UK Finance

Response to HM Treasury on

Draft Statutory Instrument: The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2024

January 2025

UK Finance is the collective voice for the financial services industry. Representing 300 firms, we are a centre of trust, expertise and collaboration at the heart of financial services, championing a thriving sector and building a better society.

We welcome the opportunity to respond to HM Treasury's draft Statutory Instrument (SI) – The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2024 Activities) (Amendment) (No. 2) Order 2024.

Our members strongly support the regulation of Environmental, Social and Governance (ESG) ratings providers. Assessments of ESG factors are used for investment decisions and influence capital allocation, and we agree with HM Treasury's assessment that proportionate regulation will improve clarity and trust in ESG ratings.

To help improve quality and assurance before the implementation of the new regulatory regime for ESG ratings, UK Finance participated in the Data and Ratings Working Group (DRWG) to develop the voluntary Code of Conduct for ESG Ratings and Data Products Providers.

Given the short timeframe to respond to the draft Statutory Instrument (SI), our response reflects a segment of our members' views on the proposals but does not fully incorporate all perspectives of UK Finance's wider membership. As such, we would appreciate further opportunity to engage with the government and FCA as the regime is developed.

Our detailed comments in response to the SI are contained in the Annex.

Below, we also set out general comments on the new regulatory regime, which HM Treasury and the FCA should consider as they develop the detail overlaying the SI.

Calibration of UK regime in relation with EU regime

Government and regulators should continue to seek to calibrate the UK and EU regimes to minimise unnecessary divergence. This could apply, for example, in relation to exclusions, as UK Finance members have identified several beneficial exclusions in the EU regime, e.g. its exclusion for labelling activities, provided the labels granted do not involve the disclosure of an ESG ratings; and its exclusion for legally mandatory disclosures required at the product or legal entity level.

The exclusion for legally mandatory disclosures is likely to be particularly critical, as the UK implements its own disclosure regime including Sustainability Disclosure Requirements and

possibly disclosures associated with a UK Green Taxonomy. The EU expressly excludes from the scope of its ESG ratings regulation products labelled in accordance with the Sustainable Finance Disclosure Regulation (SFDR) and EU Taxonomy disclosures.

Given it is not yet clear what the UK Green Taxonomy regime will comprise and whether it will include any entity or product-level mandatory reporting, authorities will need to take care that if the UK regime implements additional disclosure requirements, then those do not place firms within the scope of ESG rating regulation from a UK perspective and not an EU perspective.

Extraterritorial scope

We support the regulation of overseas ESG ratings providers in line with the intention set out in the government's response but we would welcome further opportunity to engage with UK authorities on the detailed application (without causing any unnecessary delay to the implementation of the regime).

The draft SI proposes a new approach to the regulation of overseas entities, as section 63U(2)(b) of the draft SI brings into scope ratings "made available by an ESG ratings provider not located in the UK". Paragraph 4.21 of the Treasury's consultation response explains that the FCA is considering its approach to overseas ESG ratings providers applying for UK authorisation, which includes exploring whether, according to size, significance, or market impact in the UK, an ESG ratings provider would be expected to be incorporated in the UK.

While we recognise the rationale for bringing overseas entities into scope, we note that this is the first time that a UK regulator will explicitly authorise and regulate overseas firms (without that overseas firm having a UK permanent establishment) and that this represents a change in approach and a novel expansion of the UK regulatory perimeter set out in section 19 of FSMA.

Some UK Finance members note that whilst this could mark a significant regime change, it is being introduced via a sectoral piece of legislation rather than subject to a specific consultation on the UK's overseas framework. These members note that HM Treasury **signalled its intent** to consult on potential changes to the regime for overseas firms in 2020-21, but this did not take place.

Nevertheless, we recognise the importance of finding a solution for overseas firms as part of the ESG ratings regulatory regime, particularly to ensure a level playing field with UK-based firms. To safeguard against regulatory arbitrage, it is critical to avoid a scenario where ESG ratings providers establish themselves in jurisdictions with less stringent requirements and then offer their products in the UK. We are happy to arrange a separate discussion with our members to explore potential solutions.

Members also note that further work is needed to define market access arrangements as set out in paragraphs 3.42-3.43 of the government response and will be keen to engage closely as this develops.

Future FCA rules and guidance

We understand that much of the detail underpinning the regime will be set out in due course by the FCA. We expect FCA rules and guidance to align closely with the principles set out in

the Code of Conduct for ESG Ratings and Data Products Providers. We set out some examples of features for inclusion in the regime below:

Securing quality:

- In line with the recommendations of the International Organisation of Securities Commissions' (IOSCO's) principles, ESG rating providers should have appropriate quality-checking mechanisms in place to, inter alia, screen for potential incoherencies and deviations against a peer group or against previous years, checking on a regular basis whether there is any discrepancy between the evaluation results and the service provision methodologies.
- Where ESG evaluations are outsourced, the outsourced service provider should be expected to comply with the same relevant actions as those expected of the ratings provider.

Conflicts of interest:

- ESG ratings providers should establish a firewall between sales and evaluation divisions, such as assigning separate staff members for these functions.

Engagement:

- Engagement between ESG ratings providers and assessed entities is essential. The lack of opportunity for rated entities to input into a rating increases the risk that resulting ratings are inaccurate and mischaracterise the performance of those entities. So too does the inability to challenge or correct ratings, as well as a lack of alignment in timings of reporting of the ratings and the period of assessment the rating is based on.
- Rated entities should be able to bring factual errors to the attention of the ESG ratings provider and there should be responsibility for ratings agencies to correct identified errors and draw attention to the error where a rating has been reviewed. After the errors are identified, ESG ratings providers should be required to have processes in place to mitigate the error from occurring again.

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Annex: UK Finance response on draft Statutory Instrument:

The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2024

#	Category	Draft Statutory Instrument text	UK Finance response
1	Exclusions(charity)	*Ancillary non-commercial provision* *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 by way of a business relationship separate to the person's activities as a journalist, an academic or a charity.* *Interpretation* *63ZB. In this Chapter—* *"charity" means—* *(a) in England and Wales, a charity registered under section 30(1) of the Charities Act 2011(a);* *(b) in Scotland, a charity registered under section 3 of the Charities and Trustee Investment (Scotland) Act 2005(b);* *(c) in Northern Ireland, a charity registered under section 16(2) of the Charities Act (Northern Ireland) 2008(c);*	Charities that provide ESG ratings should be included in scope. At least one of the major providers of ESG assessments (i.e. CDP) is a not-for-profit organisation and its ratings are used as input into other ESG rating providers. It is therefore critical for transparency, comparability and reliability that ESG ratings from not-for-profit entities should be included in the regulatory perimeter. Only providers that can guarantee the quality and accuracy of their product should participate in the market. Should UK authorities conclude that a not-for-profit exemption is appropriate, we suggest that this should be subject to ensuring that there is a mechanism in place to impose regulation on any entity that becomes a systemic consolidator/operator in the market, as is the case for CDP.

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2	Exclusions (investment research)	*Regulated products and services* *63V. (1) A person does not carry on an activity of the kind specified by article 63U by providing an ESG rating in the course of carrying on—* *(a) another regulated activity,* *(b) an activity that is subject to approval by the FCA under a provision of assimilated law(a) or legislation restated by virtue of section 4 of the Financial Services and Markets Act 2023(b), or* *(c) an activity that is within the scope of a market access arrangement.*	Authorities should clarify how the exclusion for investment research (which members understand to cover both independent and non-independent research) will work, or revise the draft SI to explicitly set out an exemption for investment research (whether independent or non-independent). We welcome the Treasury's policy intention that investment research will not require dual authorisation to provide ESG ratings as described in paragraph 3.39 of the Treasury's consultation response. That exemption is intended to be based on the "regulated products and services exclusion" – "(a) another regulated activity". However this does not explicitly cover investment research and there appears to be a gap between the drafting of the regulated products and services exclusion given how, in practice, investment research is regulated. We understand that investment research itself is not a regulated activity that requires a permission unless it constitutes investment advice. In addition, we would also welcome confirmation of how the legislation and future FCA rules are intended to apply to UK branches of overseas firms.

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3	Exclusions (second party opinions (SPOs) and controversy reports)	*Regulated products and services* *63V. (1) A person does not carry on an activity of the kind specified by article 63U by providing an ESG rating in the course of carrying on—* *(a) another regulated activity,* *(b) an activity that is subject to approval by the FCA under a provision of assimilated law(a) or legislation restated by virtue of section 4 of the Financial Services and Markets Act 2023(b), or* *(c) an activity that is within the scope of a market access arrangement.*	We support the explicit inclusion of controversy reports in the regime. Paragraph 3.56 of the Treasury's consultation response states that some external reviews (e.g. second-party opinions, verifications) "may" be captured by the updated regulated activity definition and the government has not sought to introduce a specific standalone exclusion for such products. UK Finance members believe that controversy reports, second party opinions (SPOs) and similar assessments should be in scope. In particular, although the Treasury's consultation response does not explicitly mention the exclusion of controversy reports, controversy reports typically provide an assessment of one or more environmental, social or governance factors, require analysis and judgement, and rely on a final assessment.
4	Exclusions (proxy advisor service)	*Regulated products and services* *63V. (1) A person does not carry on an activity of the kind specified by article 63U by providing an ESG rating in the course of carrying on—* *(a) another regulated activity,* *(b) an activity that is subject to approval by the FCA under a provision of assimilated law(a) or legislation restated by virtue of section 4 of the Financial Services and Markets Act 2023(b), or*	Paragraph 3.57 of the Treasury's consultation response mentions that the updated regulated activity definition may not capture proxy advisor services and the government will explore whether to exclude ESG ratings in the final SI where they are provided as part of proxy advisor services. We do not believe that proxy advisor services should be excluded from the regulation. Whilst some proxy advisor services are already regulated, ESG ratings or controversy reports, which are often

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		(c) an activity that is within the scope of a market access arrangement.	included in proxy reports, do not appear to be covered by this legislation.
5	Editorial issue	*The Activity - ESG ratings* *63U. (2) This paragraph applies where—* *(a) a rating is made available by an ESG rating provider located in the UK by any means;* *(b) a rating is made available by an ESG rating provider not located in the UK by way of a business relationship, including but not limited to a subscription or any other contractual relationship, with a person located in the UK.* *(3) For the purposes of paragraph (2)(b), the circumstances in which an ESG rating is made available by an ESG rating provider include where—* *(a) the rating is made available by the ESG rating provider to another person;* *(b) the rating is made available by that person or a third party to a person located in the UK;* *(c) the ESG rating provider could reasonably have expected the ESG rating to be made available to a person located in the UK.*	We would like to confirm that the elements (a) to (c) of Article 63U(3) are intended to be either cumulative or mutually exclusive. We assume that they are cumulative and thus that there should be an “and” at the end of (b) after the semi-colon.