Published on *The National Law Review* https://natlawreview.com

Financial Conduct Authority Publishes Draft Voluntary Code of Conduct for ESG Ratings and Data Product Providers

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On July 5, an industry-led working group convened by the UK's financial regulator published a draft voluntary code of conduct for ESG data and ratings providers (the Code). The Code would apply to all companies based in the UK that compile the ESG ratings of different firms. The development of the Code is part of the UK's wider green finance strategy and comes a year after the Financial Conduct Authority (FCA) announced the launch of its consultation.

The Working Group comprises the International Capital Market Association (ICMA) and the International Regulatory Strategy Group (IRSG) and is co-chaired by M&G, Moody's, the London Stock Exchange Group and law firm Slaughter & May. Over the course of developing the Code, the Working Group met with regulators in other jurisdictions including Singapore, Japan and Canada.

In order to demonstrate consistency with international standards, the Code is based on recommendations made by the International Organization of Securities Commissions (IOSCO). IOSCO's recommendations form the basis of six Principles (each underpinned by a series of actions) in the Code, which in turn are focused on four outcomes:

- **Good governance:** Ensure appropriate governance arrangements are in place to enable companies to promote and uphold the Code.
- **Systems and controls:** Adopt and implement written policies and procedures designed to ensure companies issue high-quality ratings and data.
- **Management of conflicts of interest:** Identify, avoid or appropriately manage, mitigate and disclose actual or potential conflicts of interest that may compromise the independence and objectivity of operations.
- **Transparency:** Make adequate levels of public disclosure and transparency a priority. This includes methodologies and processes to enable users to understand the product and associated conflicts of interest while maintaining a balance with any proprietary or confidential information, data and methodologies.

The Working Group is currently running a consultation on the Code that is due to close on October 5, 2023. It is envisaged that the final version will be published by the end of the year.

In parallel, HM Treasury has been assessing whether ESG ratings providers should be brought within the FCA's regulatory perimeter. If that occurs, the FCA will be required to draft and introduce applicable regulations. In the short-term therefore, the Code will provide the requisite guidance, consistency and transparency for investors and stakeholders. If the FCA is selected as the regulator for ESG ratings and data providers, the Code will nonetheless continue to apply to out-of-scope firms.

Taking the Temperature: We have previously discussed **the growing demand for regulation of the ESG ratings market and its importance to facilitating ESG-related investment.**

The development of the draft Code coincides with the announcement **that the European Commission, as part of its sustainable finance package, proposed regulation of EU ESG ratings providers, as** we have discussed**. The Commission proposes measures to prevent obvious conflicts of interest, such as prohibiting ratings providers from providing consulting services to investors or the sale of credit ratings. The regulation also "provides requirements on disclosures around" ratings methodologies and objectives, and "introduces principle-based organizational requirements on" provider activities. Under the EU's proposed regime, providers would be authorized and supervised by the European Securities and Markets Authority. The movement toward regulation, reflects the lack of consistency among ESG ratings providers and the absence of established industry norms relating to disclosure, measurement methodologies, transparency and quality of underlying data – issues also cited in a** recent study**. For instance, earlier this year MSCI** announced significant changes **to its ESG investment fund ratings methodology that "aim to raise the requirements for a fund to be assessed as 'AA' or 'AAA' rated, improve stability in Fund ESG Ratings and add transparency through simpler attribution analysis." However, these changes will result in downgrades to 31,000 of the funds currently rated by MSCI.**

National Law Review, Volumess XIII, Number 207

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