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# ESG Initiative From FCA Likely To Inform Future Regulation

By **Ferdisha Snagg and Andreas Wildner** (January 11, 2023, 9:15 AM GMT)

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The booming environmental, social and governance data and ratings sector includes a broad range of products and services. Broadly, ESG data is raw or processed ESG-related information about an entity or financial product.

ESG ratings provide assessments of the ESG profile or ESG exposure of an entity or financial product, e.g., scores, rankings and evaluations. Such products are playing an increasingly important role in financial markets.

Financial markets regulators, including the U.K.'s Financial Conduct Authority, have not failed to notice this phenomenon or to take stock of the potential risks to the efficient functioning of markets and investor protection.

As a first step toward addressing the concerns, the FCA announced the formation of a working group to develop a voluntary code of conduct for ESG data and ratings providers on Nov. 22 last year. The International Capital Market Association and the International Regulatory Strategy Group have been appointed as the working group's secretariat.

The working group will comprise a range of stakeholders including ESG data and ratings providers, rated entities and investors. It will report to the FCA once a draft code has been written but, otherwise, the development of the code will remain industry-led and industry-owned.

Considering the policy rationale for the code and the direction of travel of regulation in the sector, this article explains why the code may not in reality be voluntary and discusses some of the ways in which market participants can address the implications of the code for their businesses.

**The Evolving Regulatory Landscape**

Many investors, in particular financial services firms now routinely integrate ESG considerations into their investment activities. Financial services firms are also constantly expanding their offerings of ESG-focused products, such as ESG-labeled debt instruments or funds.

It is not surprising, therefore, that ESG data is becoming a key factor in respect of investment and capital allocation decisions, and that market participants are increasingly reliant on ESG data and ratings.

Yet the activities of ESG ratings and data products providers generally fall outside the scope of U.K. regulation.

The rapid growth of the largely unregulated market for ESG data and ratings provision creates risks of harm, both for individual consumers and for the integrity and functioning of markets generally.

Observing the lack of consistency among ESG ratings issued by different providers, the FCA has highlighted concerns in relation to:

- Lack of transparency of methodologies and interpretability of ratings, which may result in consumers being unable to interpret ratings or being misled as to allocation of capital;

- Insufficient governance structures to ensure proper controls and that methodologies are subject to ongoing review and validation; and

- Conflicts of interests, such as in cases where rating providers also provide other services, e.g., consulting services on how issuers can enhance their ratings.[1]

These concerns are also reflected in the FCA's proposals on sustainability disclosure requirements and related guidance.[2]

These include guidance that:

- Where an FCA-authorized firm relies exclusively or largely on ESG data services provided by a third party to make judgments about ESG matters for a sustainability product, it should disclose this in precontractual materials;[3] and

- In carrying out due diligence on data, research and analytical resources, including when third-party ESG data service providers are used, an FCA-authorized firm should:

    - Assure the quality and fitness for purpose of data, research and analytical inputs by conducting appropriate model validation and data governance;

    - Understand how data and research inputs are sourced and derived, including relevant methodologies, and consider carefully how any gaps and limitations in such inputs may hinder achievement of the product's stated objectives.[4]

The FCA has therefore concluded that there is "a clear rationale for regulatory oversight of certain ESG data and rating providers."[5]

HM Treasury shares the same view. On Dec. 9, the U.K. chancellor of the exchequer confirmed that, within the first three months of 2023, HM Treasury will consult on bringing ESG ratings providers into the regulatory perimeter.[6]

The policy actions of the FCA and HM Treasury are paralleled by initiatives of regulators in other jurisdictions, such as the call for evidence on market characteristics for ESG-rating providers in the EU issued by the European Securities and Markets Authority,[7] as well as recommendations from the International Organization of Securities Commissions.[8]

**Why a Code of Conduct**

The code initiative takes account of the potentially long lead time for an extension of the regulatory perimeter. The FCA intends that the timely development of the code will help build trust in the market, protect market integrity and promote effective competition.

It hopes that by bringing together the expertise of key stakeholder groups within the ESG data ecosystem, the code will be comprehensive, proportionate and globally consistent. The code would be structured around the key outcomes of transparency, good governance and management of conflicts of interests.[9]

This initiative is not the first time that U.K. authorities have employed the instrument of a code of conduct, and have positioned such a code as a global standard. A notable example is the FX Global Code,[10] a set of principles of good practice for FX, or foreign exchange, market

participants to promote the integrity and effective functioning of the global wholesale FX market.

The code was created following the Fair and Effective Markets Review, published by the FCA, HM Treasury and the Bank of England in 2015 to reinforce confidence in the wholesale fixed income, currency and commodities markets.[11]

In 2017, the FCA published a consultation on industry codes of conduct setting out a framework for the FCA's recognition of particular codes of conduct that, in the FCA's view, set out proper standards of market conduct for unregulated markets and activities.[12]

In July 2018, the FCA implemented its proposals in form of a policy statement.[13] The FCA has since recognized four industry codes, including the FX Global Code.

**Will the Code of Conduct in Reality Be Voluntary?**

It may be questioned whether the code, given the voluntary nature of its adoption or compliance with it, could really be effective to address the harms identified by the FCA.

However, it would be wrong to consider the code to be completely voluntary in the sense of not creating any risk for ESG data and rating services providers, bearing in mind the ultimate aim of U.K. authorities to introduce regulatory oversight of the ESG data and ratings sector.

Market participants should therefore be aware of the potential risks arising from the creation, and likely FCA recognition, of the code. Leaving aside likely commercial pressure to commit to the code, key risks in this respect are regulatory as well as litigation risks.

The FCA's recognition of a code of conduct has a bearing on its approach to enforcement in the relevant area. In particular, under the senior managers and certification regime, senior managers and other individuals within the scope of the FCA's individual conduct rules are required to "observe proper standards of market conduct."[14]

This applies to both regulated and unregulated activities that relevant individuals undertake in the course of their employment and mirrors principle 5 of the FCA Principles for Businesses — a firm must observe proper standards of market conduct.[15]

While the FCA will not take action based solely on a breach of provisions in market codes, whether recognized or not, individuals, and their regulated firms, should consider market codes in determining such proper standards and may be evaluated by reference to such market codes.

It is also worth noting that where a recognized code exists, it is relevant to all parties undertaking unregulated activity within the code's scope, irrespective of whether they are signatories to the code.

Moreover, the code is likely to inform future regulation. If a firm decides not to adhere to the code, it would merely be delaying the inevitable, and potentially be giving itself less time to develop, and if necessary iterate, an appropriate compliance program.

Litigation risk may arise where, in the circumstances, certain types of reference to the code result in enforceable obligations. This could be, for example, in situations where an ESG data or ratings provider enters into a contract that is governed by or subject to the code, in which case a court may hold that the requirements under the code have been incorporated into the contract as express terms.

Alternatively, the requirements of a code of conduct may also give rise to enforceable obligations in the form of terms implied into a contract. In addition, where the code is referred to in marketing materials, claims in misrepresentation or negligent misstatement could potentially be brought.

Compliance with the code is likely to offer the best mitigation against such risks. Therefore, market participants should keep up to date on legal and regulatory developments relevant to the code and its recognition. Indeed, it is likely to be in their best interest for firms to engage with the process of developing with the code as much as possible.

Once the code has been adopted, firms, especially ESG data and ratings providers, will likely need to develop and implement a program of compliance, including gap analyses to identify and

remedy any shortcomings in their governance, systems and controls, as well as training to support the embedding of the code's standards within the organization's culture.

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[1] See FCA, "Enhancing climate-related disclosures by standard listed companies and seeking views on ESG topics in capital markets", Consultation Paper 21/18, June 2021, accessible at https://www.fca.org.uk/publication/consultation/cp21-18.pdf, para 4.49.

[2] FCA, "Sustainability Disclosure Requirements (SDR) and investment labels", Consultation Paper 22/20, October 2022 (the "SDR Consultation", accessible at https://www.fca.org.uk/publication/consultation/cp22-20.pdf.

[3] SDR Consultation, Appendix 2, para 7.

[4] SDR Consultation, Appendix 2, para 13.

[5] FCA, "ESG integration in UK capital markets", Feedback Statement 22/4, June 2022, accessible at https://www.fca.org.uk/publication/feedback/fs22-4.pdf, para 1.4.

[6] See Statement UIN HCWS425 made on 9 December 2022, accessible at https://questions-statements.parliament.uk/written-statements/detail/2022-12-09/hcws425.

[7] https://www.esma.europa.eu/sites/default/files/library/esma80-416-250_call_for_evidence_on_market_characteristics_for_esg_rating_providers_in_the_eu.pdf. ESMA subsequently sent a letter to the European Commission regarding the outcome of the call of evidence, accessible here.

[8] IOSCO, "Environmental, Social and Governance (ESG) Ratings and Data Products Providers Final Report", November 2021, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf.

[9] See Terms of Reference of the ESG Data and Ratings Code of Conduct Working Group, accessible https://www.fca.org.uk/publication/documents/drwg-terms-of-reference.pdf.

[10] FX Global Code, 19 November 2021, https://www.globalfxc.org/docs/fx_global.pdf.

[11] https://www.fca.org.uk/news/news-stories/fair-and-effective-markets-review-published.

[12] FCA, "Consultation Paper on Industry Codes of Conduct and Discussion Paper on FCA Principle 5", Consultation Paper 17/37, November 2017, https://www.fca.org.uk/publication/consultation/cp17-37.pdf.

[13] FCA, "Industry Codes of Conduct and the Feedback on FCA Principle 5", Policy Statement 18/18, July 2018, https://www.fca.org.uk/publication/policy/ps18-18.pdf.

[14] FCA Handbook, COCON 2.1.5R.

[15] FCA Handbook, PRIN 2.1.1R.

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