as to what will be in scope of regulation.

2.45 The phrases "*established methodology*" and "*defined ranking system*" are included for the specific purpose of capturing systematically produced assessments which methodically draw comparisons between several entities or products to produce ESG ratings. An "established methodology" is one involving techniques and procedures systematically utilised to identify, collect, analyse and interpret data in order to produce a rating.

2.46 The words "*unless the ESG rating provider could not reasonably have expected the ESG rating to influence a decision to make a specified investment*" have been included as part of the activity definition in the draft SI. This is to protect ESG rating providers who are acting in good faith from inadvertently breaching regulatory requirements as a consequence of unexpected actions taken by a third party.

2.47 For clarity, the term "*ESG rating provider*" means an entity that produces and makes available ESG ratings. This includes firms providing standalone ESG ratings, as well as those providing an ESG rating as part of an existing regulated activity, who wish to benefit from the regulated products and services exclusion set out in Chapter 3. The use of the term "*made available*" within the activity definition in the draft SI is intended to include, but not be limited *to, "providing to another person in hard-copy or electronic form or publishing on a website or other digital medium"*. To note, the sole activity of the distribution of an ESG rating (on its own and without any manipulation or alteration of the original rating) will not be in scope of the proposed regulation.

Chapter 3
Exclusions

Recap on original proposals from the Consultation

3.1 The RAO specifies exclusions for when permission is not required to carry out a regulated activity. This is to ensure that the scope of regulation is appropriate and proportionate. As part of the consultation, HM Treasury put forward a number of potential exclusions relating to the provision of ESG ratings which HM Treasury considered could be appropriate.

3.2 Exclusions are put in place where an activity is specified as a regulated activity according to the RAO (in this case, providing ESG ratings), but there is a clear policy rationale for excluding certain activities from the scope of the regulatory regime. Please see Chapter 1 for more detail on the functioning of the RAO.

3.3 HM Treasury consulted on eight potential exclusions from the original proposed scope, and invited participants to share views on others.

Individual exclusions considered in the Consultation

3.4 HM Treasury asked for views on the exclusion of **not-for-profit entities** from regulation. This would exempt those not-for-profits from authorisation and regulatory requirements.

3.5 HM Treasury also asked for views on excluding **internal ratings,** where firms such as asset managers produce ESG ratings for internal use within that firm only, to support investment decisions. The proposed exclusion did not extend to circumstances in which such firms also produce external ESG ratings for other entities. HM Treasury considered whether the internal ratings exclusion should also cover 'intra-group' ratings, where ratings produced by a firm are transferred from one entity to another within that same firm's corporate group.

3.6 HM Treasury sought views on excluding other activities which interact with, or have similar features to, ESG ratings, but which are materially different or are regulated elsewhere. These activities included the production of:

- **Credit ratings** which consider the impact of ESG factors on creditworthiness. Exclusion was proposed because these products are already subject to regulatory requirements under the CRAR.

- **Investment research** products, such as equity research reports. These are established products which may incorporate ESG considerations, but which are materially different to the ratings of ESG factors only, which HM Treasury aimed to capture.
- **External reviews**, including second-party opinions, verifications and certifications of ESG-labelled bonds. These activities can run up against some of the same issues as ESG ratings but may benefit from different requirements which are more tailored to the provision of assurance-like activities in a non-audit capacity.
- **Proxy advisor services**, such as voting or recommendations to shareholders of firms. Recommendations by proxy advisors, even if related to ESG matters, are provided for a specific purpose (informing shareholders) and therefore should not be subject to the same regulation as ESG ratings. Some of these services are also already regulated by the FCA, which would be a more appropriate approach.
- **Consulting services**, even where these relate to ESG matters. This was proposed on the understanding that where consulting services involve ESG ratings, these are often bespoke or private ad hoc reviews, rather than ratings which systematically influence capital allocation. However, certain scenarios which are more likely to impact capital allocation, such as when a one-off ESG rating is provided for the purpose of an IPO, were proposed to be included in the scope of the regulation.
- **Academic research or journalism**, even where that relates to ESG matters. HM Treasury proposed to carve these out as distinct activities which should not be subject to financial services regulation in this context.

Question 10

Do you agree that each of the eight scenarios listed above (in paragraphs 3.2, 3.3, and 3.5 of original consultation document) should be excluded from regulation?

3.7 HM Treasury received 79 responses to this question. 20% of respondents agreed with the exclusion of all eight scenarios. 4% of respondents disagreed with all eight scenarios being excluded (i.e. thought that all should be included). 76% of respondents agreed with some, but not all, of the eight scenarios proposed for exclusion.

Charities and not-for-profits

3.8 HM Treasury received 74 responses about excluding the provision of ESG ratings by not-for-profit entities. This includes registered charities in the UK, or not-for-profits registered overseas. 54%

of respondents disagreed with this exclusion, 27% of respondents agreed and 19% offered mixed views.

3.9 80% of respondents representing charity and not-for-profit providers supported an exclusion for charities. Some questioned why the exclusion should only apply to registered charities, rather than not-for-profits more generally. 20% of respondents representing charity and not-for-profit providers opposed an exclusion for charities, on the basis that this might create an incentive to circumvent regulation or reduce the effectiveness of ESG ratings regulation.

3.10 There were two opposing considerations presented by respondents – first, that ESG ratings, regardless of the status of their provider, have the same degree of potential impact and risk of harm to the end user. This is weighed against the fact that not-for-profits tend to have fewer operational resources and capacity to engage with a full-scale authorisation process and ongoing compliance.

3.11 A common thread running throughout responses opposing the exclusion of not-for-profit entities was that such entities will pose the same risks of harm as a for-profit provider and should therefore carry the same supervisory accountability. Many respondents argued in favour of creating a baseline standard of transparency for all ESG ratings providers.

3.12 Of the 27% of respondents who agreed with excluding charities and not-for-profits, one respondent highlighted that much not-for-profit activity is done for philanthropic purposes, i.e. that ratings are provided on a non-commercial basis, or for free. Another noted that not-for-profits have less scope for conflicts of interest, as the main purpose is to contribute to sustainability rather than commercial gain. Respondents also noted the role of not-for-profits in providing innovative stimulus to the market.

Internal and Private Use

3.13 HM Treasury received 71 responses about excluding ESG ratings produced by an entity for its own internal use only (i.e. where an ESG rating is created by an entity to support its own decision making). 79% of respondents agreed with the proposed exclusion, 13% disagreed, and 8% of responses offered a mixed view.

3.14 Of the respondents supporting this exclusion, many agreed that any rating created solely for internal use and not disclosed externally should be discounted from a future regulatory perimeter. Respondents suggested that the exclusion should apply to ratings produced for internal use only, but should not exclude dual-purpose ratings (i.e. those used both within an entity but also sold externally).

3.15 A number of respondents noted that internally produced ratings are often used in marketing or client communications, suggesting that such ratings should also be treated (and regulated) as ESG ratings provision.

3.16 Respondents also suggested that 'intra-group' ratings, (whereby an entity in one part of a corporate group produces and transfers internal ratings to another entity within the same corporate group), should be excluded when not marketed to a third party. There was concern that these ratings may be caught in regulation by default. Some respondents suggested that such ratings could be subject to a subsection of any proposed regulation to ensure transparency and fair competition.

3.17 The 13% of respondents opposed to excluding internal use cases suggested that all market participants should be treated equally. On the basis that internal ratings may be used to support an investment strategy, such respondents noted that internal ratings pose similar risks of harm as ratings provided to third parties. Therefore, they advocated for taking a consistent approach across the board, by including internal ratings within the scope of regulation. Likewise, on intra-group ratings, respondents noted that ratings produced by one part of a corporate group provided to another member of the group, present the same risks as those produced by third-party ESG data and ratings providers, so these too should be regulated.

3.18 Respondents also noted the need to consider the scenario whereby an entity solicits an ESG rating from an external provider purely for its own internal, private use. In these cases, at least one respondent suggested that bespoke, private ratings of this kind should be excluded from regulation as they are client specific. Where these private ESG ratings are not intended for public consumption, they have a different profile to widely available ESG ratings.

Credit Ratings

3.19 HM Treasury received 59 responses about excluding credit ratings. 88% of respondents agreed with the proposed exclusion, 10% of respondents disagreed, and 2% gave a neutral response. The overwhelming majority who supported the proposed exclusion suggested that credit ratings are already adequately captured within the CRAR, therefore exclusion from another regulatory framework would be proportionate and also avoid potential overlaps or conflicts between two sets of regulation.

3.20 10% of respondents disagreed with an exclusion for credit ratings. This was on the basis that risks presented by credit ratings that assess ESG factors may not be sufficiently addressed by the CRAR. Therefore, an exclusion may leave a regulatory gap.

Investment Research

3.21 HM Treasury received 61 responses about excluding investment research. 85% of respondents agreed with this proposed exclusion and 15% of respondents disagreed.

3.22 The respondents who supported this exclusion argued that this is already a highly regulated activity, and any additional regulatory overlay should be avoided. Respondents who disagreed with the proposed

exclusion noted that the inclusion of ESG ratings in equity research reporting is done with the intention – or outcome – of affecting investment decisions. Therefore, the same approach should be taken to ESG analysis, investment research and ratings. To this end, one respondent proposed that there should be clear thresholds set to identify research that may contain an 'ESG rating-type' assessment and so avoid regulatory loopholes.

External Reviews (including second-party opinions)

3.23 HM Treasury received 60 responses about excluding external reviews, including second-party opinions. 63% of respondents agreed with this proposed exclusion, 35% of respondents disagreed and 2% of respondents gave a neutral response.

3.24 Whilst these products encounter some of the same issues as ESG ratings, respondents largely thought that they may benefit from different requirements which were tailored to the provision of assurance-like activities in a non-audit capacity. Those respondents in favour of the exclusion noted that external reviews have a different function compared to mainstream ESG ratings which are used explicitly for investment purposes. Similar to investment research, those opposing the exclusion noted that external reviews are a tool that can influence investor decisions, so should be included.

Proxy Advisor Services

3.25 HM Treasury received 60 responses about excluding proxy advisor services. 70% of respondents agreed with the proposed exclusion whilst 30% of respondents disagreed.

3.26 Respondents in favour of this exclusion highlighted that the primary purpose of these services is to provide an opinion, which may incorporate ESG factors but does not provide an explicit ESG rating or score. Therefore, whilst they might ostensibly meet the defined activity of ESG rating provision, they should not be included in the perimeter of ESG ratings regulation. 11% of respondents highlighted that, following the implementation of the Shareholders Rights Directive (SRD II)[16] and the creation of The Proxy Advisors (Shareholders Rights) Regulations[17] in 2019, proxy advisors and their services are already captured by other regulation and therefore exclusion from ESG ratings regulation would be appropriate.

3.27 Respondents who supported the inclusion of proxy advisor services within ESG ratings regulation noted the growing trend of ESG assessments being included within proxy reports. These respondents considered that the proposed exclusion could therefore inadvertently

[16] Shareholder Rights Directive | EUR-Lex (europa.eu)

[17] The Proxy Advisors (Shareholders' Rights) Regulations 2019

create a gap whereby ESG assessments included in proxy reports remain out of scope of the Proxy Advisors Regulations yet are also exempt from regulatory oversight of the provision of ESG ratings. It was also highlighted that some proxy advisors offer additional services to help companies improve or provide an explanation of the rating or conclusions that the proxy advisor itself has issued.

Consulting Services

3.28 HM Treasury received 57 responses concerning the exclusion of consulting services. 70% of respondents agreed with the proposed exclusion, 28% of respondents disagreed and 2% gave a neutral response.

3.29 Respondents who were in favour of excluding consulting services noted that consulting business activities are qualitatively different from ESG ratings provision. Whilst consulting provides information and assessments of performance in certain cases, this is less frequently done on a systematic basis, compared to typical ESG ratings provision. Certain respondents noted that although these services can influence capital allocation, including them within scope would create a disproportionate regulatory burden.

3.30 Respondents who disagreed with the proposed exclusion suggested that such an exclusion would undermine the intended aim of regulating ESG ratings; that is, to address conflicts of interest and ensure transparency. Such views suggested that standardised supervisory requirements should be in place where any consultancy service has provided any fund research containing an ESG rating which is systematic and has influence on capital allocation.

Academic Research and Journalism

3.31 HM Treasury received 59 responses about excluding academic research and journalism. 73% of respondents agreed with the proposed exclusion, 24% of respondents disagreed and 3% gave a neutral response.

3.32 Respondents suggested this exclusion would be appropriate where investment content is not the main focal point of the publication. However, some academic or journalistic outputs, which consider specialist comparative data and information relating to ESG ratings, possibly should be included. It was also suggested that journalism would need to be categorically defined. One respondent noted the use of 'controversies' ESG ratings products within journalism, which are synthesised by a commercial entity using journalistic or media sources, should also be included. They argued that such products should fall within scope of regulation where they process underlying material and provide an output score, rating or metric intended to evaluate or quantify the level of controversy pertaining to individual issues.

3.33 Some respondents who disagreed with the proposed exclusion highlighted that the work of journalists and academics within the ESG

space can be very influential regarding investment decisions, therefore clarity may be required regarding what is permissible within the regulatory perimeter.

Question 11

Are there any other exclusions which should be provided for?

3.34 HM Treasury received 24 responses to this question. There were a variety of suggestions from respondents and a request for clarity on various scenarios involving third party providers, fund fact sheets, marketing materials and publications involving ESG ratings. Some respondents suggested that financial products screened for ESG characteristics (e.g. funds or other product offerings, such as eligible collateral) should be excluded. Some respondents suggested that products which incorporate an element of an ESG rating, but which are made available to clients as part of a broader service and not marketed as an ESG rating product, should be excluded.

3.35 Some respondents were concerned that, as the market for ESG products is a rapidly evolving landscape, there is a risk that innovation in the ESG product space could be stifled where an appropriate exclusion under the RAO is not available for a future ESG product offering. Therefore, it is important to ensure that the description of the regulated activity is made sufficiently clear and avoids creating uncertainty through exclusions. Some respondents noted that a targeted definition of an ESG rating would consequently limit a wider scope and narrow the necessary list of exclusions.

3.36 8% of respondents suggested that the provision of ratings of carbon credits or related products (such as those produced by "Carbon Credit Rating Agencies") should be excluded from ESG ratings regulation at this time. Whilst these respondents generally supported the objectives of the proposed regulation, they noted that the government's policy on voluntary carbon and nature markets (VCNMs) was still developing and that voluntary carbon credits were not specified investments under the RAO. Respondents noted that there may be instances whereby carbon credits were linked to specified investments under the RAO and asked for clarity on whether these would be captured under the regulation.

Government Response

3.37 The government has designed the scope of regulation, including specific exclusions to address primary risks of harm, whilst being proportionate. The set of exclusions in the draft SI are focussed on the relevant activity, rather than the entity conducting the activity. The need for certain exclusions has been impacted by the updates made to

the proposed definition of the regulated activity itself (as set out in Chapter 2). **The government welcomes technical comments on the draft SI, including how it addresses the updated set of exclusions as set out below.**

Regulated products and services

3.38 The production of certain regulated products or services sometimes involves the creation of an ESG rating as part of that product or service (e.g. ESG ratings are sometimes used to produce or explain certain credit ratings or benchmarks). Some firms such as asset managers also use ESG ratings to support engagement with end-investors and the marketing of funds, and to benchmark ESG performance against the wider sector. Without a specific exclusion, this type of activity could theoretically require dual authorisation by falling within the scope of the ESG ratings regulation by virtue of the activity definition as set out in the accompanying draft SI.

3.39 The "regulated products and services" exclusion has been created to exclude firms from needing to apply for permission to provide ESG ratings where, in the course of carrying on another regulated activity in respect of which they are authorised, they create an ESG rating as part of the development and delivery of that other regulated activity. Where ESG ratings are created in this way, the provider will not be required to apply for permission to provide ESG ratings, as long as those ESG ratings are not also provided as a standalone product or service. This exclusion applies in respect of any product or service that is regulated by the FCA. Of the eight exclusions listed in the original consultation, this exclusion applies to **credit ratings** and **investment research**.

3.40 The government has taken this approach to regulated products and services because it takes the view that it would be disproportionate to require dual authorisation. However, while dual authorisation is not desirable, the regulation of existing regulated activities may not fully address the risks of harm associated with ESG ratings. Whether as part of an existing regulated activity or not, it is important that all firms have appropriate safeguards in place when producing ESG ratings to help ensure ratings are high quality, robust, transparent, and free from conflicts of interest.

3.41 The government also seeks to support a level playing field between all producers of ESG ratings where they are likely to influence investment decisions and capital allocation. As such, the government supports the FCA reviewing existing rules and guidance pertaining to other relevant regulated activities to assess whether, and where, standards may need to be enhanced, to help ensure a level playing field between all firms producing ESG ratings. Where a firm fails to comply with these standards, as with any FCA rule breach, the FCA will have the full range of its regulatory toolkit to take appropriate action.

3.42 The government is continuing to consider whether and how this exclusion for regulated products and services should be applied to

overseas firms who benefit from market access arrangements in respect of products and services which incorporate an ESG rating as part of that product or service. This includes reviewing whether any existing overseas market access regimes may justify the exclusion of overseas firms who produce those products and services as part of the development and delivery of a regulated product or service.

3.43 Following an initial review, the government expects that there are three main products and services produced by overseas firms who benefit from UK market access arrangements which might be suitable for exclusion as part of the "regulated products and services" exclusion in the SI, namely: Credit Ratings, Benchmarks and Overseas Funds. The table below (Table 3.A.) lists the current market access or overseas regimes that apply in respect of these products and services and the powers pursuant to which they were made. Thereby negating the need for producers of those products and services from within that jurisdiction to seek full authorisation from the FCA in order to carry on those activities in the UK, albeit certain notification conditions may nevertheless apply. These are likely to be the focus of government consideration in this area and there are different considerations for each of the three regimes. The third column of Table 3 contains a list of decisions made by the UK (or "onshored" into UK legislation when leaving the EU), granting market access to particular countries or territories, under the market access regimes. For example, the implementing (onshoring) decisions listed against credit ratings grant equivalence in respect of credit rating agencies produced in the United States, Mexico, Japan, Hong Kong and the EEA States respectively.

3.44 **The Overseas Funds Regime –** The Overseas Funds Regime (OFR) is designed as a more streamlined process for overseas funds to be sold to UK retail investors. In the course of conducting regular business, managers of OFR recognised funds may produce ratings to, for example, support their engagement with end investors. Funds recognised under the OFR are subject to levels of consumer protection that are equivalent to those that UK funds are subject to. The government's expectation is that the use/production of ESG ratings by managers of OFR funds would be consistent with the other areas assessed in terms of the level of consumer protection. However, if the FCA makes rules relating to UK authorised fund managers producing ESG ratings, consideration will be given to whether any similar requirements should apply to managers of OFR funds.

3.45 **Credit Rating Agencies** – There are two routes through which credit ratings produced by overseas credit rating agencies can be used for regulatory purposes in the UK. The certification regime is available to CRAs established in jurisdictions deemed to be equivalent under the UK Credit Rating Agencies Regulation (CRAR), provided their ratings are not of systemic importance to the financial stability or integrity of the UK's financial markets and the legal and supervisory framework in the CRA's home jurisdiction is equivalent to the UK. CRAs that wish to apply for FCA certification must meet the requirements in the UK CRAR. The endorsement regime is available to overseas CRA groups

which have a CRA registered and established in the UK. Where a UK registered CRA endorses ratings from an overseas affiliate, those ratings can be used in the UK for regulatory purposes. The FCA publishes a list of jurisdictions where the legal and supervisory framework meet the conditions for endorsement to take place. UK CRAs must comply with the requirements in the CRAR when endorsing credit ratings. Overseas CRAs that are using one of the existing access routes under the CRAR will not be required to become authorised as an ESG ratings provider to continue to provide credit ratings in the UK, even if those credit ratings include ESG considerations.

3.46 **Benchmarks** – The UK has extended the third country transitional regime under the UK Benchmarks Regulation (BMR) to end 2030. This means that benchmarks produced by overseas benchmarks administrators can be used in the UK without the administrator being required to fall within one of the third country access routes set out under the BMR, via recognition, endorsement or equivalence. This transitional regime is in place due to concerns that, should the third country benchmarks regime come into force, it could reduce the number and variety of important benchmarks available in the UK. This is because some third country benchmark administrators may be unable or unwilling to come through the existing access routes for continued market access to the UK. For example, some third country benchmarks are provided on a non-commercial basis and therefore the administrators may lack the economic incentives to come through these access routes. The transitional period was extended to provide more time for HM Treasury to consider where reforms are needed to the UK's third country benchmarks regime. Overseas benchmark administrators will not be required to become authorised as an ESG ratings provider to continue to provide benchmarks into the UK under the third country transitional regime or other market access routes under the BMR – endorsement, recognition or equivalence, even where the production of those benchmarks may be based on ESG factors.

3.47 **The government welcomes further views from stakeholders on whether other products and services produced by overseas firms who benefit from market access arrangements might be suitable for exclusion and/or whether the table below adequately reflects those overseas regimes that ought to be the focus of government consideration when deciding how best to set the parameters of this particular exclusion.**

Table 3.A.

Product / Service	Provision	Country / Territory-specific Decisions
Credit Ratings	Article 4, Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (Text with EEA relevance) (Retained EU legislation) Article 5.6, Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (Text with EEA relevance) (Retained EU legislation)	• https://www.fca.org.uk/firms/credit-rating-agencies/use-credit-ratings-uk • Commission Implementing Decision (EU) 2019/1279 • Commission Implementing Decision (EU) 2019/1280 • Commission Implementing Decision (EU) 2019/1283 • Commission Implementing Decision (EU) 2019/1284 • The Credit Rating Agencies Regulation Equivalence Directions 2020
Benchmarks	Article 51(5), Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014 (Text with EEA relevance) (Retained EU Legislation)	
Overseas Funds	Section 271A, The Financial Services and Markets Act 2000	• The Financial Services and Markets Act 2000 (Overseas Funds Regime) (Equivalence) (European Economic Area) Regulations 2024
Overseas Funds	Article 4A, Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds (Text with EEA relevance)	

Ancillary non-commercial provision

3.48 The government considers that it would be disproportionate to apply regulation to non-commercial activities undertaken as an integral part of academia, journalism, and charity.[18] Such activities can

[18] Charities covers charities registered in the UK.

incorporate or create ESG ratings, but do not lead to the systematic, business relationship provision of these ratings as the entity's primary activity (for example, a newspaper publishing as part of their general reporting an incidental article ranking ESG performance in various sectors, or an NGO producing a one-off quantitative evaluation of certain corporates).

3.49 In the interests of proportionality, an exclusion will apply to ESG ratings produced as an integral part of journalistic, academic, or registered charitable activity, except where the rating is provided on a business relationship basis separate to the person's activities as a journalist, an academic or a charity.[19] **To note, this proposed exclusion will be further tested for any loopholes that may be evident and will be reviewed accordingly.**

3.50 As per inserted article 63U(2)(b) in the draft SI, charities located overseas who are unable to benefit from the exclusion would only be in scope of the regulation when making their ESG ratings available by way of a business relationship, to a person located in the UK.

Ratings for internal use

3.51 Some financial services firms develop ESG ratings for the sole use of the firm (**'internal ratings'**) for instance, to support analysts as an orientation device to a sector or geography at the start of an investment process. Other financial services firms develop ESG ratings for the sole use of the firm and other entities within the same corporate group (so-called, **'intra-group ratings'**). As the former is a subset of the latter, the government has grouped the two together under the umbrella term 'intra-group ratings' and excluded them from the scope of regulation. The exclusion only applies where the ESG rating provider reasonably expects that the rating will not be made available to a third party outside the corporate group.

3.52 **'Bespoke/Private ratings'** are those whereby a single entity solicits a rating of itself from an external ESG ratings provider. The government has excluded these from the scope of regulation where the rating is provided only to the soliciting entity and their corporate group. The exclusion only applies if the ESG rating provider reasonably expects that the rating will not be made available to a third party outside the corporate group of the firm who has solicited the rating.

3.53 The government has taken this approach across these three categories of ratings because the main aim of the regulation is to promote transparency and management of conflicts for third party end-users of ratings where those ratings are likely to influence an investment decision. The government does not consider it

[19] Charities defined for the purposes of ESG ratings regulation include (a) in England and Wales, a charity registered under section 30(1) of the Charities Act 2011; (b) in Scotland, a charity registered under section 3 of the Charities and Trustee Investment (Scotland) Act 2005; (c) in Northern Ireland, a charity registered under section 16(2) of the Charities Act (Northern Ireland) 2008(c);

proportionate to intervene in the internal business processes of firms, particularly where ratings of this kind are not intended for external consumption.

Accreditation or certification

3.54 Accreditation or certification products, such as Energy Performance Certificate (EPC) ratings, will be excluded from the ESG ratings regulation where the rating is developed solely for such processes. This exclusion only applies where the purpose of the accreditation or certification is not to influence a decision to make a specified investment. This exclusion is present on the basis that such products do not systematically affect capital allocation.

Public authorities

3.55 Public authorities, central banks and international organisations will be excluded from the scope of regulation as there is no evidence to suggest that such entities produce ESG ratings by way of a business relationship, nor with intent to influence investment decisions.

Other exclusions

3.56 Some **external reviews** (e.g. second-party opinions, verifications) may be captured by the updated regulated activity definition, for example those that use a defined ranking system of rating categories. The government has not sought to introduce a specific standalone exclusion for such products given the evidence that some of these are likely to meet the regulated activity definition and are usually a standalone product, not captured elsewhere in the regulatory landscape.

3.57 **Proxy advisor services** – Respondents to the consultation noted that the primary purpose of these services is to advise investors' voting decisions, rather than providing ESG ratings per se. The updated regulated activity definition may not capture proxy advisor services (unless the ESG rating is provided as part of those services). The government will explore whether to exclude ESG ratings in the final SI where they are provided as part of proxy advisor services, rather than as a standalone product or service. The government notes that some proxy advisor services are already subject to regulation, although this is a notification regime that does not require FCA authorisation.[20]

[20] Shareholder Rights Directive | EUR-Lex (europa.eu)

Chapter 4
Territorial scope

Recap on original proposals from the Consultation

4.1 In the initial consultation, HM Treasury proposed to capture, at a minimum, the direct provision of ESG ratings to users in the UK, by both UK firms and overseas firms. This included direct provision to both institutional and retail users in the UK. These proposals did not capture the provision of ESG ratings by any UK or overseas firm to any user outside the UK.

4.2 'Direct provision' was defined as capturing ratings that are 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. It did not intend to capture ratings accessed for free by a UK user. The direct provision approach, applying both to UK and non-UK providers, was proposed to protect UK users from harm, and to create a level playing field for UK providers and non-UK providers.

4.3 The consultation welcomed views on exclusions for specific instances of direct provision and also sought views on the treatment of the indirect provision of ESG ratings to UK users. This refers to instances where there is not a direct contractual agreement with a UK user, but ESG ratings become available for UK use (with the same risks of harm). For example, where ESG ratings are made available by 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).

4.4 The second component of territorial scope relates to the implementation of overseas regimes, with a view to supporting interoperability between jurisdictions, thereby reducing undue regulatory burdens. The consultation paper noted the possible scope of using HM Treasury's market access framework to provide for recognition of appropriate overseas jurisdictions, where those jurisdictions introduce compatible regulation to the UK regime, and where there are appropriate cooperation mechanisms.

Question 12

Do you agree with the proposal to regulate the direct provision of ratings to users in the UK, regardless of the location of the provider?

4.5 HM Treasury received 75 responses to this question. 87% of respondents agreed with regulating the direct provision of ratings to UK users, regardless of the jurisdiction and location of the provider. Many noted that the direct provision approach provided optimal consumer protection for UK users of ESG ratings, as it ensures regulation of all ESG ratings made available to them. Respondents noted that regulating all providers regardless of their location would create a level playing field and support the competitiveness of UK ESG ratings providers. On the other hand, some respondents noted the risk of withdrawal from the UK market by overseas providers in response to regulation, reducing UK users' access to overseas ESG ratings.

4.6 A small proportion (7%) of respondents disagreed with regulating the direct provision of ESG ratings to users in the UK. The main concern raised by these respondents was the difficulty of knowing whether UK users are using the ratings. They also suggested the need for a clearer definition of 'user'. Some of these respondents noted the difficulty of regulating ESG ratings provided by overseas entities. These respondents argued that many ESG ratings are provided for free on web pages or via a subscriber model, without verification or registration of users. The remaining 6% of respondents had mixed views.

Question 13

(For UK users of ESG ratings) Are you concerned that this proposal would hamper the choice of ESG ratings available to you?

4.7 HM Treasury received 41 responses to this question. 44% of respondents were not concerned that the proposal to regulate direct provision of ratings to UK users, regardless of the location of the provider, would limit the number of ESG ratings available to them. 29% of respondents had concerns that regulating direct provision would affect consumer choice, while 27% had mixed views. Some respondents noted that most major financial centres are considering adopting regulation of ESG ratings, which might reduce the impact on consumer choice through market withdrawals.

4.8 Some respondents had concerns that regulating direct provision to UK users could reduce user choice, due to the increased costs of

complying with regulation. Respondents suggested that aligning the UK's approach with IOSCO's recommendations would reduce the risk of withdrawal of providers from the UK market. Some respondents also noted that over regulation may discourage innovation and market competitiveness, especially for smaller and newer ESG ratings providers.

Question 14

Should any instances of direct provision of ESG ratings to users in the UK be excluded from regulation (for example, the provision of ESG ratings to UK branches of overseas firms, or to retail users who are temporarily physically located in the UK)?

4.9 HM Treasury received 40 responses to this question. 30% of respondents suggested that there were no exclusions needed from the direct provision approach, 44% suggested some exclusions, and 26% of respondents made more general comments.

4.10 12 respondents suggested that certain instances of direct provision to UK users should be excluded from the scope of ESG ratings regulation, to ensure that regulation is proportionate and can be fully implemented. These included the provision of ratings to users only temporarily located or present in the UK, for example by making a 'permanent presence' in the UK part of the defined scope.

4.11 One respondent noted the infeasibility of the direct provision regulatory approach altogether, given the challenge of regulating overseas providers due to lack of visibility of end-users and the challenge of binding providers in overseas jurisdictions to the UK regulation where they do not have a registered presence in the UK. In a similar vein, another respondent suggested that ESG ratings providers that don't have bilateral contracts (i.e. paid agreements) with UK entities should be exempt, whilst noting the challenge of global (group-level) contracts.

4.12 A further respondent noted that any exclusion should not require ESG ratings providers to have sight of precise end use cases or validate users' self-reporting of their location. In connection with this, one respondent proposed excluding distributors and intermediaries, as it would be challenging to evidence compliance for a third-party product.

Question 15

Are there any scenarios of indirect provision of ESG ratings to UK users which should also be regulated?

4.13 HM Treasury received 36 responses to this question. 64% of respondents supported regulating certain scenarios of indirect provision of ESG ratings to UK users. 28% of respondents disagreed, and 8% were ambivalent.

4.14 The primary issue raised was the need to capture ESG ratings distributed by intermediaries – that is, firms which distribute but do not produce the original rating - whether a third party or an intra-group rating. Respondents noted this would present a significant loophole. Other respondents proposed that ESG ratings incorporated into any other products available in the UK, such as indexes, should also be regulated.

4.15 Respondents noted that users face the same risk of harm from ratings provided directly or indirectly. As in Question 12, one respondent also noted that free ratings should be included in regulation, for example when published on the internet, or provided indirectly (as part of a bundle or paid-for package). In these instances, respondents suggested designing the regulation to capture the activity rather than the entity.

Question 16

How would the territorial scope proposed in this chapter interact with initiatives related to ESG ratings in other jurisdictions, such as proposals for regulation or codes of conduct?

4.16 HM Treasury received 59 responses to this question. Almost all responses supported some degree of alignment of the UK's regulation with international standards, as a way of addressing possible market withdrawals and to reduce the regulatory burden. 71% of respondents encouraged regulatory harmonisation between the UK's approach and IOSCO recommendations, or other jurisdictions. A small number of respondents explicitly encouraged interoperability with the European Union's regulatory proposals for ESG ratings.

4.17 3% of respondents noted the option of the UK making market access decisions, which would recognise other jurisdictions' regulation of ESG ratings as equivalent to the UK's. 7% of respondents were

supportive of continued cooperation between jurisdictions developing similar regulations and 3% of respondents were keen to maintain a level playing field across other jurisdictional initiatives. 7% of respondents anticipated difficulties in achieving any effective territorial scope definition and subsequent compliance.

4.18 Respondents noted that the direct provision approach would place the UK in line with other jurisdictions such as the EU's proposal (as of June 2023). Many respondents also welcomed HM Treasury's acknowledgement that it would consider market access for overseas ESG ratings regimes. Respondents noted that this would produce down-stream positive effects for users of ESG ratings, given that lower compliance costs may translate to cheaper services.

Government Response

Territorial extent

4.19 The regulation of ESG ratings provision will be focussed on protecting users in the UK market from the greatest risks of harm. The scope of the regulation set out in the draft SI is designed to capture:

- UK firms providing ESG ratings to UK users by any means - this applies whether provided by way of a business relationship (paid for by the user, either on its own or as part of another service or bundle of products) or provided for free to users.
- Overseas firms providing ESG ratings to UK users by way of a business relationship (paid for by the user in the UK, either on its own or as part of another service or bundle of products). This reference to a business relationship means that for overseas ESG ratings providers, paid-for ratings and ratings that are provided as part of a broader commercial arrangement will be in scope, whether by a subscription model or any other contractual relationship, including as part of a bundle of products or services, to a person located in the UK.
- The scope is also designed to capture the provision of ESG ratings to non-UK users by UK firms. This was not proposed in the initial consultation but is designed to support confidence in the UK's growing ESG ratings sector, and to provide clarity to all market participants whether in the UK or outside.

4.20 This approach has been taken to capture as many ESG ratings provided to users in the UK market as possible in order to address potential harms and, where possible, to create a level playing field between UK and overseas providers. This approach is designed to capture the majority of ESG ratings provided to UK users, whilst reflecting the practicalities of regulating overseas providers.

4.21 As part of its design of the future regulatory framework for the provision of ESG ratings, the FCA is considering its approach to overseas ESG ratings providers applying for UK authorisation. This includes exploring whether, according to size, significance, or market impact in

the UK, an ESG ratings provider would be expected to be incorporated in the UK. The FCA are continuing to reflect on the most appropriate approach for overseas ESG ratings provision, including whether the best means of achieving this would be via existing Threshold Conditions, guidance, or some other means and will engage with firms to inform its policy thinking. This will form part of the FCA's consultation on the firm-facing rules under the ESG ratings regime.

4.22 The regulation is designed to capture only ESG ratings providers that produce and make available ESG ratings. It does not apply to intermediaries or distributors who merely distribute (but do not *produce*) the ESG rating in question. This contrasts with the initial proposal of regulating direct provision, which would have captured both distributors and providers.

4.23 An ESG rating provider who produces ESG ratings and then distributes them via a third party will be captured by regulation (because they will have *produced* the ESG rating and *made it available* to the distributor). The distributor in this scenario is not captured, as they have only *made the rating available* – they have not *produced* it. This applies both to UK and overseas ESG ratings providers, who distribute via an intermediary.

4.24 An overseas ESG rating provider who makes their rating available to a UK user via a third party located outside the UK will also be in scope of the regulation. This is in order to close a loophole whereby an overseas ESG ratings provider could seek to avoid regulation by producing an ESG rating that they then make available to a user in the UK via a separate distributor *outside* the UK. However, the overseas ESG rating provider in this scenario is only captured where they could reasonably have expected the ESG rating to be made available to a person located in the UK, whether via that separate distributor or another third party.

International alignment

4.25 The overwhelming majority of responses support a high degree of international alignment, to ensure proportionate regulation and mitigate regulatory frictions which might reduce provision and use of ESG ratings.

4.26 The government has incorporated this into the UK's regulatory regime by:

- Aligning definitions broadly with IOSCO's definition of ESG ratings provision which will help support global calibration.
- The FCA also intends to develop a regulatory regime that is informed by the IOSCO recommendations, aligning territorial approach with that of the European Union where appropriate, to facilitate maximum interoperability, without detriment to UK regulatory intentions.

4.27 The government is also considering the appropriate approach to third country regimes for inclusion in the legislation and exploring

other access routes into the UK for overseas providers (as an alternative to full UK authorisation). This could include market access regimes, and the government is reflecting on whether and when these could be used by overseas providers.

Chapter 5
Proportionality

Recap on original proposals from the Consultation

5.1 In its consultation, HM Treasury welcomed views on the benefits to be gained from improved transparency, governance, and processes of ESG ratings providers, regardless of the size of the provider. However, it also acknowledged that smaller providers may be disproportionately affected by regulation than larger ones, which could make it harder for them to compete. For instance, it may be more challenging for smaller providers to meet some of the conditions that regulation imposes as well as bearing its financial costs. Should regulation represent a considerable barrier to entry for smaller providers, they might also be disincentivised from entering the UK market. In addition, it is recognised that some smaller providers play key roles in driving innovation within the market. So, it is important to consider that firms can compete with one another, that market entry isn't unfairly disincentivised and that firms can innovate and develop new products, so that the market can continue to naturally evolve further.

5.2 Some ideas put forward within the consultation to address the question of proportionality included: ESG ratings providers of all sizes being subject to authorisation requirements under the RAO, with further enhanced requirements in FCA rules for larger providers. Alternatively, only ESG ratings providers of a certain size could be subject to authorisation requirements under the RAO, with smaller providers possibly being subject to requirements using other mechanisms, such as the Designated Activities Regime (DAR)[21] or a bespoke regime, without a requirement to seek authorisation. An opt-in mechanism was also proposed as a consideration. Such a mechanism would enable smaller providers to choose to be subject to full requirements or authorisation, like larger providers, allowing them to demonstrate to their users that they are meeting the same standards.

5.3 One of the questions linked to building a proportionate regime was how to effectively define a small provider. Views were therefore welcomed on how best to distinguish between sizes of provider. HM Treasury highlighted that if the best criteria for designation was considered to be by measurement of size, then the Companies Act 2006 definitions (see below tables) could be a suitable metric tool for categorisation. Factors in play to consider would be annual turnovers, balance sheets and employee headcount.

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[21] See Chapter 2, Financial Services and Markets Act 2023 (legislation.gov.uk)

Table 5.A Micro-entities under the Companies Act 2006

To be considered a micro-entity under section 384A of the Companies Act 2006, the firm must meet at least two of the following conditions:	
1. Turnover	Not more than £632,000
2. Balance sheet total	Not more than £316,000
3. Number of employees	Not more than 10

Table 5.B Small companies under the Companies Act 2006

To be considered a small company under section 382 of the Companies Act 2006, the firm must meet at least two of the following conditions:	
1. Turnover	Not more than £10.2 million
2. Balance sheet total	Not more than £5.1 million
3. Number of employees	Not more than 50

Question 17

Should smaller ESG ratings providers be subject to fewer or less burdensome requirements?

5.4 HM Treasury received 78 responses to this question. 64% of respondents agreed that smaller ESG ratings providers should be subject to fewer requirements. Of those respondents supporting this proposal, one of the main views offered was that this approach would support fair competition and encourage diversity and innovation. Please see Table 5.C for a general breakdown of respondents.

Table 5.C.

Respondent Type	Yes (agree)	No (disagree)
ESG ratings providers	16	9
ESG ratings users	8	5
ESG rated body	3	4
ESG consultants	6	1
Other	17	9
Total	**50**	**28**

5.5 Some respondents noted that larger ESG ratings providers, by the nature of their high volume of market activity, influence the financial market on a greater scale compared to smaller providers, and should therefore be subject to greater regulatory oversight. However, some respondents noted that a smaller ESG ratings provider could have a comparable volume of activity within the market, as to a larger ESG ratings provider by virtue of their influence, client base or reputation. Some respondents highlighted that fewer regulatory requirements for smaller providers should not advertently or inadvertently undermine the main focus of a regulatory regime, which is to help improve the quality and integrity of ESG ratings and their provision.

5.6 In general, respondents saw merit in a proportionate regime, that would subject smaller providers to fewer regulatory requirements, but did note that there might be a need for baseline regulatory standards to be established for this approach to be effective.

5.7 30% of respondents disagreed with the proposal for smaller ESG ratings providers to be subject to fewer regulatory requirements. Generally, those disagreeing with the proposal felt that the size of a ratings provider was not a relevant consideration and were unclear as to how being subject to fewer regulatory requirements would support integrity within the ESG ratings landscape. Some respondents highlighted concerns around the potential to create a two-tier system whereby smaller firms, subject to less rigorous regulation, could find themselves at a possible disadvantage as prospective users may only choose to work with fully regulated and authorised providers.

5.8 Some respondents suggested that if a regulatory regime was created on the principles of the four IOSCO recommended key regulatory outcomes (see page 11, Figure 1A) then this could help create a level playing field for all providers, regardless of a provider's size, and support core transparency and integrity in the provision of ESG ratings.

5.9 6% of respondents felt that the same rules, including the requirement to be authorised, should apply to all providers regardless of size, but in a proportionate way so as to limit any negative impact on the current diversity and innovation seen within this landscape and not hinder market competition.

Question 18

(For ESG ratings providers) What impact would an authorisation requirement have on your business? Please provide information on the size of your business when answering this question.

5.10 HM Treasury received 24 responses to this question. 54% of respondents cited their belief that there would be a significant impact upon their business, both from a financial and resourcing perspective, if they were required to seek authorisation to provide ESG ratings. Respondents highlighted the extra cost that requirements may bring, with suggested estimates that the additional financial cost of regulation to a provider could be as high as £500,000 per year. Other respondents highlighted that regulatory compliance could result in a reassessment of the profitability of their ESG ratings activities and their continued involvement with this activity.

5.11 21% of respondents predicted there would be minimal impact upon their business whilst 8% felt there would be a medium impact. 17% of respondents did not specifically articulate a level of expected impact.

5.12 Whilst not all respondents provided information on the size of their business, a recurring comment cited by those who believed there would be a significant impact upon their activity, was that small entities providing ESG ratings could feel significant financial and resource impacts, depending on the nature of the exact requirements. Respondents therefore reiterated that regulatory requirements could impede the profitability of smaller providers and, in turn, create a knock-on effect by negatively impacting innovation within this market.

5.13 Other concerns raised by respondents related to the timing and resource implications for providers of all sizes to become authorised. Respondents supported there being consideration given to allowing sufficient time to achieve authorisation.

5.14 Those respondents that predicted minimal impact from any authorisation requirements felt that this would be contingent upon regulatory requirements not being overly prescriptive and associated administration fees being minimal.

5.15 Respondents highlighted that if their firm were subject to regulation, in line with the four IOSCO recommended key regulatory outcomes, then they would see minimal operational impact, but they could still incur significant legal, compliance and financial impacts from the requirement to become authorised.

Question 19

Do you have any views on an opt-in mechanism for smaller providers?

5.16 HM Treasury received 55 responses to this question. Of those, 58% agreed with the concept of an opt-in mechanism for small providers, 18% of respondents disagreed with this concept, whilst 24% offered mixed or uncertain views.

5.17 Of the 58% of respondents who were supportive of an opt-in mechanism, there was generally an opinion that this would encourage market competition and innovation whilst also easing the impact on smaller providers aspiring to full authorisation but requiring more time and capacity to achieve the necessary standards.

5.18 Respondents who disagreed with an opt-in mechanism suggested that this could defeat the objective of introducing a regulatory perimeter as it would create an environment allowing unregulated providers to operate alongside regulated providers and create doubt in the minds of users as to the validity and merit of an unauthorised provider operating outside of the regulatory perimeter. Respondents were also concerned that such an approach would not encourage firms to meet a baseline of regulatory standards as some entities may choose to operate without authorisation.

5.19 Of respondents offering mixed views, there was opinion that smaller firms would be keen to choose to opt-in as it would allow them to demonstrate market credibility and an ambition to compete effectively with larger providers. Respondents also suggested that this mechanism could temper any shift amongst users towards favouring regulated providers, by providing the opportunity to opt-in and compete effectively within the market. One respondent suggested that an opt-in mechanism could be useful, but only as a temporary measure to ease the introduction of regulatory requirements.

Question 20

What criteria should be used when evaluating the size of ESG ratings providers?

5.20 HM Treasury received 45 responses to this question. 33% of respondents felt that the impact of an ESG ratings provider upon the market was the most effective criteria on which to base proportionality.

31% of respondents were of the opinion that annual turnover and number of employees was the criteria that should be considered. 20% of respondents felt that a suitable criterion would be the Companies Act 2006 definitions of micro-entities and small companies. 13% of respondents suggested that a provider's revenue, purely from ESG ratings-related activities, could be an effective criterion. 3% felt that any kind of criteria utilised would be too complicated to define.

5.21 Among those respondents who believed a provider's impact upon the market was the most suitable measurement on which to base proportionality, there was a suggestion that the total number of a provider's users could be the metric used to decide whether the firm is included within any regulatory perimeter. It was recognised among some respondents that a provider's influence and impact could be difficult to measure effectively and proportionally, and the size of client base could possibly be the only reasonable material metric of measure.

5.22 From those respondents supportive of turnover and staffing levels being used as criteria to measure a company's size, a question was raised as to whether such quantifications would cover UK operations only or would also quantify a company's global operation. Respondents also highlighted that the deployment of automation and AI-powered modelling to generate an ESG rating has impacted the workforce size of some providers – allowing for an increased capacity to deliver a high volume of ratings whilst minimising resources required.

5.23 Respondents voicing support for using a definition based upon the Companies Act 2006 felt that this could be used as a basis to adjust the level of regulation but should not be utilised as a metric to exempt any entity from regulatory requirements.

Question 21

What level could the criteria for small ratings providers be set at (i.e., how could 'small ratings provider' be defined)?

5.24 HM Treasury received 34 responses to this question. Of those, 38% indicated that the best criteria for defining a 'small ratings provider' was with reference to the Companies Act 2006 definition. 21% of respondents saw market impact (defined via the number of ratings provided) as being a suitable criterion for defining a small ratings provider. 18% of respondents felt that revenue from ESG ratings services provided should serve as a suitable criterion. 15% of respondents saw a combined measure of turnover and employee headcount as appropriate factors to consider. 9% of respondents were neutral or of mixed opinion.

The responses received to this question failed to specify a 'level' for defining a small ratings provider. Responses primarily reiterated

preferences as stated in response to Question 20. However, where respondents referenced the Companies Act 2006 as a suitable guiding criterion to use, respondents quoted use of the threshold figures provided as the best metrics available to evaluate a company's size.

Question 22

Is there anything else you think HM Treasury should consider in potential legislation to regulate ESG ratings providers?

5.25 There were 61 responses received to this question, with a majority of comments and considerations already reflected elsewhere within this consultation response. However, there were some new points were raised that are worth highlighting which are relevant to a future regulatory regime.

5.26 One suggestion was for the regulatory regime to endorse a 'double materiality' methodology being used when creating/providing ESG ratings. A double materiality assessment is a comprehensive evaluation that enables organisations to identify the ESG issues that are significant both to their operations and their stakeholders. This type of assessment can be viewed as instrumental in shaping an organisation's ESG strategy and in determining the prioritisation of its initiatives. It involves a thorough examination of the organisation's activities, as well as those occurring within its value chain - both upstream and downstream.

5.27 Another suggestion was to consider an approach whereby ESG ratings users are required to request and obtain 'comfort letters' from ESG ratings providers. This letter would confirm that the ESG ratings provider was exercising due skill, care, and diligence in their ratings provision processes. A further suggestion was to publish a list of regulated providers to reassure users that they are using the services of a regulatory-compliant ESG ratings provider. It should be noted that the FCA currently do hold such a register of authorised firms with the activities for which they have permissions. Moving forward, the FCA would expect to incorporate into the register those that will be authorised to provide ESG ratings.

5.28 Finally, some respondents were concerned about a perceived duopoly within the ESG ratings provision market and the risk that some users are focussed more on branding and market presences than ensuring that the ratings being provided are transparent and free of conflict-of-interest issues.

Government Response

5.29 The government, through analysis of responses and consultation with the FCA, has considered how proportionality can be most suitably

achieved. Appropriate exclusions (as discussed within Chapter 3) are significant in helping to achieve a degree of proportionality, along with a considered tailoring of the regulatory regime design to appropriately address the risks of harm posed by providers.

5.30 The government is keen to continue to encourage market competition whilst avoiding creating incentives for ESG ratings providers to structure themselves in a way that avoids regulation. The government considered whether fewer requirements for smaller providers would prove successful in promoting a diverse and innovative ESG ratings ecosystem, or alternatively incentivise ESG ratings clients/users to engage only with fully regulated providers.

5.31 The question of utilising an 'opt-in' mechanism within a regulatory regime was also carefully considered, in tandem with the option of a 'grace period' granted to smaller providers, which could allow for an extended timeframe to fulfil the necessary regulatory requirements to achieve full authorisation status.

5.32 Ultimately, save for firms that are subject to the exclusions set out in Chapter 3, the government has concluded that requiring all in-scope ESG ratings providers to be FCA authorised is the best option to achieve a fair and proportionate regulatory regime. This means that all firms in scope of regulation will be required to submit an application for authorisation and the FCA will apply a risk-based approach when assessing these applications. In addition, and as highlighted previously in Chapter 1, if a firm is providing an ESG rating as part of an existing regulated activity for which they already have permission, they will not be required to apply for an additional authorisation for providing ESG ratings. However, while dual authorisation is not desirable, the regulation of existing regulated activities may not fully address the risks of harm associated with ESG ratings. The FCA intend to review existing rules and guidance pertaining to other relevant regulated activities to assess whether, and where, standards may need to be enhanced, to help ensure a level playing field between all firms producing ESG ratings. Where a firm fails to comply with these standards, as with any FCA rule breach, the FCA will have the full range of its regulatory toolkit to take appropriate action.

5.33 It will be for the FCA to develop a forward looking, outcomes-based approach to the authorisation and supervision of ESG ratings providers as part of future regulation, following the amendments to the regulatory perimeter brought forward by the government, via the introduction of secondary legislation.

5.34 The FCA's approach to regulation is proportionate and evidence-based, prioritising key areas of focus and on firms that pose a higher risk to the FCA's statutory objectives. For example, under their supervisory approach, the FCA have heightened focus on firms with the greatest potential impact on consumers or their relevant markets. The FCA will carry out engagement with the market to assess risks and impact, to inform their proportionate approach.

5.35 Therefore, the FCA will consider proportionality as part of the development of the regulatory requirements for ESG ratings providers. As previously explained in paragraph 1.29, this will include carrying out a cost benefit analysis to assess the likely impact of the proposed requirements and whether the costs are proportionate to the benefits anticipated from the introduction of a regulatory regime for ESG ratings provision.

5.36 Regarding other considerations raised by respondents, the government notes the FCA set out in their feedback document on ESG integration in UK capital markets, FS22/4 ,the importance of ESG ratings being objective, independent and free from bias, determined as the result of a systematic process, and of reliable quality.[22] The FCA does not have any intention in its future regulation of ESG ratings to prescribe the contents of an ESG rating.

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22 https://www.fca.org.uk/publication/feedback/fs22-4.pdf

Chapter 6

Stakeholders and Contact

HM Treasury intends to lay the final SI in 2025, subject to Parliamentary time allowing. HM Treasury will consider technical comments on this draft SI, focused on any changes that need to be made to this draft instrument to achieve the outcomes the government seeks to achieve, as set out in this Consultation Response.

Any comments should be provided to ESGRatingsConsultation@HMTreasury.gov.uk by **14 January 2025**.

Processing of personal data

This section sets out how we will use your personal data and explains your relevant rights under the UK General Data Protection Regulation (UK GDPR). For the purposes of the UK GDPR, HM Treasury is the data controller for any personal data you provide in response to this consultation.

Data subjects

The personal data we will collect relates to individuals responding to this consultation. These responses will come from a wide group of stakeholders with knowledge of a particular issue.

The personal data we collect

The personal data will be collected through email submissions and are likely to include respondents' names, email addresses, their job titles, and employers.

How we will use the personal data

This personal data will only be processed for the purpose of obtaining opinions about government policies, proposals, or an issue of public interest.

Processing of this personal data is necessary to help us understand who has responded to this consultation and, in some cases, contact certain respondents to discuss their response.

HM Treasury will not include any personal data when publishing its response to this consultation.

Lawful basis for processing the personal data

The lawful basis we are relying on to process the personal data is Article 6(1)(e) of the UK GDPR; the processing is necessary for the performance of a task we are carrying out in the public interest. This task is consulting on the development of departmental policies or proposals to help us to develop good effective policies.

Who will have access to the personal data

The personal data will only be made available to those with a legitimate need to see it as part of consultation process.

We sometimes conduct consultations in partnership with other agencies and government departments and, when we do this, it will be apparent from the consultation itself. For these joint consultations, personal data received in responses will be shared with these partner organisations in order for them to also understand who responded to the consultation.

HM Treasury may share full responses to this consultation, including any personal data provided (such as your name and email address) with the Financial Conduct Authority (FCA) for the purpose of policy development. In some cases, the FCA may contact respondents to seek clarification on issues raised in their responses.

As the personal data is stored on our IT infrastructure, it will be accessible to our IT service providers. They will only process this personal data for our purposes and in fulfilment with the contractual obligations they have with us.

How long we hold the personal data for

We will retain the personal data until the consultation process has been completed and the policy is implemented. After this, we will only retain personal data if it is embedded in a response, but we will not use it for any unrelated purposes.

Your data protection rights

You have the right to:

- request information about how we process your personal data and request a copy of it
- object to the processing of your personal data
- request that any inaccuracies in your personal data are rectified without delay
- request that your personal data are erased if there is no longer a justification for them to be processed
- complain to the Information Commissioner's Office if you are unhappy with the way in which we have processed your personal data

How to submit a data subject access request (DSAR)

To request access to your personal data that HM Treasury holds, contact:

The Information Rights Unit

HM Treasury

Horse Guards Road

London

SW1A 2HQ

dsar@hmtreasury.gov.uk

Complaints

If you have concerns about our use of your personal data, please contact the Treasury's Data Protection Officer (DPO) in the first instance at privacy@hmtreasury.gov.uk

If we are unable to address your concerns to your satisfaction, you can make a complaint to the Information Commissioner at casework@ico.org.uk or via this website: https://ico.org.uk/make-acomplaint.

Annex 1
Consultation Respondents

(Individual respondents are not named)

ABRDN

Achilles Information Ltd

ADS

Aegon

AIC

AICPA & CIMA

AIMA

Babcock International

BAE systems

Baillie Gifford & Co.

Barclays

BeZero Carbon

Bloomberg

CDP

CEN--ESG Ltd.

Centrica

CFA UK

Chancery Advisors

Charities Aid Foundation

Chartered Governance Institute

Chemical Industries Association

CHP

Clarity AI

Confluence

Deloitte

DevlinMambo

EASRA

EcoVadis

EIRIS Foundation

ESG BOOK

Ethical Screening

FCA Financial Services Consumer Panel

Federated Hermes Ltd

FIA EPTA

Finance & Leasing Association

Financial Inclusion Centre

First Sentier Investors

FVOR

Glass Lewis

Hace

ICAEW

Iceberg Data Lab

ICMA

IEEFA

IIGCC (Institutional Investors Group on Climate Change)

Impak Analytics

Imperial Brands PLC

Intercontinental Exchange (ICE.COM)

International Regulatory Strategy Group

Invesco

Investment Association

The Investor Relations Society

ISDA/AFME

ISS

International Underwriting Association (IUA)

Kennedys

Lloyd's Market Association

LSEG

M&G

Main Street Partners

Manulife Investment Management

McQuhae & Co.

Minerva Analytics

Moodys

Morningstar

MSCI

Nationwide Building Society

North Peak Advisory

Phoenix Group

PIMFA

Planet Mark

Polymer Capital Management

Qinetiq

Queens University School of Law (Belfast)

Quilter

RightMove PLC

Rocca Investments

S&P GLOBAL

Schroders

Sizewell C Ltd

Square Mile Investment Consulting

SRI Services

Standard Ethics

Sustainable Fitch

SYLVERA

Tisa UK

U Impact

UKSIF

Vested Impact

Wesleyan Assurance Society

XPS Pensions Group

Yorkshire Building Society

HM Treasury contacts

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