THE
INVESTMENT
ASSOCIATION

IA views on HMT draft statutory instrument on the future regulatory regime for Environment, Social and Governance (ESG) ratings providers

14 JANUARY 2025

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £9.1 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 49% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

Introduction

On 14 November, HMT published a draft statutory instrument on the future UK regulatory regime for Environment, Social and Governance (ESG) ratings providers. This secondary legislation will be introduced to expand the regulatory perimeter in the FSMA 2000 (Regulated Activities) Order 2001 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. Once the draft legislation is law, the FCA will then have the powers to develop a regime to regulate ESG ratings providers.

The IA welcomes the opportunity to respond to HMT's draft statutory instrument. As stated in our June 2023 response to the original consultation, overall, we support the development of a regulatory framework for ESG ratings providers and welcome the demand for greater transparency of objectives sought, methodologies adopted and quality assurance processes put in place by sustainability-related ratings and also ESG data providers.

Sustainable and responsible investment continues to be a dominant theme for the investment management industry. Although, as highlighted in the IA 2023-2024 Investment Management Survey, in the UK we have seen the waning of retail investor demand for sustainable investment strategies through 2023 as performance challenges have affected investor appetite. That said, funds and mandates with a focus on sustainability account for 10% of assets under managements (AUM) and a key requirement of forming sustainable and responsible investment strategies is access to high-quality sustainability-related data and

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ratings. ESG data and ratings providers therefore play an essential role and provide information and services that are material to investment decisions.

We agree that bringing ESG ratings providers under the regulatory perimeter is the most robust way to address the significant challenges and concerns our members face when procuring ESG ratings (and data).

This response expands below on the following parts of the draft legislation:

- Scope and exclusions
    - Asset managers internal ratings
    - Ancillary non-commercial provisions (journalist, academic and charities)
- Definitions of 'ESG ratings' and 'ESG scores'
- Future reviews to include ESG data providers

1. Scope/exclusions

Asset managers internal ratings

It is our understanding from reading the draft legislation that it is HMT's intention for intra-group ratings to be out of scope of the legislation but only where the rating is not made available to a third party outside the corporate group (paragraph 63W). An 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 (paragraph 63V (1)(a)) for which they are authorised, as long as the provision of that rating is not a standalone product or service.

The above would suggest that where asset managers disclose ESG ratings to clients as part of the asset management service, given clients would be considered third parties, asset manager proprietary ratings provided to third parties, so clients in this case, regardless of what form and in what manner, would be in scope and the exclusion provided in the draft legislation only means asset managers wouldn't have to apply for permissions to provide a rating. This interpretation is also what seems to be stated by the Government in paragraph 3.40 of the response to the 2023 consultation where it states, '*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.*'

This seems to leave it open for the FCA to require asset managers to comply with additional rules subject to an assessment of the appropriateness of existing standards - they just would not have to apply for permissions.

In our response to the 2023 consultation, we conveyed how investment managers proprietary scoring systems can be used in a number of ways and gave a number of scenarios that should be out of scope of the ESG rating providers regulatory framework. We disagree with the position the Government has come to if our interpretation above is correct. Furthermore, if a fund manager develops their own in house methodology under the FCA Sustainability Disclosure Requirements (SDR) regime to meet the criteria to have a robust, evidence-based standard of sustainability, which is then disclosed to investors as an ESG rating (regardless of what it is called), there is a risk with the draft legislation that this scenario would not be covered by any exemption, i.e. the firm would be classed as an ESG rating provider and would have to comply with the rules that follow. An in-house rating would only be excluded where it is kept entirely in house and not disclosed externally. This however contradicts current transparency requirements under SDR which require the disclosure of the details regarding standard of sustainability including the basis on which

the standard is considered appropriate. It seems unreasonable that fund managers, as a result of complying with the SDR regime, would then fall in to scope of being an ESG rating provider as part of their regulated activities when disclosing how they are selecting and assessing, rating and ranking investments and where it is their own in-house methodology or a combination with external rating providers.

There are other scenarios that we think would be caught by the legislation that should not be. For example:

- Some firms, for example platforms, are providing free ESG tools to other firms/clients to use for them to personally "rate" and rank their investments according to selected ESG data criteria. ESG data is provided/pulled through based on externally provided ESG data and rating information which is then used by users (via the platform) to then rate and rank their investments according to, e.g. best carbon rated etc. There is a concern that the platform is somehow providing an ESG rating "tool" (and is an ESG rating provider) that will be relied upon by users for investment decisions based on underlying data which is rating and ranking their investments according to methodology.
- Asset managers could be impacted where ESG ratings are provided to index providers when creating tailored indices for the fund's benchmark. Whilst the exemption covers ratings produced for regulated products, it is unclear whether this is only where the provider already has permission to do this. Some of our members don't have permission as a benchmark administrator to create indices.

Also, regarding the provision by asset managers of proprietary ESG ratings to third party/external platforms and the subsequent 'making available' to users of those platforms – it is unclear who is 'making available' the data. For instance, where asset managers participate by providing proprietary data (and ratings) to external platforms that was produced in the course of a regulated activity, but is made available to users via the platform itself, what are the implications for the asset manager and platform? Under the rule, who is 'making available' the data? Is the intention that the provision of this information would then capture the asset manager as an ESG rating provider – or would it apply to the platform? How does the chain of activity capture the asset manager (if at all)?

Prior to the draft legislation being finalised, we would like clarification from HMT on our above interpretation. We do not agree that where a rating is used as part of fund marketing, it should be in scope of the legislation. Investment firms are already regulated entities, and investment products are also subject to extensive regulation, for example, disclosure requirements around methodologies used, including value assessment requirements and Consumer Duty requirements. The ultimate distinction is that ratings are not the product in itself, but a means to achieving a desired investment outcome. In this sense, they are similar to proprietary credit ratings or internal stock ratings that firms utilise for portfolio construction purposes. Proprietary ESG ratings used for product purposes should be treated in the same way as those ratings utilised in mainstream investment products, irrespective of whether they are disclosed to clients, at product level or not disclosed at all.

Ancillary non-commercial provisions (journalist, academic and charities)

The draft legislation provides a specific exclusion for ancillary non-commercial provision:

Paragraph 63Y - *A person does not carry on an activity of the kind specified by article 63U by providing an ESG rating as an integral part of their activities as a journalist, an academic or a charity, except where the rating is provided* <u>*by way of a business relationship separate to the person's activities as a journalist, an academic or a charity*</u>*.*

In the main, we agree that activities of journalists, academics and charities should be excluded from scope.

However, it is our members' feedback that the phrase underlined above, in particular 'by way of a business relationship', is not clear enough and needs to be further explained/expanded to ensure that it is consistently applied and well understood by the market.

We agree that the legislation should avoid bringing into scope those organisations whose ratings are not paid for by users, unless they are otherwise funded by third parties for the purpose of their assessments being used in this way by users or funded for the purpose of utilisation by investors. This would help in distinguishing charities who are intentionally, and financially benefitting from, providing rating/opinion for investors from those that are not.

We also want to emphasise that without a clear exemption, the regulation risks applying to organisations that did not intend for investors to rely on their assessments as formal investment 'ratings'. This, in turn, risks reducing available information from these organisations that is relevant for the public good, promoting good practice, and supporting corporate accountability.

2. Definitions

In this section, we comment on the definitions for 'ESG rating' and 'ESG score'.

'ESG Rating'

The draft legislation proposes the following definition of 'ESG rating':

'Interpretation 63ZB. In this chapter [ ] "ESG rating" means 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;'

In our consultation response, we urged HMT to ensure alignment of the ESG ratings with international descriptions, most notably that of IOSCO. Since that response in June 2023, the EU legislation on the regulation of ESG rating providers has been finalised. We need to ensure that the UK legislation covers both providers that are rating from an ESG profile (or impact of ESG factors on value) and those that are rating from an impact perspective. Therefore we propose the following change in bold to the definition of an ESG rating to reflect this as well as to align with the EU definition.

"ESG rating" means an assessment regarding ***a rated item's profile/characteristics and/or exposure to risks or impact in relation to*** *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;*

As we noted in our 2023 response, it is important to recognise that ESG ratings do not all measure the same thing or do so in the same way. It is necessary to allow differences in approaches, provided rating providers are clear on what is being assessed. For instance, one provider may assess the financial risk posed to a company from ESG factors (i.e. single materiality), while another may assess the impacts a company has on the environment and society (i.e. double materiality). This is one of the main differences between ESG ratings. Given different ESG investors may want to focus on one or the other, there should not be a push to pick only one of these objectives. However, rating providers should always make clear to users of their ratings what is actually being assessed – and do so in a way that is simple, transparent, and easy to use.

'ESG score'

We note the draft legislation does not cover the regulation of the provision of ESG data. However, it is still not entirely clear exactly what is in scope and what is not from the definitions provided under section 63ZB. For example, with the definition of an 'ESG score', it is not clear if an Implied Temperature Rise (ITR) metric or a Climate Value at Risk (CVaR) metric from a data provider would be in-scope of the legislation. Both make an *assessment* ("evaluation or value-judgement") about an ESG matter using a pre-establish statistical or algorithmic system or model. However, both of these metrics are more logically thought of as ESG data rather than as ESG Ratings. Does HMT intend for datasets such as these ones to be in-scope?

3. Future provisions for ESG data providers

As stated above, we note the draft legislation does not cover the regulation of the provision of ESG data. Our 2023 response stated we do not think that ESG data should be excluded from scope of the legislation and provided examples where several types of ESG data may seem like raw/reported data but actually embed assessment or value judgement.

Therefore, we propose the following addition in bold to Part 6, review section of the draft legislation:

7.—(1) The Treasury must from time to time —

(a) carry out a review of this Order ***including whether providers of data products on ESG factors should be included in the scope of the Order****, and*

(b) publish a report setting out the conclusions of the review.

End.