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Editorial Office

729 15th Street, NW, Suite 500, Washington, D.C. 20005
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Articles and Submissions

Direct editorial inquiries and send material for publication to:

Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway, #18R, Floral Park, NY 11005, smeyerowitz@meyerowitzcommunications.com, 631.291.5541.

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Environmental, Social, and Governance Ratings: United Kingdom Confirms Regulatory Regime

Nicola Higgs, Rob Moulton, Becky Critchley, and Charlotte Collins*

In this article, the authors explain that the UK's regulatory regime for environmental, social, and governance ratings providers will have broad reach, although its implementation will likely take several years.

On 14 November 2024, the United Kingdom, through HM Treasury, laid out the future UK regulatory regime for environmental, social, and governance (ESG) ratings providers.[1] It previously consulted on proposals for the new regime in spring 2023.

HM Treasury has now confirmed:

> With the global ESG market predicted to surpass $40 trillion by 2030, 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.

New Regulated Activity: Providing ESG Ratings

Secondary legislation will be introduced to expand the regulatory perimeter in the FSMA (Financial Services and Markets Act) 2000 (Regulated Activities) Order 2001 (RAO) to capture the activity of providing ESG ratings, including ratings produced in the United Kingdom and ratings produced overseas that are made available to UK users by way of a business relationship.

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Affected ESG ratings providers will need to obtain authorisation from the UK Financial Conduct Authority (FCA) and comply with the regulatory regime, as prescribed by the FCA. In a nod to the international momentum on this topic and in order to avoid fragmentation, HM Treasury expects future FCA rules to be informed by the International Organisation of Securities Commissions (IOSCO) 2021 recommendations,[2] with the regulatory outcomes focused on promoting transparency, good governance, management of conflicts of interest, and robust systems and controls.

The draft Statutory Instrument,[3] which was open for technical comments until 14 January 2025, 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.

ESG Rating

Key definitions in the draft Statutory Instrument, relevant to what will constitute providing an ESG rating under the new regime, are as follows:

- *ESG Rating*: "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."
- *ESG Opinion*: "an ESG rating involving substantial analytical input from an analyst, whether or not it is characterised as an ESG opinion."
- *ESG Score*: "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."
- *Established Methodology*: involves techniques and procedures systematically utilised to identify, collect, analyse, and interpret data in order to produce a rating.
- *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.

- *Made Available*: includes, but is not limited to, "providing to another person in hard-copy or electronic form or publishing on a website or other digital medium."

The UK government has confirmed its 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).

Further Guidance on Scope

A key policy objective of the UK government is to capture ESG ratings that are "likely to influence" a decision to make an RAO-specified investment. Examples include:

- A rating that is likely to be used to inform asset allocation and portfolio construction (except if the ESG rating provider could not reasonably have expected the rating to influence a decision to make a specified investment); and
- Pre-initial public offering ratings, since these ratings can be reasonably expected to be likely to influence a decision to make a specified investment.

HM Treasury has decided not to introduce a stand-alone exclusion for external reviews such as second-party opinions and verifications, which it acknowledges may be captured by the updated regulated activity definition, such as those that use a defined ranking system of rating categories.

Exclusions

The set of exclusions in the draft Statutory Instrument focus on the relevant activity, rather than the entity conducting the activity.

- *Regulated Products and Services*: The "regulated products and services" exclusion has been created to exempt firms from needing to apply for permission to provide ESG ratings where they create an ESG rating as part of the development and delivery of another regulated activity for which they are authorised. If 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 stand-alone product or service. This exclusion applies in respect of any product or service that is regulated by the FCA (notably, funds, benchmarks, research, and credit ratings). 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 providing ESG ratings. This is perhaps the most notable shift between HM Treasury's consultation and the proposed Statutory Instrument, since it indicates that even if firms do not require a new regulatory permission, they may still need to comply with new FCA conduct of business rules around the provision of ESG ratings. The FCA's forthcoming consultation therefore will be significant for all regulated firms who incorporate ESG ratings into their products or services.

- *Ancillary Non-Commercial Provision*: An exclusion will apply to ESG ratings produced as an integral part of journalistic, academic, or UK-registered charitable activity, except if the rating is provided on a business relationship basis separate to the person's activities as a journalist, an academic, or a charity. Charities located overseas that are unable to benefit from the exclusion would only be in scope of the regulation when making their ESG ratings available to a person located in the United Kingdom by way of a business relationship.
- *Ratings for Internal Use*: These ESG ratings are produced for the sole use of the firm and/or other entities within the same corporate group (so-called intra-group ratings). The exclusion would apply only if the ESG ratings provider reasonably expects that the rating will not be made available to a third party outside the corporate group.
- *Bespoke/Private Ratings*: This exclusion applies if a single entity solicits a rating of itself from an external ESG ratings provider. The government plans to exclude these ratings from the scope of regulation where the rating is provided only to the soliciting entity and their corporate group. The exclusion will apply only 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.

- *Accreditation or Certification*: Accreditation or certification products, such as Energy Performance Certificate ratings, will be excluded from the ESG ratings regulation if the rating is developed solely for such processes. This exclusion will apply only if the purpose of the accreditation or certification is not to influence a decision to make a specified investment.
- *Public Authorities*: Public authorities, central banks, and international organisations will be excluded from the scope of regulation as no evidence exists to suggest that such entities produce ESG ratings by way of a business relationship, nor with intent to influence investment decisions.

The government will explore whether to exclude ESG ratings in the final Statutory Instrument that are provided as part of proxy advisor services, rather than as a standalone product or service.

Distributors of ESG Ratings

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 regime.

Jurisdictional Scope

The UK ESG ratings regime is intended to capture:

- *UK Firms*: providing ESG ratings to UK and non-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 United Kingdom, either on its own or as part of another service or bundle of products).

By capturing overseas firms, HM Treasury has maintained its proposals for a regime with an unusually wide territorial scope. However, non-UK providers who act in good faith—for example, by restricting UK distribution/use—will not be in scope as a result of a UK user inadvertently gaining access to that provider's rating.

Unusually for firms requiring FCA authorisation, the FCA is exploring whether, according to size, significance, or market impact in the United Kingdom, an ESG ratings provider would need to be incorporated in the United Kingdom (or not). This will form part of the FCA's consultation on the ESG ratings regulatory regime.

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 this regime could be introduced for overseas providers.

Timing

The overall process of designing, developing, and commencing the ESG ratings regulatory regime in the United Kingdom is expected to take approximately four years, so firms that consider themselves in scope of the UK proposals have some time to consider their global ESG rating distribution strategy, which will necessarily require waiting for more information from both HM Treasury and the FCA on their plans for overseas ratings providers.

Notes

* The authors, attorneys with Latham & Watkins LLP, may be contacted at nicola.higgs@lw.com, rob.moulton@lw.com, becky.critchley@lw.com, and charlotte.collins@lw.com, respectively.

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