EXPLANATORY MEMORANDUM TO

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (REGULATED ACTIVITIES) (ESG RATINGS) ORDER 2025

2025 No. [XXXX]

1. Introduction

1.1 This Explanatory Memorandum has been prepared by His Majesty's Treasury and is laid before Parliament by Command of His Majesty.

2. Declaration

2.1 Lucy Rigby KC MP, Economic Secretary to the Treasury, confirms that this Explanatory Memorandum meets the required standard.

2.2 Fayyaz Muneer, Deputy Director for Prudential and Sustainability at HM Treasury, confirms that this Explanatory Memorandum meets the required standard.

3. Contact

3.1 David A. Fryer at HM Treasury, ESGRatingsConsultation@hmtreasury.gov.uk can be contacted with any queries regarding the instrument.

Part One: Explanation, and context, of the Instrument

4. Overview of the Instrument

What does the legislation do?

4.1 This legislation brings the provision of an Environmental, Social, or Governance (ESG) rating into regulation under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (S.I. 2001/544) (RAO), by making it a specified kind of activity, when that rating is likely to influence a decision to make an investment specified in Part 3 of the RAO (referred to in this memorandum as "making a specified investment"). This will require providers of an ESG rating to be authorised and supervised by the Financial Conduct Authority (FCA). The scope of the regulated activity and the various exclusions provided for in the instrument are explained at section 5 below.

Where does the legislation extend to, and apply?

4.2 The extent of this instrument (that is, the jurisdiction(s) which the instrument forms part of the law of) is England and Wales, Scotland and Northern Ireland.

4.3 The territorial application of this instrument (that is, where the instrument produces a practical effect) is England and Wales, Scotland and Northern Ireland.

5. Policy Context

What is being done and why?

5.1 ESG ratings are a spectrum of products, usually marketed as providing an assessment of the ESG profile, characteristics, exposure to risks and/or impact of a company, fund, or other financial instrument. ESG ratings are widely relied upon by investors to guide investment decisions in line with sustainability risks, opportunities and preferences.

5.2 The market has developed quickly and without formal oversight, leading to stakeholders and users raising concerns about transparency, governance arrangements, internal controls, and potential conflicts of interest within ESG ratings providers. Internationally, both the International Organisation of Securities Commissions (IOSCO)[1] and the Organisation for Economic Co-operation and Development (OECD)[2] have recommended regulators pay more attention to ESG ratings and data.

5.3 Following consultation, analysis and engagement with industry (detailed further in section 7 of this memorandum), the government has decided to legislate to require providers of ESG ratings to be authorised by the FCA and abide by relevant regulatory rules. The intention is to enhance the integrity of the market by fostering robust governance, effective management of conflicts of interest, and sound systems and controls, while also advancing transparency. This will boost investor confidence and reduce greenwashing, addressing concerns highlighted in responses to the consultation, which overwhelmingly favoured regulation.

Scope

5.4 ESG ratings which come within the new regulated activity are defined as assessments regarding one or more environmental, social or governance factors, which are prepared using an "established methodology" (involving techniques and procedures systematically utilised to identify, collect, analyse and interpret data in order to produce a rating) and a "defined ranking system of rating categories" (examples of which might include colour coding, scores, or other classes expressed using symbols, numbers or letters). Under the definitions in the instrument, a firm will 'provide' an ESG rating only if it both 'produces' the rating and 'makes it available'. Firms that only distribute ESG ratings produced by others are not intended to be captured by regulation. The instrument brings within the specified activity of providing an ESG rating those ratings which are likely to influence a decision to make a specified investment but excludes those where the provider could not reasonably expect the rating to have influenced such a decision.

5.5 The Government reasonably expects that firms providing ESG ratings have an understanding of their customer base and target market, for example, for sales and marketing purposes. It will be relevant for firms to consider whether their customers are financial market participants, and whether their ratings are typically used to inform their customers' decisions in relation to specified investments or alternatively, to support other commercial or operational activities, such as supply chain management. The regulatory focus is on the likelihood of use; it is not a requirement to know the exact use of every rating provided. Where a person providing an ESG rating could not reasonably have expected that rating to influence a decision to make a specified investment then that rating will be considered out of scope.

5.6 Where a UK-based ESG ratings provider supplies ESG ratings – whether paid or free – to any client or customer, whether located in the UK or overseas, this activity will fall within scope as it is recognised as a specified activity. Where an ESG rating is provided, directly or indirectly, to a UK customer by an overseas provider, this activity will fall within scope as it is recognised as a specified activity, unless the ESG rating is provided to a UK customer by an overseas provider for free, in which case this activity will be excluded from the scope of the regulated activity.

[1] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf
[2] https://www.oecd.org/en/publications/esg-ratings-and-climate-transition_2fa21143-en.html

Exclusions

5.7 Recognising that ESG ratings are provided by a range of different actors, the scope of the regulated activity is designed to be proportionate to the risk of harm, avoid dual regulation, and maintain consistency with the existing regulatory framework. This scope is delivered via various exclusions to the regime including:

- Where a person provides an ESG rating as part of another financial service or activity that is already regulated by the Financial Conduct Authority (FCA). This exclusion also applies where the FCA has already given approval under other applicable laws, or where the activity is permitted under special arrangements for overseas providers (market access arrangements). An ESG rating is also excluded if provided during the course of carrying on an activity (for example, marketing) relating to a recognised scheme (such as those under the Overseas Funds Regime or section 272 of FSMA), or in connection with alternative investment funds (AIFs) marketed into the UK under the National Private Placement Regime (NPPR). These exclusions do not extend to ratings which are provided as a standalone service, separately to the process of carrying out a financial service or activity for which the provider is already regulated or subject to other permissions as listed in the exclusions.
- Where a person provides an ESG rating which can also be characterised as providing a benchmark as defined in the Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 (commonly referred to as the UK Benchmarks Regulation). This exclusion also applies where such benchmarks are exempted from the UK Benchmarks Regulation under Article 2 or benefit from its third country regime transitional provision.
- Where a person provides an ESG rating which is used to produce or incorporated into a credit rating under the Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (commonly referred to as the Credit Ratings Agencies Regulation), or which is exempted under Article 2 of the Credit Ratings Agencies Regulation.
- Activities undertaken as a charity, academic, or journalist (where the rating is provided on an occasional or one-off basis, or there is no remuneration, other financial benefit or incentive).
- Accreditation and certification activities, where the purpose is not to influence a decision to make a specified investment, such as those designed to inform corporate strategy or personal purchases
- ESG ratings produced by a person purely to comply with a legal or regulatory requirement (such as regulatory reporting) which that same person is subject to.
- ESG ratings that are provided as part of proxy advisory services are excluded from the scope of regulation, whether those services are regulated or unregulated, provided they meet the definition of proxy advisory services set out in regulation 2 of the Proxy Advisors (Shareholders' Rights) Regulations 2019. This exclusion is intended to ensure that ESG ratings delivered in the context of advising shareholders on voting or governance matters, as defined by those regulations, are not subject to overlapping or duplicative regulatory requirements under the ESG ratings regime.

- Intra-group ESG ratings where the rating is provided by one group member to another and the provider does not, except in limited circumstances, reasonably expect the ESG rating to be made available outside the group.

Savings and Transitional Provisions

5.8 The savings and transitional provisions in Part 3 of this instrument establish the framework for the management of applications to the FCA for permission to carry on the new regulated activity of providing an ESG rating, before the legal requirement to hold such a permission comes into full legal effect (referred to in the instrument as "the main commencement day"). This will enable the FCA to deal with significant numbers of applications for permission ahead of time. The effect of the provision is that the FCA may specify time periods for applications, and firms that apply in the specified period will be treated as though the new regulated activity is not yet in force, in the unlikely event that their application has not been determined by the main commencement day.

5.9 Where applications are made before the main commencement day but outside the period specified by the FCA and are refused by the FCA or withdrawn by the applicant, the transitional regime will apply. The FCA is also given a power to direct that a firm that applied within the specified period should be subject to the transitional regime, if the FCA considers this is necessary to advance its objectives relating to consumer protection, integrity or competition. Firms operating under the transitional regime will be prohibited from undertaking any new ESG ratings activities following notification of their transitional status. These firms will be exempt from the requirement to hold permission for the provision of ESG ratings in respect of pre-existing contracts to produce ESG ratings, or to maintain a pre-existing public ESG rating, but will be subject to obligations to report their activities to the FCA and to inform their customers that they are not required to hold such permission.

5.10 Under the transitional regime, the FCA may impose conditions, cancel exemptions, require information, and publish details or public censures regarding non-compliance. Standard notice and appeal processes apply. Both the savings and transitional provisions will last one year from the main commencement date.

What was the previous policy, how is this different?

5.11 This instrument brings the provision of an ESG rating within the regulatory perimeter for the first time in UK law. It introduces new obligations on ESG ratings providers, many of whom may not previously have been regulated. Prior to this instrument, IOSCO published its recommendations for ESG ratings and data providers in November 2021, calling for greater transparency, governance, and oversight in the sector. Building on these, the FCA appointed the International Regulatory Strategy Group (IRSG) and International Capital Market Association (ICMA) to convene and be the Secretariat for the ESG Data and Ratings Working Group (DRWG). The DRWG developed an industry-led and owned Voluntary Code of Conduct[3], published in December 2023, setting out principles and best practice for ESG ratings and data product providers to improve reliability and trust in the market.

[3] https://www.icmagroup.org/assets/DRWG-Code-of-Conduct-for-ESG-Ratings-and-Data-Products-Providers-v3.pdf

6. Legislative and Legal Context

How has the law changed?

6.1 The RAO specifies kinds of activities and investments for the purposes of the Act - FSMA 2000. When an activity of a specified kind is carried on by way of business in relation to an investment of a specified kind, it is a "regulated activity" for the purposes of the Act. Section 19 of the Act prohibits persons from carrying on any regulated activity in the United Kingdom unless they are either authorised or exempt.

6.2 This instrument is made under sections 22(1) and (5), 428(3), and paragraph 25 of Schedule 2 to FSMA (2000). It specifies a new regulated activity: the provision of ESG ratings where those ratings are likely to influence a decision to make a specified investment. The activity falls within the meaning of section 22(1) of FSMA 2000 when carried on by way of business and in relation to a specified investment. As such, a person will only be permitted to carry on this activity if they are authorised or exempt.

6.3 This instrument inserts a new Chapter 15F into the RAO. This chapter defines the scope of the new regulated activity (article 63U) and sets out a number of exclusions (articles 63V to 63Z5), including exclusions for regulated products and services, unregulated benchmarks, unregulated credit ratings, intra-group ratings, private use, ancillary non-commercial provision, public authorities, central banks and international organisations, accreditation or certification, regulatory or legal requirements, and proxy advice.

6.4 This instrument includes transitional and savings provisions to allow persons who are within scope of the new regulated activity and have applied for the relevant permission (including variation of pre-existing permission) to continue providing ESG ratings during a limited period following commencement, subject to appropriate conditions and FCA supervision. Provision is also made for exemptions, notifications, FCA directions, and the ability for the FCA to vary or cancel such exemptions. The transitional regime will expire one year after the main commencement date, unless extended by direction of the FCA in defined circumstances.

Why was this approach taken to change the law?

6.5 The purpose of this instrument is to bring the provision of ESG ratings into the FCA's regulatory perimeter. HM Treasury considered alternative legislative approaches, but authorisation and regulation under the framework of the Act was considered the most effective and appropriate method for changing the law. This aligns with the approach taken for similar policy measures in financial services. HM Treasury confirmed the intention to take this approach in its consultation response, published in November 2024, and referred to below.

7. Consultation

Summary of consultation outcome and methodology

7.1 The previous government published a public consultation on the regulation of ESG ratings providers[4], which ran from 30 March 2023 to 30 June 2023. The consultation sought views and responses to questions on the case for the introduction of regulation for ESG ratings providers; the scope of a regulatory perimeter; the description and

[4] https://assets.publishing.service.gov.uk/media/642556f460a35e00120cb180/ESG_Ratings_Consultation_.pdf

definition of an ESG rating and its provision; activities to exclude from regulation; the sectoral and territorial scope of regulation; and proportionality.

7.2 The consultation received 94 responses from a range of representatives from ratings providers, users (including investors, financial institutions) trade bodies, advisory bodies and civil society. 95% of respondents supported the introduction of regulatory oversight.

7.3 Following response analysis, the government published a consultation response[5] on 14 November 2024, accompanied by a draft statutory instrument[6] to bring ESG ratings providers into regulation. The government welcomed technical comments from stakeholders on this.

7.4 30 sets of comments were received, representing trade bodies, banks, ESG ratings and data providers, investment managers and civil society groups. These comments broadly covered the definition of an ESG rating, the activity of providing an ESG rating and proposals for a variety of further products to be considered for exclusion.

7.5 These comments have been carefully considered together with further engagement with stakeholders, to help further clarify and understand the issues being raised, and, where appropriate, the instrument has been refined and amended.

7.6 Financial services policy is a reserved matter. However, HM Treasury shared the original consultation, consultation response and draft statutory instrument with the devolved governments and Territorial Offices as a matter of courtesy and for information. No comments were received.

8. Applicable Guidance

8.1 The government does not propose to provide any guidance in relation to this instrument. The FCA will provide information and guidance in due course on the operation of the regulatory regime.

Part Two: Impact and the Better Regulation Framework

9. Impact Assessment

9.1 A full Impact Assessment has not been prepared for this instrument because, in line with Better Regulation guidance, the government considers that the net impact of this instrument upon businesses will be less than net £10 million Equivalent Annual Net Direct Costs to Business. There will be one-off and ongoing impacts arising from the costs of in scope ESG ratings providers needing to familiarise themselves and comply with FCA rules, which are expected to be prepared by the FCA under the Act. As any rules will be subject to an FCA cost-benefit analysis, these impacts have not been considered further at this stage in line with Better Regulation guidance. A de minimis Impact Assessment has been prepared instead and will be published alongside the Explanatory Memorandum on the .gov.uk website.

[5] https://assets.publishing.service.gov.uk/media/6735d760b613efc3f18230da/UK_Government_consultation_response_on_a_future_regulatory_regime_for_Environmental__Social__and_Governance_ratings_providers.pdf
[6] https://assets.publishing.service.gov.uk/media/6735d7392469c5b71dbc7b10/The_Financial_Services_and_Markets_Act_2000__Regulated_Activities___Amendment___No._2__Order_2024_-_Draft_Statutory_Instrument.pdf

Impact on businesses, charities and voluntary bodies

9.2 This instrument will impact on business, charities or voluntary bodies that are identified as being in scope of the regulatory perimeter.

9.3 The legislation does impact small or micro businesses.

9.4 As any rules will be subject to further cost-benefit analysis, these impacts have not been considered further at this stage in line with Better Regulation guidance.

9.5 There is no, or no significant, impact on the public sector.

10. Monitoring and review

What is the approach to monitoring and reviewing this legislation?

10.1 In line with the requirements of the Small Business, Enterprise and Employment Act 2015 the Economic Secretary to the Treasury, Lucy Rigby KC MP has made the following statement:

"It is not proportionate to include a review clause in this instrument because the estimated annual net direct cost to business is less than £10 million and the number of small businesses in scope is very low".

Part Three: Statements and Matters of Particular Interest to Parliament

11. Matters of special interest to Parliament

11.1 None.

12. European Convention on Human Rights

12.1 The Economic Secretary to the Treasury, Lucy Rigby KC MP, has made the following statement regarding Human Rights: "In my view the provisions of the Financial Services and Markets Act 2000 (Regulated Activities) (ESG Ratings) Order 2025 are compatible with the Convention rights."

13. The Relevant European Union Acts

13.1 This instrument is not made under the European Union (Withdrawal) Act 2018, the European Union (Future Relationship) Act 2020 or the Retained EU Law (Revocation and Reform) Act 2023 ("relevant European Union Acts").