HM Treasury

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

Consultation

March 2023

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This publication is available at: www.gov.uk/official-documents.

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ISBN 978-1-915596-81-9 PU 3300

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Foreword

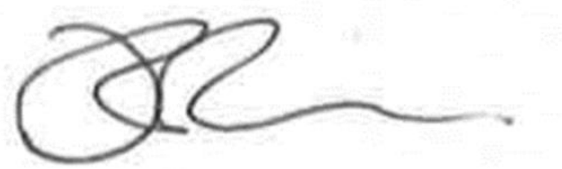
As a world-leading financial services centre, the UK's financial sector is both a significant pillar of our economy, supporting more than 2.5 million people across the UK, and is uniquely placed in its ability to support our commitment to meet net zero.

Today, the government has published an updated Green Finance Strategy, reinforcing our ambition for the UK to continue as a global leader in green finance. As part of that plan, we have published this consultation on regulating environmental, social and governance (ESG) ratings.

With projections that $33.9 trillion of global assets under management will consider ESG factors within three years, the importance of reliable ESG information is critical and growing. ESG ratings – which assess firms' management of ESG risks, opportunities, and impacts – are a key element of this. It is right for them to play their part in providing valuable insight to market participants. Providers of ESG ratings should be supported and encouraged to promote transparency and deliver strong outcomes for the benefit of UK markets and ultimately consumers. Developing the market for credible ESG ratings is a real opportunity to be seized by the UK, building on its strengths as an open, innovative, and sustainable global financial centre.

The potential new regulatory regime on which we are consulting – one of the first of its kind globally – would be designed to deliver these aims. Any future regulation would need to be proportionate and clear, allowing firms to innovate and grow while maintaining standards of good practice. It should also be aligned with international standards and the UK's partners.

I look forward to receiving feedback on these proposals, to help us build a cutting-edge, robust, and reliable ESG ratings sector in the UK.



Baroness Penn, Treasury Lords Minister

Chapter 1
Introduction

1.1 Environmental, social, and governance (ESG) factors increasingly matter in financial markets. In fact, of the £10 trillion worth of assets under management in the UK in 2021, nearly half (47%) had integrated ESG into the investment process.[1] This growth is expected to continue across jurisdictions, with predictions that assets under management globally will reach $33.9 trillion by 2026.[2] Consumer demand is an important contributing factor to this trend – research shows consumers increasingly want more sustainable financial products and services.[3]

1.2 As the consideration of ESG factors increases, firms and consumers increasingly rely on related services, such as ESG ratings and data. ESG ratings can be described as assessments of the ESG characteristics of entities, such as companies and sovereigns; or of products, like financial instruments. ESG data is data on the same, but with no final assessment or value judgment. These services are used in different ways, including incorporating sustainability-related factors into investment decision-making. This means such ESG-related services have a growing impact on investment decisions and therefore capital allocation.

HM Treasury objectives

1.3 In 2019 the UK became the first major economy in the world to legislate to introduce a binding target to reach net zero greenhouse gas emissions by 2050. Private investment will be crucial to delivering this net zero target, building climate resilience, and supporting nature's recovery. That transition will see trillions of pounds reallocated, and managing this capital is a significant opportunity for UK financial and professional services.

1.4 The government today published an updated *Green Finance Strategy*. This outlines a refreshed green finance policy framework and sets out details of ambitious work to ensure the UK's green finance policies come together to achieve an efficient pathway to net zero across the economy.

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[1] Investment Management Survey 2021-22 full report.pdf (theia.org)

[2] Up from $18.4 trillion in 2021. ESG-focused institutional investment seen soaring 84% to US$33.9 trillion in 2026, making up 21.5% of assets under management: PwC report

[3] https://www.ey.com/en_gl/consumer-products-retail/make-sustainability-accessible-to-the-consumer

1.5 The government has previously set out its approach to supporting the financial services sector in aligning with environmental goals in *Greening Finance: A Roadmap to Sustainable Investing.* That Roadmap recognised the growing use of ESG ratings and data in the UK, and noted that the government would consider bringing these products into the regulatory perimeter.

1.6 This perimeter is the scope of firms and activities which are regulated by the financial services regulators, including the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). It is set by HM Treasury in legislation, as the government department responsible for financial services policy. In this capacity, HM Treasury seeks to improve financial services regulation to protect consumers and to promote the UK's position as a world-leading financial services centre. More broadly, HM Treasury wants to achieve strong and sustainable growth of the economy as a whole, with financial services as one of the UK's key growth sectors.

1.7 These broad objectives – the government's wider aims of greening finance and HM Treasury's aims for the financial services sector and the economy – guide government thinking about ESG ratings and data. As a result, in December last year, the Chancellor announced as part of the Edinburgh Reforms that the government wants to improve transparency and promote good conduct in the ESG ratings market. To explore the best way to promote those outcomes, HM Treasury is now consulting on a potential regulatory framework for ESG ratings providers.

Rationale for regulation

1.8 ESG ratings can cover a wide range of things. For example, an ESG rating can assess an entity's exposure to, and management of, ESG risks (such as flooding risk) and/or ESG opportunities (such as trends like clean technology). Alternatively, it can assess an entity's impact on wider ESG matters (such as a company's impact on air quality due to its carbon emissions). ESG ratings are sometimes compared to credit ratings, but they are inherently multidimensional, unlike credit ratings which focus on only the creditworthiness of an entity or financial instrument.

1.9 As set out above, ESG ratings, are increasingly influential. Research shows that a change in an ESG rating of an entity can lead to responses in financial markets.[4] In 2020, 65% of institutional investors were found to use ESG ratings at least once a week.[5] This influence becomes more material when firms embed ESG ratings into their investment processes (e.g., in benchmarks and indices, or in investment

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[4] The Economic Impact of ESG Ratings by Florian Berg, Florian Heeb, Julian F Kölbel :: SSRN

[5] Rate the Raters 2020 Report (sustainability.com)

mandates). It is amplified further when it comes to the largest ESG ratings providers – an informal survey of UK users found that all of them used the services of the single largest provider.[6]

1.10 Despite their increasing prominence, market participants have raised concerns about ESG ratings. Some challenges raised are in relation to ESG ratings providers' methodologies and objectives, which can be opaque and lead to confusion about what a rating implies. There are other concerns about how an ESG ratings provider interacts with the rated entity. For example, there may be potential for conflicts of interest where an ESG ratings provider also provides advice to the rated entity on how to improve that rating; or scenarios where the dialogue between a rating provider and rated entity could be improved. These issues can affect market confidence.

1.11 In a consultation paper on climate-related disclosures and ESG in capital markets (CP21/18), the FCA asked market participants about the case for regulatory oversight of ESG ratings and ESG data providers.[7] As summarised in the FCA's feedback statement (FS22/4), respondents agreed with the areas identified by the FCA as posing potential harm from the provision of ESG ratings and ratings-like products. These include a lack of transparency, poor governance and systems and controls, poor management of conflicts of interest, and issues related to engagement with the rated entity. On this basis, and considering its statutory objectives,[8] the FCA has concluded it sees a clear rationale for regulatory oversight of certain ESG ratings and data providers when their products are used in financial markets.[9]

1.12 Internationally, both the International Organization of Securities Commissions (IOSCO) and the Organisation for Economic Co-operation and Development (OECD) have recommended regulators pay more attention to ESG ratings and data.[10] Specifically, IOSCO set out recommendations for how authorities could enable ESG ratings and data providers to deliver high-quality and independent products, whilst appropriately addressing conflicts of interest. The OECD highlighted ways in which policy and practice could be improved to help ESG ratings support the low-carbon transition and sustainable growth.

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6 ESG integration in UK capital markets: Feedback to CP21/18 (fca.org.uk)

7 CP21/18: Enhancing climate-related disclosures by standard listed companies and seeking views on ESG topics in capital markets (fca.org.uk)

8 The FCA's strategic objective is to ensure relevant markets function well. Its operational objectives are to: protect consumers from bad conduct, protect the integrity of the UK financial system, and protect effective competition in the interests of consumers.

9 FS22/4: ESG integration in UK capital markets | FCA

10 FR09/2021 Environmental, Social and Governance (ESG) Ratings and Data Products Providers (iosco.org); and ESG ratings and climate transition: An assessment of the alignment of E pillar scores and metrics | en | OECD

1.13 Momentum is also growing in individual jurisdictions. In 2022, the European Securities and Markets Authority (ESMA) conducted a call for evidence to gain a better understanding of the ESG ratings market in the EU.[11] Japan's Financial Services Agency (FSA) published a voluntary code of conduct for ESG ratings and data providers operating within Japan.[12] Most recently, the Securities and Exchange Board of India (SEBI) published a consultation paper seeking views on a regulatory framework for ESG rating providers.[13]

1.14 Considering industry concerns, international initiatives, and the FCA's view, HM Treasury recognises that growing reliance on unregulated ESG ratings, particularly in investment decisions, can raise risks. This can impact both the performance of investments and the credibility of the sustainable investment market. **Therefore, HM Treasury considers there is clear benefit to be gained from improving the transparency of methodologies, governance, and processes of ESG ratings providers. These outcomes could be brought about through regulation.**

1.15 Such regulation creates an opportunity for the UK to deliver on four of the government's objectives – net zero, consumer protection, UK international competitiveness, and economic growth. Ensuring good regulatory outcomes for ESG ratings can build confidence in these products and the wider sustainable investment market. This can support the transition to net zero by helping investors understand whether and how their money is supporting the transition or other ESG goals. Better ESG ratings would benefit consumers, who are often the end-users of investment products that increasingly rely on ESG ratings. As one of the first jurisdictions planning to introduce such regulation, this provides an opportunity for international leadership by the UK, which can act as a blueprint for others. Finally, a robust ESG ratings market can help support the sustainable growth of the UK economy.

1.16 Both the scope of who any potential regulation applies to, and the regulatory requirements themselves, should be targeted and proportionate to the risks that ESG ratings pose. This is important also because the ESG ratings market is relatively nascent and will continue to develop. As such, HM Treasury is seeking views on the best way to ensure a proportionate but effective scope of regulation in the UK.

1.17 HM Treasury recognises that ESG data may raise some similar risks to ESG ratings. However, as ESG data is less processed than ESG ratings and does not include an assessment, the greatest risk of harm is judged to arise from unregulated ESG ratings (see the 'ESG data'

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[11] ESMA launches Call for Evidence on ESG ratings (europa.eu); ESMA publishes results of its Call for Evidence on ESG ratings (europa.eu)

[12] Finalization of "the Code of Conduct for ESG Evaluation and Data Providers" (fsa.go.jp)

[13] SEBI | Consultation Paper on ESG Disclosures, Ratings and Investing

section in Chapter 2). Therefore, the proposed focus of this consultation is on ESG ratings specifically.

Purpose of the consultation

1.18 The UK's approach to financial services is based on the Financial Services and Markets Act 2000 (FSMA). The FSMA model delegates the setting of regulatory standards to the expert, operationally independent regulators – the FCA and PRA – within an overall policy framework set by government and Parliament.

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

1.20 In addition, through the Financial Services and Markets (FS&M) Bill, HM Treasury is legislating to create a new Designated Activities Regime (DAR). When an activity has been designated, any person conducting that activity will be required to follow rules for it, unless they are exempt. However, unlike regulated activities under the RAO, the DAR will not involve an automatic authorisation requirement. The RAO and the DAR are key components of the regulatory perimeter.

1.21 In line with this model, if regulation for ESG ratings was to be brought forward, it would be for HM Treasury to introduce legislation to amend and expand the regulatory perimeter. This is expected to be done through an amendment to the RAO, which would require firms brought into the perimeter to become FCA authorised and to meet specified Threshold Conditions.[15] That is because the checks conducted at authorisation are considered necessary to appropriately regulate these entities. This could also involve legislation under the DAR once the FS&M Bill reaches Royal Assent, or other legislation, for a sub-set of firms. The FCA, as the appropriate regulator for markets, would then set firm-facing requirements in their rules. This consultation seeks input to inform the first stage of that process – amending the RAO, and any other legislative changes

1.22 The consultation seeks views on initial policy proposals. As such, it does not include settled positions or proposed legal drafting, which will be worked up using input from this consultation, if HM Treasury decides to pursue regulation for ESG ratings providers.

[14] The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (legislation.gov.uk)

[15] See Schedule 6 to FSMA 2000 Financial Services and Markets Act 2000 (legislation.gov.uk)

1.23 In summary, the core policy proposal set out in this consultation is that the following activity is brought into regulation: **the direct provision of an assessment of environmental, social, or governance factors to a user in the UK, where the assessment is used in relation to a specified investment in the RAO, unless an exclusion applies.** Further activities may also be brought into regulation, including some cases of indirect provision of these assessments, and where these assessments are used in relation to certain things other than RAO specified investments.

1.24 If HM Treasury extends the regulatory perimeter to include ESG ratings providers, then the FCA would be expected to conduct a cost-benefit analysis and to consult on any new requirements for these providers, following its normal processes. Considering international momentum, consistency with international standards and other jurisdictions is vitally important to avoid the risk of fragmentation. Therefore, HM Treasury expects that any requirements would be developed taking into account international developments, in particular the recommendations provided by IOSCO.

1.25 The FCA has indicated that, subject to consultation, they anticipate their regulatory approach would take the main elements of IOSCO's recommendations as a starting point for rules. This is outlined in Figure 1.A below. The FCA would not seek to harmonise the varying methodologies and objectives of ESG ratings as a regulatory outcome. The government supports this approach, given the inherent multidimensionality of ESG ratings.

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

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

1.26 HM Treasury and the FCA will consider how any new requirements in this area fit in with existing regulatory regimes. Views are welcome from respondents on whether there are areas where new regulation on ESG ratings could overlap with existing regulation, such as the UK Benchmarks Regulation, and what the effects of this would be.

Questions for Respondents

1. Do you agree that regulation should be introduced for ESG ratings providers?
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.
3. Are there any practical challenges arising from overlap between potential regulation for ESG ratings providers and existing regulation?
4. Are there any other practical challenges to introducing such regulation?

Chapter 2

Description of ESG ratings and their provision

2.1 Ratings of ESG matters come in many different forms.[16] There is also a broad range of terminology in this space – not all ESG ratings use the term “rating”, they can also be called a score, mark, assessment, opinion, solution, etc. 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.

2.2 If the regulatory perimeter were amended, HM Treasury’s intention would be to capture a wide range of ESG ratings used in financial markets, regardless of their name or how they are marketed. As such, **HM Treasury proposes that 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.**

2.3 This proposed approach is deliberately broad and includes any environmental, social, or governance characteristics. This intends to include any assessments, regardless of their self-identification (i.e., whether they are called “ratings”, “scores”, “marks”, or anything else, including where market participants currently consider these to be data products). The scope intends to include ESG assessments which are directly produced by analysts, as well as assessments which are generated through an algorithm. That is because development of an algorithm is assumed to involve a human assessment – for example, selecting which criteria should be considered and how they should be weighted in the final rating. A broad scope would also help ensure the regulatory framework applies to new products which may be developed in the future.

2.4 This concept of an ESG rating would be tied to use in financial markets, as covered in the Providing an ESG rating section below.

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[16] For a sample overview of ESG ratings and data products, see FR09/2021 Environmental, Social and Governance (ESG) Ratings and Data Products Providers (iosco.org) pages 8-10.

ESG data

2.5 **HM Treasury's proposed scope excludes data on ESG matters where no assessment is present.** As such, raw data that is unprocessed is not included. This scope should also not include data which is only minimally processed, for example by formatting or summarising, so long as there is no separate assessment provided. This proposed exclusion would also encompass estimates and proxy data, such as those which aim to fill gaps in a data set.

2.6 The reason for excluding ESG data is that the biggest risk of harm, and the most substantial issues identified by market participants and international authorities, are linked to the presence of an assessment. The content of data – even which is formatted or summarised – is inherently more transparent than a rating which relies on a final evaluation. The methodologies used to create a rating are more likely to be complex and opaque than those of pure data products. A final ESG rating is also likely to be more subjective and vary more widely between providers than data.

2.7 Some of the same risks of harm do arise with ESG data, for example relating to interaction with the entities on who the rating or data is provided. However, ESG-data specific initiatives are expected to help address some of the issues particularly relevant to ESG data. This includes plans to introduce sustainability-related corporate reporting standards aligned with the International Sustainability Standards Board (ISSB) as set out in the government's Greening Finance Roadmap, and the Net-Zero Data Public Utility initiative, which would allow all stakeholders free access to key climate transition-related data.[17] As more firms report ESG data in line with new standards and initiatives, the need for data estimates is expected to reduce. Therefore, in this case, HM Treasury considers regulation should be tailored to the greatest potential risk of harm from ESG ratings only.

2.8 HM Treasury and the FCA will continue to monitor the ESG data market and engage with market participants to understand whether further intervention may be necessary. In the meantime, a voluntary Code of Conduct for ESG rating and data providers is being developed by an industry working group.[18] This Code of Conduct is expected to be in line with IOSCO recommendations, and as such may have some similarities with potential FCA regulation. Providers who fall outside the scope of potential regulation, such as providers of pure ESG data products, could adopt this Code of Conduct.

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[17] Net-Zero Data Public Utility (nzdpu.com)

[18] ESG Data and Ratings Code of Conduct Working Group | IRSG

Providing an ESG rating

2.9 HM Treasury seeks to address risks raised by the material influence of unregulated ESG ratings on decisions related to financial services in the UK. As such, regulation to address these risks should capture the provision of ESG ratings when they are used for a broad range of activities which relate to financial services. This includes (but is not limited to) investments like 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.

2.10 If the regulatory perimeter were extended by an amendment to the RAO, this would be captured by developing a new regulated activity. Regulated activities ordinarily need to be carried on by way of business in relation to an investment set out in Part III of the RAO ("specified investments").[19] The list of specified investments includes a wide range of investments related to financial services. To fit with the proposal of a broad scope, **HM Treasury therefore proposes that the new regulated activity would cover providing an ESG rating to be used by persons in the UK in relation to an RAO specified investment.**[20]

2.11 This proposed approach requires ESG ratings providers to understand how the ESG rating they are providing is being used. This may be through agreements such as contractual relationships between an ESG ratings agency and a user, including licensing agreements (for example benchmark indices) or tailored services (for example metrics targeted at regulated disclosures).

2.12 There are ESG ratings of other things which may not be clearly in scope of specified investments, such as some voluntary carbon credits. HM Treasury will consider whether these kinds of ESG ratings should be accounted for within the scope of this regulation or through other channels.

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[19] The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (legislation.gov.uk).

[20] For an overview of specified investments, see PERG 2.6 Specified investments: a broad outline - FCA Handbook.

Questions for Respondents

5. Do you agree with the proposed description of an ESG rating?
6. Do you agree that ESG data, where no assessment is present, should be excluded from regulation?
7. Do you agree with the proposal to regulate the activity of providing ESG ratings to be used in relation to RAO specified investments?
8. (For ESG ratings providers) Do you know when an ESG rating you provide will be used in relation to a specified investment?
9. Are there ESG ratings used in relation to anything other than an RAO specified investment which also should be included in regulation?

Chapter 3
Exclusions

3.1 The RAO specifies exclusions for when carrying on a regulated activity does not require authorisation. This is to ensure that the scope of regulation is appropriate and proportionate. There are a number of potential exclusions related to the provision of ESG ratings which HM Treasury considers could be appropriate.

3.2 HM Treasury proposes that the regulated activity would not involve the provision of ESG ratings by not-for-profit entities. Therefore, if a provider is a registered charity in the UK, or a registered not-for-profit entity in another jurisdiction, then HMT's proposal is that they should be exempt from authorisation and regulatory requirements under the new regime. Views are welcome on whether this would raise any issues where not-for-profit entities provide ESG ratings as the core of their activities.

3.3 HM Treasury also thinks it may not be appropriate to include ESG assessments where ratings are created by an entity solely for use by that entity. Excluding them should help ensure proportionality for firms like asset managers, who may create their own ratings for internal use only, such as to make investment decisions.

3.4 However, scenarios exist where a firm creates ratings for their own internal use as well as for external use (i.e. the firm sells on these ratings, as a standalone product or as part of a bundle of products). These scenarios should not be subject to the exclusion. Firms may also produce ESG ratings to be used by other entities in their group ("intra-group ratings"). Views are welcome on whether such ratings should be regulated.

3.5 There are other related activities which HM Treasury considers could also be excluded from the regulated activity. That is because they can be conceived of as distinct from the provision of an ESG rating and therefore a different approach to them is warranted. As such, HM Treasury proposes to exclude:

- Credit ratings which consider the impact of ESG factors on creditworthiness. That is because these products are already subject to requirements under the Credit Ratings Agencies Regulation.[21]

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[21] Credit rating agencies | FCA

- Investment research products, such as equity research reports. These are established products which may incorporate ESG considerations, but which are different to the ratings of only ESG matters which HM Treasury wants to capture.

- External reviews, including second-party opinions, verifications, and certifications of ESG-labelled bonds. These activities can raise 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 appears to be more appropriate mechanism.[22]

- Consulting services, even where these relate to ESG matters. That is on the understanding that, if consulting services involve ESG ratings, these are often bespoke and 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 Initial Public Offering (IPO), should be subject to regulation.

- Academic research or journalism, even where that relates to ESG matters. Those are distinct activities which should not be subject to financial services regulation in this case.

3.6 However, where a firm engages in or provides the above activities or products, but also regularly provides ESG ratings for use in relation to specified investments (as described in Chapter 2) as a separate activity, then the provision of the ESG ratings would be in scope of regulation.

Questions for Respondents

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

11. Are there any other exclusions which should be provided for?

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22 Proxy advisors | FCA

Chapter 4
Territorial scope

4.1 The requirement for a person to be FSMA-authorised only applies when they carry out a regulated activity "in the United Kingdom". However, determining the location in which an activity is carried out varies according to the nature of that activity. In the case of ESG ratings, **HM Treasury proposes to capture, at a minimum, the direct provision of ESG ratings to users in the UK, by both UK firms and overseas firms**. This includes direct provision to both institutional and retail users in the UK. This would not capture the provision of ESG ratings by any UK or overseas firm to any user outside the UK.

4.2 'Direct provision' intends to capture where an ESG rating is provided to a UK user who has paid for that rating, either on its own or as part of another service or bundle of products. It does not intend to capture scenarios where a UK user accesses a free rating. HM Treasury welcomes views on whether there are any scenarios in which direct provision of ESG ratings to a UK user should be excluded from regulation.

4.3 The overall approach is motivated by HM Treasury's desire to address the risk of harm to UK users from unregulated ratings. These risks can arise whether an ESG rating is provided by a provider located in the UK or in another country. Such an approach is in line with a number of other areas of the UK's regulatory perimeter and would likely be necessary since UK users can (and do) easily obtain ESG ratings which are provided by overseas providers. If overseas providers were not in scope, then regulation may not provide the appropriate protection for UK users. Furthermore, a definition which only captures providers located in the UK could result in a situation where firms could move offshore to easily evade UK regulations but still serve UK customers. This would create an unlevel playing field for providers based in the UK.

4.4 If other jurisdictions introduce similar regulation to that which would be present in the UK, and where there are suitable cooperation mechanisms, HM Treasury will consider whether to expand its deference framework to provide for the recognition of equivalent overseas regimes.

4.5 Like the link to specified investments described in Chapter 2, this proposed approach relies on the assumption that providers understand who the users of their ESG ratings are and where they are located. This may be information that is provided as part of the normal running of an ESG ratings business.

4.6 There may be further scenarios that HM Treasury wishes to include in the scope of regulation, such as some instances of indirect provision of ESG ratings to UK users. For example, this could be where an ESG ratings provider does not have a contractual agreement with a UK user, but its ESG ratings become available to UK users anyway (for example via intermediaries). Or, it could be 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 use an 'issuer-pays' model and that provider, or the rated firm who is the issuer, makes that rating available to UK investors). This will require careful consideration to ensure a workable territorial scope.

4.7 Whether firms carrying out these activities would be required to have a physical presence in the UK in order to obtain authorisation is for the FCA to determine and under consideration. This is expected to be informed by the FCA's existing framework for international firms and based on the nature and scale of the firm's activities, and the risks of harms the activities could cause.[23] The detail of any such requirements would be subject to full FCA consultation.

Questions for Respondents

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?
13. (For UK users of ESG ratings) Are you concerned that this proposal would hamper the choice of ESG ratings available to you?
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)?
15. Are there any scenarios of indirect provision of ESG ratings to UK users which should also be regulated?
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?

[23] https://www.fca.org.uk/publication/corporate/approach-to-international-firms.pdf

Chapter 5

Proportionality

5.1 The ESG ratings market is varied and evolving, including firms of different sizes. Estimates of the number of providers vary, ranging from over 150 major ESG data providers (some of which also provide ratings) in 2020,[24] to 30 significant ESG ratings and data providers in 2022.[25] Further research suggests that the top three providers made up circa 60% of the market.[26]

5.2 The FCA has also pointed out in its feedback statement (FS22/4) that the market is growing rapidly, with new firms entering the market as well as consolidation of firms through mergers and acquisitions. This presents a picture of a market with several big, influential providers who provide ESG ratings that are widely used, and many smaller providers.

5.3 HM Treasury considers there are benefits to be gained from improved transparency, governance, and processes of ESG ratings providers, regardless of the size of the provider. However, smaller providers may be more disproportionately affected by regulation than larger ones, which can make it harder for them to compete. Smaller providers are more likely to struggle to meet some of the conditions that regulation imposes as well as its costs, such as paying FCA fees and meeting the FCA's Threshold Conditions. Should regulation represent a considerable barrier to entry for smaller providers, they might also be disincentivised from entering the UK market. In addition, smaller providers play a key role in driving innovation in the market. It is important 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 evolve further.

5.4 Appropriate exclusions (as discussed in Chapter 3) and tailoring are also particularly important considering the intended breadth of the regulated activity. For these reasons, HM Treasury intends that the regulatory regime for ESG ratings providers should be proportionate and is considering how proportionality for smaller providers could be ensured. This could take a number of forms. For example:

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24 Sustainable investing: fast-forwarding its evolution (kpmg.com)

25 ESG Ratings and ESG Data in Financial Services – A view from practitioners (irsg.co.uk)

26 ESG Data is Now Worth it (opimas.com)

- ESG ratings providers of all sizes could be subject to authorisation requirements under the RAO, with further enhanced requirements in FCA rules for larger providers; or
- Only ESG ratings providers of a certain size could be subject to authorisation requirements under the RAO. Smaller providers could be subject to requirements using other mechanisms, such as the DAR or a bespoke regime, but these would not require authorisation

5.5 To foster competition if smaller providers were subject to more proportionate requirements, an opt-in mechanism could also be considered. 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 clients that they are meeting the same standards. An opt-in mechanism could therefore help prevent larger providers from retaining a perceived competitive advantage of being subject to full requirements or FCA-authorised.

5.6 HM Treasury welcomes views on the impact that requiring authorisation, meeting of the Threshold Conditions, as well as any other ongoing requirements (were they in line with the IOSCO recommendations), may have on smaller providers.

Defining small providers

5.7 There is no single definition in legislation of a small firm. The Companies Act 2006 sets out one set of definitions for micro-entities as well as small companies. These definitions are summarised in Table 4.A and Table 4.B below.[27] Other definitions exist elsewhere, including those that are tailored to specific financial services firms.

Table 4.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

[27] Further detail, including exclusions, is set out in the Companies Act 2006. Companies Act 2006 (legislation.gov.uk).

Table 4.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

5.8 Both smaller and larger providers provide ESG ratings with similar objectives and, at times, methodologies. Therefore, it is difficult to distinguish between ESG ratings providers based on the products they provide, and size of the provider is likely to be a more useful metric.

5.9 Views are welcome on an appropriate way to distinguish between smaller providers of ESG ratings and larger ones. This involves understanding the best criteria to measure size – that is, whether it is using one or more of the following: turnover, balance sheet total, number of employees, or another metric. It also involves understanding the appropriate level for these criteria to be set, to distinguish between smaller ESG ratings providers and larger ones. Finally, views are welcome on whether proportionality should apply on any other grounds, beyond just size of the firm.

Questions for Respondents

17. Should smaller ESG ratings providers be subject to fewer or less burdensome requirements?
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.
19. Do you have any views on an opt-in mechanism for smaller providers?
20. What criteria should be used when evaluating the size of ESG ratings providers?
21. What level could the criteria for small ratings providers be set at (i.e., how could 'small ratings provider' be defined)?
22. Is there anything else you think HM Treasury should consider in potential legislation to regulate ESG rating providers?

Chapter 6

Responding to this consultation

6.1 This consultation sets out a proposed policy approach to bringing ESG ratings providers into the UK regulatory perimeter. The government will carefully consider the responses received and use these to inform a response. If taken forward, further technical consultations will be issued by the FCA on specific firm rules.

6.2 This consultation will close on 30 June 2023. The government is inviting stakeholders to provide responses to the questions set out above. Responses are welcome from all stakeholders, including ESG ratings providers, ESG data providers, users of ESG ratings, trade associations, representative bodies, academics, legal firms, and consumer groups. Respondents are welcome to send views in response to all, or just some, of the questions in this consultation.

6.3 Please send responses to ESGRatingsConsultation@hmtreasury.gov.uk.

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
1 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-a-complaint.

HM Treasury contacts

This document can be downloaded from www.gov.uk

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gov.uk