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UK Government Opens Consultation on Future Regulatory Regime for ESG Ratings Providers

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In March 2023, the UK government launched a consultation on the future regulatory regime for environmental, social and governance (ESG) ratings providers. These providers compile, package and sell information to market participants about companies' ESG performance and risk. Recognising the growing use of these assessments by companies and consumers when making financial decisions, the consultation seeks to understand whether these assessments should be brought within the regulatory perimeter of the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

Setting the (green) scene

The consultation was launched against the background of the UK's updated Green Finance Strategy, which aims to mobilise private capital to assist the government in achieving its sustainability, environmental and climate goals (e.g., to deliver net-zero greenhouse gas emissions by 2050). In part, the government intends to achieve this by addressing concerns regarding the use of ESG assessments and ensuring that ratings providers use transparent methodologies, are well-governed and are void of conflicts of interest. The government believes these outcomes could be '**brought about through regulation**'.

Other consultations, nationally and internationally, have already concluded the same. For example, the FCA carried out its own consultation in 2021, which found that there was a '**clear rationale for regulatory oversight**' of ESG ratings providers. Other jurisdictions (e.g., the European Union, Japan and India) are either carrying out consultations or have already introduced voluntary codes of conduct.

Purpose of the consultation

When choosing to measure ESG impact, there are as many ESG methodologies as there are ESG ratings providers. Although this can be explained by the '**inherent multidimensionality**' of ESG ratings to an extent, stakeholders have raised concerns about some of the methodologies being '**opaque and lead[ing] to confusion**'. These potential risks can undermine confidence in ESG ratings and their usefulness and have prompted the government to consider whether the regulatory perimeter is appropriately set.

Under the UK's Financial Services and Markets Act 2000, a person can only carry out a regulated activity if it is authorised to do so by the appropriate regulator – like the FCA – or is otherwise exempt. One of the regulatory proposals for ESG ratings providers entails them being FCA-authorised, subject to meeting certain minimum conditions. This consultation seeks stakeholders' views on the impact of this potential legislative change.

The consultation is broken down into five sets of questions on the following topics:

- Whether regulation for ESG ratings providers should be introduced and the practical challenges that might arise as a result.
- How "ESG ratings" should be defined and the context(s) in which ratings providers should be regulated.
- Potential exclusions from the regulation (e.g., where an ESG assessment is created by a company solely for use by that company).
- The territorial scope of the regulation.
- How the regulation can be made proportionate to the risks that ESG ratings – and ratings providers – pose.

As discussed above, the UK is not the only country considering how to tackle the risks and reap the benefits arising from the use of ESG assessments. The consultation emphasises the need for international cohesion, and the FCA has already indicated that it would seek to follow the recommendations of the International Organization

of Securities Commissions (IOSCO) as a '**starting point**'. IOSCO recommends that any proposed regulation for ESG ratings and data should focus on:

- Transparency.
- Good governance.
- Management of conflicts of interest.
- Robust systems and controls.

Interestingly, the consultation notes that the FCA would not seek to '**harmonise the varying methodologies**' used by ESG ratings providers. Instead, the regulation would focus on ensuring that the methodologies used are transparent, including in respect of the individual underlying components assessed and the measurement objectives.

Next steps

The government is inviting stakeholders to respond to the consultation by 30 June 2023. Stakeholders are welcome to send their views in respect of all – or just some – of the questions.

If the government decides to extend the regulatory perimeter to incorporate ESG assessments, the FCA will likely carry out further public consultation, following its normal processes, at a later date.

Cooley comment

Although the proposals considered in this consultation are at an early stage, HM Treasury has stated that it considers there to be '**clear benefit**' from the introduction of regulation. In doing so, the government is not seeking to curb the influence of ESG ratings providers, but instead, it is seeking to ensure that their assessments can be properly relied on, thereby delivering better outcomes for the market and consumers alike. The government sees new regulation as an opportunity to boost four of its key objectives: net-zero emissions, consumer protection, international competitiveness and economic growth – mirroring the multidimensionality of ESG ratings in the multidimensionality of benefits it is seeking to achieve.

As ever, though, this is not without risks. The ESG assessment market, although growing, is still nascent, and the potential for overregulation to stymie innovation is real, especially as the market is currently dominated by two or three large players. If you could be affected by this potential regulation, we recommend responding to the consultation now, when it is at this early stage.

Cooley lawyers will continue to monitor this space. Please reach out to the authors or to your regular Cooley contact if you would like to discuss this further.

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Key Contacts

Fergal Duggan London	fduggan@cooley.com +44 (0) 20 7556 4225
Juan Nascimbene London	jnascimbene@cooley.com +44 (0) 20 7556 4558

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