The Business, Entrepreneurship & Tax Law Review

Volume 8 | Issue 1 Article 5

It's Hard to Hit a Target that Doesn't Exist: A Novel Conceptual Framework for ESG Ratings

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It's Hard to Hit a Target that Doesn't Exist: A Novel Conceptual Framework for ESG Ratings

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ABSTRACT

We introduce a conceptual framework to understand some of the persistent shortcomings we observe in ESG ratings and their potential consequences for financial stability, corporate policy, and regulation. Our framework consists of analyzing three different stages in the production of ESG ratings: (1) Data Collection and Disclosure, (2) Measurement, and (3) Dissemination. At each stage, we clearly identify the parties involved, their incentives and limitations, and the noise or bias introduced to ESG ratings due to misaligned incentives, data constraints, or inadequate regulations. In the Data Collection and Disclosure stage, noise and bias are introduced when rated companies disclose data selectively or have limited capacity for collecting or sharing relevant data. In addition, the data collection and disclosure methods used across companies and rating providers are usually not standardized. Because of these deficiencies, it is possible that some companies engage in greenwashing. At the Measurement stage, when ESG ratings are calculated, noise and bias are introduced to the process due to a lack of consensus on what constitutes "good" ESG performance, as well as the use of widely diverging methodologies that tend to lack transparency or replicability. These issues may lead to limited competition among rating providers and a race to the bottom, where rating providers cater to rated companies by providing inflated ratings. At the Dissemination stage, noise and bias are introduced

because ratings produced by different providers are not always directly comparable. For example, it is not clear if some ratings focus on risk exposure or risk contribution. In addition, some ratings are difficult to verify or lack timeliness, which might bias the perception of end users and the way they use these ratings for investment decisions, regulations, or internal corporate policies. Importantly, our framework allows us to devise potential solutions for some of the problems highlighted in our analysis. These solutions include improving disclosure standards, incentivizing public data access to foster competition as well as transparency of rating methodologies, and relying on regular audits to verify the accuracy of corporate disclosures and ESG ratings.

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"When a measure becomes a target, it ceases to be a good measure."
Charles Goodhart, Economist

I. Introduction

As of 2022, global ESG-oriented investing exceeded $30 trillion.[1] As ESG considerations increasingly play a major role in guiding investor and company decisions, understanding and measuring corporate ESG performance becomes a key consideration. Traditionally, evaluations of corporate performance were confined mainly to financial results. More recently, however, companies and third parties have shown a growing concern about evaluating corporate performance along nonfinancial dimensions, including environmental and social impact. In this nascent and fast-growing field, ESG, which stands for Environmental, Social, and Governance, has emerged as a key framework to help make sense of the many facets of corporate nonfinancial performance. Yet, despite the widespread interest in ESG, measuring corporate performance along these dimensions is proving challenging. The aim of this article is, first, to provide a conceptual framework that allows us to identify issues with ESG measures and their consequences for investors, companies, and policymakers, and second, to suggest ways to improve the design and use of ESG measures.

Although concerns with business impacts on communities and the environment have existed for a long time, articulating the business case for why companies should proactively care about the environment and society is a much more recent phenomenon. The term ESG entered the mainstream with the 2004 UN report titled *"Who Cares Wins,"* which encouraged business stakeholders to embrace ESG as an aspect of corporate operating performance that ultimately impacts corporate financial performance.[2] Figure 1 presents a summary of the ESG framework. In this framework, E refers to the company's environmental impacts and risks, such as greenhouse gas emissions and waste output; S refers to the social effects and risks, such as labor practices and product safety; and G refers to corporate governance practices and risks, such as board structure and treatment of minority shareholders. The key idea behind ESG is that it is relevant to internal

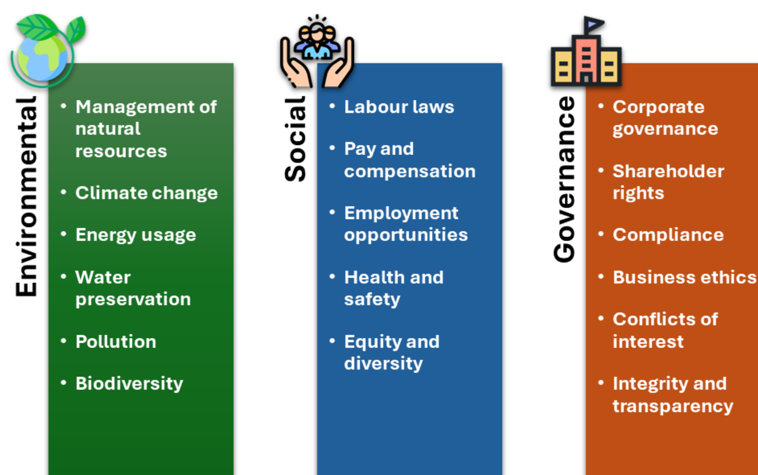
1. Witold Henisz, Tim Koller, & Robin Nuttall, *Five Ways that ESG Creates Value*, McKinsey Quarterly. (2019) https://www.gsi-alliance.org/members-resources/gsir2022.

2. Robert Eccles et al., *The Social Origins of ESG: An Analysis of Innovest and KLD*, Organization & Environment, 4 (2020).

https://scholarship.law.missouri.edu/betr/vol8/iss1/5

and external corporate stakeholders.[3] Internally, it is argued that companies should take time to understand the risks and opportunities they face along ESG dimensions (and to disclose those externally). Having insights into critical environmental, social, and governance issues that may impact business is expected to result in greater profitability and lower risk. Internally, companies that pay attention to ESG are expected to be better managed overall. Externally, it is argued that capital providers should consider ESG factors when making investment decisions. It is likely that having insights into critical environmental, social, and governance issues should alert investors of possible risks the business faces. Notably, ESG is not confined to activities directly controlled by the company but must consider impacts and risks up and down the supply chain.

Figure 1: A Summary of the ESG Framework[4]



In theory, companies with better ESG performance are likely to have better financial performance, and capital providers should allocate capital to better-performing companies. In practice, evaluating companies' nonfinancial performance is no easy feat, with many questions arising. These questions include: Which ESG dimensions are important? What indicators capture the underlying dimensions of

3. *Who Cares Who Wins*, THE GLOBAL COMPACT 58 (2004), https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf

4. Art for this figure was obtained from https://www.flaticon.com (from left to right, Freepik, Freepik and Prashant Rapolu).

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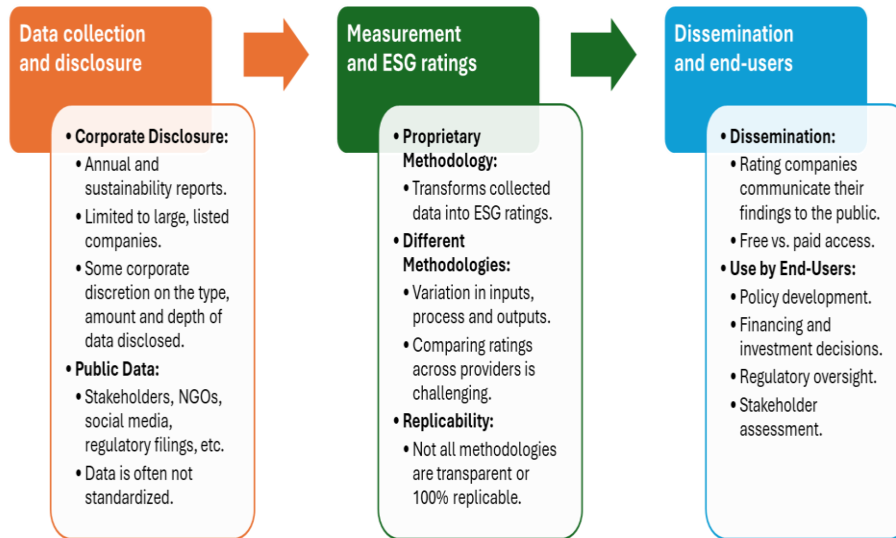
interest? Is data available and reliable? Are all indicators equally relevant? Does strong performance along one ESG dimension compensate for poor performance along another? And so on. Unlike measures and reporting of financial performance, which have been honed over time, the evaluation of nonfinancial performance is a relatively novel, uncharted territory. Today, one group has come to dominate this space—third-party ESG rating providers. ESG raters specialize in evaluating corporate nonfinancial performance and generating ESG ratings. This article focuses on these ratings, the mechanics of their creation, and their implications for companies and capital markets.

While ESG ratings have become a beacon, guiding both companies and capital providers as they work to evaluate and improve corporate ESG performance, many issues have been raised regarding the reliability and validity of these ratings. These concerns point to the need to rethink our current approach to ESG evaluation in light of its importance. We break the creation and dissemination of ESG scores into a multi-stage process to aid in analyzing issues and conceptual tractability. This conceptual separation focuses on the selective transmission of ESG-related information from the rated company/issuer to the ESG rating provider, the methodological transformation of this information into an ESG score, and the utilization of ESG scores by the end user/investor. Each step in the process faces its challenges.

Specifically, our framework models the development and use of ESG scores as a three-staged framework, not unlike a production process. These three stages are as follows: 1) companies collect and disclose corporate data to be evaluated; 2) the rating provider combines it with other data and develops a proprietary methodology to make an ESG rating; 3) the rating is subsequently reported to investors and other end users as part of a larger dataset of a universe of rated companies. Problems and issues with ratings can, thus, be classified by where they occur in the three stages of this process, illustrated in Figure 2.

Figure 2: A Three-Staged Framework to Understand ESG Ratings



II. Shortcomings of Current ESG Ratings

a. *ESG Ratings: Who Creates Them and How?*

Over the past two decades, the ESG rating industry has undergone massive growth and consolidation.[5] The largest and best-known ESG raters are established financial data providers who have expanded into the "green" market. These players include MSCI, LSEG (Refinitv), Moody's, S&P Global, and Bloomberg, among others. Thus, most ESG raters are for-profit companies selling ESG ratings and related data to interested parties such as investors and analysts.[6]

Many providers claim that their ESG ratings capture underlying corporate performance along ESG dimensions or even corporate sustainability.[7] However, rating providers sell proxies for something inherently unobservable. One view is that ratings include information on underlying investment risks. Another view is that such scores provide normative evaluations. That is, ESG scores provide information on whether a company is good or bad at what it should be doing.

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5. Michael Pagano et al, *Understanding ESG ratings and ESG indexes, in* Research Handbook of Finance and Sustainability 339, 340 (Edward Elgar Publishing, 2018).

6. *Who We Are,* CDP (2024), https://www.cdp.net/en/info/about-us. (Starting as a Climate Disclosure Project, CDP is a notable exception as a non-profit organization).

7. In contrast, some ESG providers, like Bloomberg, evaluate the extent of corporate *disclosures* about their performance.

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Given the complexity and novelty of the task, it is not surprising that the approach to creating ESG ratings is evolving continuously. Today, to develop corporate ESG ratings, providers collect data on hundreds of indicators that flow into separate ESG categories. For example, in its 2022 methodology, MSCI claimed to collect over 1,000 data points that fed into 35 key metrics. These, in turn, flowed into creating scores for each of the three pillars: environmental, social, and governance, which were subsequently summed up into a final ESG rating.

Of course, the process of generating a corporate ESG rating requires a myriad of decisions to be made along the way regarding the underlying data, the rating methodology, and the presentation of the rating. First, regarding underlying data, depending on the provider, data can come from the company alone or from various sources, including third parties such as media and regulators. Second, combining data points into a rating requires the provider to decide their relative importance. More recent methodologies rely on materiality maps, which depict the relative importance of ESG issues for different industry sectors. For example, MSCI created its own materiality map that identifies critical issues likely to impact each industry and sub-industry financial performance, where industries are defined according to the Global Industry Classification Standard (GICS).[8] This focus on the relative materiality of ESG issues recognizes that not all ESG issues are equally important across industry sectors.

More importantly, there is a question of variation in the components of ESG ratings across industries. How should one compare a "green" oil company to a "brown" electric car maker? Thus, some providers adjust ESG scores relative to industry averages. This relative ranking focuses on corporate ESG performance relative to a benchmark of industry peers rather than in absolute terms, which could leave companies with substantive environmental and social policies without recognition for their efforts. Finally, there is a question of aggregation, dissemination, and frequency of the ESG rating. For example, MCSI presents this final rating in a format similar to the familiar credit ratings, with AAA being the highest and CCC the lowest. On the other hand, many other providers assign a score out of 100. Regardless of how these and other issues are resolved, all ESG

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8. MSCI, *ESG Industry Materiality Map,* (2023), https://www.msci.com/our-solutions/esg-investing/esg-industry-materiality-map.

providers tout the reliability and accuracy of their methodologies. However, these methodologies are increasingly being scrutinized.

b. Issues with Data Collection and Disclosure

To begin with, ESG ratings suffer from issues regarding the underlying data or data inputs into the rating methodology. Although many ESG rating providers claim to base their rating on data from various sources, including media, NGOs, and regulatory filings, corporate disclosures (especially in the annual and sustainability reports) are still the most important source. Unfortunately, corporate disclosure of ESG data is still limited to large, listed companies. As a result, either ESG raters must limit the universe of rated companies to those that selectively disclose the necessary information, or they must fill in large bits of missing data. Kotsantonis and Serafeim highlight some of the issues around data imputation, which is the process by which ESG raters fill in missing data due to incomplete company disclosures.[9] They show how different methods of imputation lead to different performance scores. Moreover, to the extent that the imputation methods are based on ESG data that large, listed companies selectively disclose, the resulting scores are likely to be biased, as ESG disclosures tend to be made by companies performing relatively well in ESG.

Even when companies provide significant ESG disclosures, these disclosures are far from standardized, such that much of the data is either boilerplate, inconsistent, or irrelevant.[10] For example, Kotsantonis and Serafeim identified 20 ways to measure employee health and safety data in a random sample of 50 large, listed companies. These measures differ in the underlying constructs, terminology, and units of measurement. These inconsistencies make any comparisons of corporate performance difficult, labor-intensive, or even impossible. These challenges with noisy indicators in underlying data will likely impact the subsequent ESG ratings. Indeed, research shows that over half of the divergence in ESG ratings can be explained by

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9. Kostantonis, Sakis, & George Serafeim, *Four Things No One Will Tell You About ESG Data*, 31 J. OF APPLIED CORP. FIN. 50–58 (2019).

10. Hans B. Christensen, Luzi Hail & Christian Leuz, *Mandatory CSR and Sustainability Reporting: Economic Analysis and Literature Review,* 26 REV. OF ACCT. STUD. 1176, 1207 (2021).

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"measurement divergence" or differences in indicators used to capture a specific ESG dimension.[11]

Why is there a lack of transparency and standardization of disclosures to ESG raters? Companies cite many reasons for not providing higher-quality nonfinancial disclosures. These include a lack of demand from stakeholders, the proprietary nature of ESG data, administrative burdens, and not knowing what data is material or relevant to external stakeholders.

Yet, at the same time, research highlights that many companies engage in impression management by making selective and incomplete disclosures that are positively biased.[12] In the context of ESG disclosures, this practice has become known as greenwashing.

c. Issues with Measurement

Aside from issues with underlying data, ESG ratings face issues around ESG measurement. A big part of the challenge is that there is no widely accepted definition of what constitutes "good" ESG performance (let alone corporate sustainability). ESG performance is subject to debate and likely inherently unobservable. In other words, there is little agreement on what should be measured. Research shows that, for an average-rated company, the observed correlations between some of the more popular ESG ratings are, at best, of medium strength, and much of this divergence in ratings is caused by differences in scope.[13] This means that different ESG providers rely on different sets of attributes, which capture fundamentally different aspects of ESG performance.

This lack of a common definition of "good" ESG performance is unlikely to be resolved with better corporate disclosures. Indeed, research shows that greater levels of high-quality nonfinancial data result in more, rather than less, divergence between ESG ratings, given the subjective nature of what good ESG performance entails.[14]

11. Florian Berg, Julian F. Kolbel & Roberto Rigobon, *Aggregate Confusion: The Divergence of ESG Ratings.* 26 REV. OF FIN. 1315, 1317 (2022).

12. *See* Doris Merkl-Davies & Niamh Brennan, *Discretionary Disclosure Strategies in Corporate Narratives: Incremental Information or Impression Management?,* 2 J. OF ACCT. LITERATURE, 116, 116 (2007).

13. Berg et al., *supra* note 10 at 1340.

14. See Dane Christensen., George Serafeim & Anywhere Sikochi, *Why is Corporate Virtue in the Eye of The Beholder? The Case of ESG Ratings, 97* THE ACCT. REV. 147, 150 (2022) (Additionally, ESG rating disagreements are larger for larger companies despite larger companies typically having higher levels of disclosures.);

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The subjectivity around measuring ESG alludes to the challenges faced by raters in evaluating ESG performance. Some indicators are easier to evaluate than others. ESG indicators can be divided into inputs and outputs. An example of an input indicator would be the existence of a corporate policy on greenhouse gas emissions, and an example of an output indicator would be actual greenhouse gas emissions. Since evaluating corporate performance of ESG outcomes is more subjective, ESG providers disagree more about ESG outputs than ESG inputs.[15] Thus, for example, it is easier to agree that having a policy on emissions is good, but it is more challenging to assess whether a particular greenhouse gas emissions intensity is good or bad. Indeed, evaluating ESG performance as good or bad requires the use of a benchmark, which is often based on peer average. However, the selection of a peer group is another key challenge in assessing performance. Kotsantonis and Serafeim illustrate how changes in the definition of a peer group can lead to changes in the calculation of relative scores. However, identifying the correct peer group is difficult, especially for companies that operate in multiple industry sectors. An alternative to peer evaluation is evaluating corporate performance relative to absolute benchmarks. However, the potential additional objectivity of such benchmarking can obfuscate relative performance and decrease incentives to improve corporate policies. For example, what incentive is there for a coal or an oil company to invest in reducing carbon emissions if such policies would only move its ESG rating from the bottom of the pile to just above the bottom?

Recent research is also beginning to uncover some systematic biases in ESG rating methodologies. For example, one study found that ESG ratings are higher for companies that share the same major shareholders as the rating provider.[16] Another study found that when ESG rating provider Refinitiv changed its methodology and retroactively updated past ESG scores, the changes were strongly correlated with

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See also Rajna Gibson Brandon, et al., *ESG Rating Disagreement and Stock Returns.* 77 FIN. ANALYSTS J., 104, 107 (2021).

15. Christensen, *supra* note 14, at 3.

16. Dragon Yongjun Tang et al,, *The Determinants of ESG Ratings: Rater Ownership Matters,* PROCEEDINGS OF PARIS DEC. 2021 FIN. MEETING EUROFIDAI-ESSEC, 1 (2021).

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past financial performance.[17] In other words, companies with better financial performance retroactively received higher ESG scores.

Yet, perhaps most importantly, research is mixed on the relationship between ESG ratings and relevant corporate outcomes along non-financial dimensions. For example, while research on governance ratings finds that these ratings are associated with current financial performance, they are not necessarily linked to future corporate governance outcomes (including accounting restatements, shareholder litigation, and cost of debt).[18] In relation to overall ESG ratings, research also finds that more profitable companies have higher ESG scores (and less disagreement among providers),[19] suggesting that scores reflect current financial performance. Although ESG scores can predict future ESG news, this ability is significantly diminished when ESG raters disagree on the measurement (i.e., when different rating providers use different indicators to capture the same ESG attribute).[20] Notably, ESG ratings are not necessarily linked to corporate performance in social and environmental dimensions, including compliance with environmental and social laws or greenhouse gas emissions.[21] These findings further suggest that current ESG ratings are suffering from measurement issues.

d. Issues with Dissemination

Finally, there are issues around the dissemination of ESG ratings. The quality of financial information is enhanced when the information is comparable, verifiable, timely, and understandable. We suggest that the same characteristics would enhance the presentation of ESG ratings. The comparability of ESG ratings decreases with

17. Florian Berg, et al., *Is History Repeating Itself? The (Un)Predictable Past of ESG Ratings,* 3 (European Corporate Governance Institute Finance Working Paper 708/2020), https://doi.org/10.2139/ssrn.3722087.

18. Robert Daines et al, *Rating the Ratings: How Good Are Commercial Governance Ratings?* 98 J. OF FIN. ECON., 439, 444 (2010).

19. *See* Rajna Gibson Brandon, et al., *ESG Rating Disagreement and Stock Returns.* 77 FIN. ANALYSTS J., 104, 107 (2021).

20. George Serafeim & Aaron Yoon, *Stock Price Reactions To ESG News: The Role Of ESG Ratings And Disagreement,* 28 REV. OF ACCT. STUD. 1500, 1500 (2023).

21. Aneesh Raghunandan & Shiva Rajgopal, *Do ESG Funds Make Stakeholder-Friendly Investments?* 27 REV. OF ACCT. STUD. 842, 848 (2022); Samuel Drempetic et al., *The Influence of Firm Size on the ESG Score: Corporate Sustainability Ratings Under Review.* 167 J OF BUS. ETHICS, 333, 333 (2020).

frequent changes to the methodology. Given the novel, complex, and evolving nature of measuring nonfinancial performance, some changes in methodology can be expected. However, these changes are often made frequently, with dramatic consequences for the ratings, yet with limited transparency.[22] The verifiability of ratings is also a challenge. The divergence between the rating providers and the limited transparency of the underlying methodology makes the ratings difficult to verify. In the future, as more providers incorporate artificial intelligence (AI) into their methodologies, changes to ratings might become even more mysterious, and their verifiability might decline even further. Rating providers also differ significantly in terms of the timeliness of the ratings. Although many claim to update their database frequently (e.g., weekly), the ESG ratings are often recalculated and released annually (barring a "major" change). This limited frequency is likely to reduce the effectiveness of ESG ratings.

e. Applications of ESG Ratings

i. Investors

Investors are increasingly incorporating ESG information into their decisions. Principles of Responsible Investment (PRI) is a movement that, at its core, acknowledges and promotes the importance of incorporating nonfinancial performance into investment research. As of 2021, PRI included 3826 signatories with $121 trillion in assets under management.[23] Research suggests that investors rely on ESG information and ESG ratings in general when making investment decisions.

For example, investors respond to companies' inclusion in an ESG-themed index, which can be considered an indicator of good ESG performance.[24] Interestingly, investors tend to react more when a company is dropped from an index (resulting in a negative reaction) than when it is added to an index (resulting in no or slightly positive

22. Berg et al., *supra* note 17, at 9.

23. *About the PRI*, PRINCIPLES FOR RESPONSIBLE INVESTMENT, https://www.unpri.org/about-us/about-the-pri (last visited Mar. 22, 2024).

24. *See e.g.*, Leonardo Becchetti, Rocco Ciciretti, Iftekhar Hasan, & Nada Kobeissi, *Corporate Social Responsibility and Shareholder's Value,* 65 J.L. of Bus. Res. 1628 (2012). *See also* Jonathan P. Doh, Shawn D. Howton, Shelley W. Howton, & Donald S. Siegel, *Does the Market Respond to an Endorsement of Social Responsibility? The Role of Institutions, Information, and Legitimacy.* 36 J.L. OF MANAGEMENT 1461, 1461 (2010).

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reaction). Moreover, investors react to ESG rating changes even when they are driven by changes in methodology. For example, when ESG ratings provider Refinitiv changed its methodology, some companies experienced a change in their ratings. Companies with improved (and, conversely, worsened) scores experienced positive (and, conversely, negative) stock market returns.[25] Research also shows that investors in recent years have allocated increasing amounts of capital to mutual funds with high ESG ratings,[26] and these mutual funds tend to invest more heavily in companies with high ESG ratings.[27]

A body of research is also emerging which aims to understand the impacts of ESG ratings disagreements, and the results show that these disagreements are highly consequential.[28] For example, divergence in ESG ratings reduces investor demand for stocks[29] and impacts the market's ability to incorporate ESG news into stock prices.[30] Investors also demand a higher return for stocks with large ESG rating disagreements, possibly due to increased uncertainty.[31] High ESG rating disagreement is also associated with higher volatility and larger absolute price movement, leading to companies relying less on external financing.[32] Overall, this research highlights that ESG ratings play an important role in impacting investor decisions around the allocation of capital.

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25. Samuel M. Hartzmark, & Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*. 74 THE J. OF FIN. 2789, 2790 (2019).

26. Samuel M. Hartzmark, & Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*. 74 THE J. OF FIN. 2789, 2790 (2019).

27. Quinn Curtis, Jill Fisch, & Adrianna Z. Robertson, *Do ESG Funds Deliver on Their Promises?*, 120 MICH. L. REV., 393, 395 (2021); Aneesh Raghunandan, & Shiva Rajgopal, *Do ESG Funds Make Stakeholder-Friendly Investments?*, 27 REV. OF ACCT. STUD., 822, 823 (2022).

28. *See generally*, Dane M. Christensen, George Serafeim, & Anywhere Sikochi, *Why is Corporate Virtue in the Eye of The Beholder? The Case of ESG Ratings.*, 97 THE ACCT. REV. 147 (2022). Indeed, these impacts might be increasing over time.

29. Doron Avramov, Si Cheng, Abraham Lioui, & Andrea Tarelli, *Sustainable Investing with ESG Rating Uncertainty*., 145 J. OF FIN. ECON. 642 (2022).

30. George Serafeim, & Aaron Yoon, *Stock Price Reactions to ESG News: The Role of ESG Ratings and Disagreement.*, 28 REV. OF ACCT. STUD., 1500 (2023).

31. Rajna Gibson Brandon, Philipp Krueger, & Peter Steffen Schmidt, *ESG Rating Disagreement and Stock Returns.*, 77 FIN. ANALYSTS J. 104, 116–117 (2021).

32. Christensen, et al., *supra*, note 28.

ii. Companies

Although ESG ratings are meant to provide stakeholders with valuable information regarding corporate nonfinancial performance, rated companies are not simply bystanders in the rating process. As investors and other stakeholders have come to rely more and more on ESG ratings, some companies have become increasingly reactive to their ratings and try to manage them.[33]

Research shows that companies react to their ESG ratings in myriad ways, ranging from substantive changes to internal processes, symbolic changes to manage public perception, or communication campaigns designed to resist the narrative created by potentially negative ESG ratings.[34] For example, Chatterji and Toffel examined the conditions under which companies respond to ESG ratings by making substantive changes to their actual ESG performance. They hypothesized and found that companies with low initial ratings are more likely to improve their ESG performance, as measured by company-wide toxic pollution, than companies with high initial ratings. They also found that this result is driven by companies that face high regulatory pressures and low-cost opportunities for improvement. Thus, companies are more likely to improve their actual performance when they are pressured to do so and the cost of improvement is sufficiently low. Clementino & Perkins further found that, in responding to ratings, companies are likely to make more substantive changes to align with the rankings when they are perceived as material to key stakeholders or when they align with corporate strategy. While it is relatively easy for companies to increase their levels of disclosure, companies need

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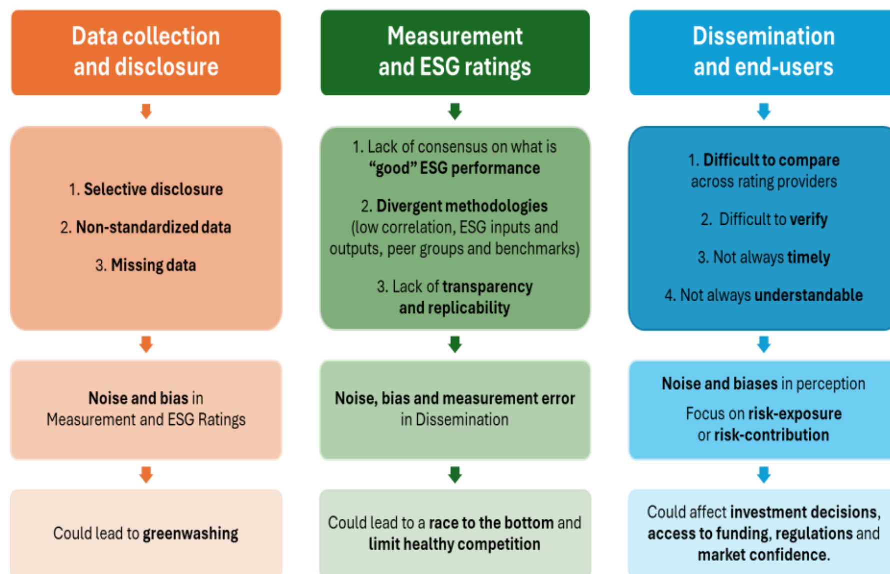
33. Amanda Sharkey, Balázs Kovács, & Greta Hsu, *Expert Critics, Rankings, and Review Aggregators: The Changing Nature of Intermediation and the Rise of Markets with Multiple Intermediaries.* 17 ACAD. OF MGMT. ANNALS 1, 48 (2023) (As ratings provide information on both, criteria for what is considered to be good performance, and the company's relative standing, they provide the company with "both impetus and guidance" to change. In contrast, other evaluative intermediaries, such as expert critics (e.g., movie critics) or review aggregators (e.g., trip advisors) might not provide rated organizations with such clear guidance on how to improve their relative standing).

34. Ester Clementino, Richard Perkins, *How Do Companies Respond to Environmental, Social and Governance (ESG) ratings? Evidence from Italy.*, 171 J. OF BUS. ETHICS 379, 392 (2021) (using interviews with rated companies, this research finds that corporate responses to ESG ratings are heterogeneous and can be mapped along a two-dimensional matrix: passive conformity, active conformity, passive resistance, and active resistance).

to be motivated to implement more substantive policies that might impact their ESG performance.

Companies are also increasingly using ratings to influence stakeholder perceptions by advertising and discussing the ratings in their disclosures. Indeed, there is a growing concern that companies are becoming more focused on improving their ESG ratings than they are on improving their underlying ESG performance. This is evidenced, for example, by companies paying rating providers for advice specifically to improve their rankings.[35]

Figure 3: Shortcomings of Current ESG Ratings and Potential Consequences



III. ANALYSIS OF ESG RATINGS USING THE THREE-STAGED FRAMEWORK

a. Three-Staged Framework

Our analysis of what could go wrong with ESG ratings starts by thinking about what an ideal, well-functioning rating system would look like. To understand this system, one must ask a basic question about ESG ratings: "What problems are ESG ratings trying to solve?"

35. *Making the Grade: Want to Lift Your Firm's Rating on Governance? Buy the Test,* WALL ST. J. (Jun. 6, 2003).

A rating will not take carbon out of the atmosphere, hire a member of the workforce from an underrepresented community, or increase shareholder representation on the board of directors.

Rather, an ESG score is primarily an information tool for investors (and other end users). This information primarily serves two purposes. First, investors could use an ESG score to better understand a company's ESG-related risks. Will a resource run short if a supplier is hit with a carbon or resource tax? Will a company get sued for discrimination or sexual harassment? Will the board misappropriate company assets? These value-relevant risks are a concern for investors, as they could decrease a company's cash flows or increase financing costs, and this would result in lower stock (and perhaps bond) prices.

Alternatively, investors could use ESG scores to promote investments that are aligned with their nonfinancial preferences. For example, an investor who cares about reducing carbon emissions might invest in a manufacturer of solar panels or decline to invest in an oil company. This is known as a values-driven investment, which means it is not necessarily a profit-driven investment and may detract from financial performance.

Note that ESG risk exposures and risk contributions are not always symmetrical, and this might be reflected in the behavior and decision-making of individual investors. For example, imagine a green energy producer in Florida. An investor who cares about risk exposures might worry about the energy plant getting struck by a hurricane. That is, this investor is more concerned about environmental risk exposure. On the other hand, an investor concerned with risk contributions might care more about the fact that the plant is producing green energy and, as a consequence, contributing less to environmental risk. One could then see that the investor concerned with risk exposure might decide to instead invest in another energy plant, say a coal plant in Indiana, that has more risk contribution but much lower risk exposure.

Traditionally, the focus on these issues was related to risk exposure. Modern corporate governance issues are enshrined in corporate law and theoretically go back to at least 1932 with Berle and Means or, more likely, to Adam Smith or earlier.[36] In any event, corporate

36. ADOLF A. BERLE JR., & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Macmillan, New York, 1932); ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

governance concerns arose long before the term "global warming" was common. Corporate governance issues primarily focus on issues related to ownership of businesses and the risk that company managers will not act in the owners' best interests. Hence, governance concerns and corporate governance measures tend to focus on risk assessment.

More recent focus on the "E" and "S" of ESG has incorporated issues of business contribution to (real or perceived) social and environmental ills. How much carbon does your company release? Or does the company engage in philanthropic activities? These questions and related activities describe the company's more extensive posture within society and embody relatively novel perspectives on corporate actions, which were traditionally assumed to target profit maximization.

There is also a conflation of the risk-exposure/risk-contribution dichotomy because many issues simultaneously relate to a company's contribution to social concern and represent risks to value. For example, policies aimed at labor, racial equality, or environmental benefits could reduce the risk of litigation and regulatory action based on workplace safety violations, discrimination, or pollution. Nevertheless, the portion of ESG that is tied to contribution assessment is novel relative to typical governance concerns.

This novelty leads to several normative questions about ESG ratings. What do we want from an ESG score? Should the focus be on risk exposure, notions of contributions to problems, or both? Should we have separate scores for risk exposure and risk-contribution measurement? Policymakers should prioritize the scope of ESG scores and how this information should be used. These questions underlie our analysis, which can be used as a framework for evaluating ESG ratings.

ESG ratings require three parties to create them. A helpful analogy is to think of any manufactured product or service. There is a supplier of inputs, a manufacturer that adds value, and an end consumer that receives the end value of the product or service. Within the three-staged framework, the company to be rated is like a supplier of the primary input (i.e., information relevant to the company's ESG policies). Although some information is also produced at the industry or economy-wide level, ESG providers primarily depend on client companies for information. Since each company's policies, investments, and behaviors are unique and proprietary, it has something like a "local monopoly" over the information that it can supply to the

rating providers. This is distinct from the typical customer-supplier relationship in which customers can choose from several suppliers.

Following the analogy, the ESG rating provider is like a manufacturer that receives the input of ESG-related information from the company that is to be rated. The ESG rating provider takes the raw input of information and uses a productive process to make an output. The productive process, in this case, is the development and application of a methodology that takes the information supplied by the company (or the market as a whole) and transforms these data into simplified and, importantly, ordinal values.[37] That is, the scores provide a normative evaluation of a company's (putative) standing in terms of its societal value, at least in terms of environmental, social, and governance outcomes. Note the difference from a typical consumer product. A consumer product adds value through the preferences of the end consumer. With a rating, there is a supposed superiority built into the rating itself, leaving little to the individual preference of the end user.

Hence, the end user, typically an investor, evaluates the ESG rating differently than a typical customer purchasing a product. All that matters for evaluation is the ordinal ranking of the ESG rating for the company being evaluated. While there may be some subjective level of importance for determining whether an ESG ranking is "high" or "low," the rated company's actual ESG performance is, theoretically, monotonically increasing in its ESG score.

In other words, the ESG rating provider (manufacturer) determines the quality of the product (ESG rating) for the end user. This contrasts with a typical consumer product, which is evaluated by end users' demand for the product in the open market. This makes the product market dynamics unique because ESG scores must be valuable to the investors to justify purchasing the data. This implies that investors can increase their profits from investment by knowing this information. Since money is fungible, ESG information is likely valuable to all investors. The scores can be easily shared once they are made. As there is no limit on the quantity an ESG rater can sell, they price to maximize revenue.

With this analogy, the three-stage conceptual framework can be viewed as a supply chain linking together the rated companies, the

37. The ESG ratings not only provide some measure of societal value from an ESG perspective but also provide a relative ranking. With the ESG scores, it is possible to make comparisons across companies from the investor's perspective. This relative ranking creates an incentive for rated companies to improve their scores as well, through improvement in ESG policies.

ESG raters, and the end users, typically investors. This framework aids in highlighting the problems that arise and, importantly, where they appear. Moreover, this view aids in identifying issues. While many problems are the same as with other supply chain relationships—such as imperfect competition, information asymmetry, and input constraints—other issues arise due to the unique nature of this market. We address some of the largest problems here.

b. Selective Disclosure and Greenwashing

The first substantial problem is that issuers have incentives to inflate their ESG ratings for various reasons. It seems evident that a higher ESG rating is better than a low one, but several factors make such a benefit economically meaningful. For example, a better rating could save money in terms of financing. Substantial literature in accounting and finance documents shows that better performance on ESG and related ratings lowers the "cost of capital" for rated companies. That is, when rated companies raise funds, like selling equity securities, they can obtain a higher price (technically a lower expected return) from investors. Dhaliwal, Li, Tsang, and Yang find that companies that disclose greater corporate social responsibility (CSR) scores reduce their cost of equity.[38] Moreover, rated companies may use ESG ratings to attract investment from funds with ESG-related mandates. Lindsey, Pruitt, and Schiller, however, suggest that such mandates may not be binding.[39] While the precise effect of ESG-related disclosures on financing is debated, it is likely a solid motivating factor in companies' desire to receive an ESG score, as it can affect investor gains.[40]

In addition to cheaper financing costs, rated companies could benefit from higher ratings from obfuscation of misdeeds, opportunism, or other scandals since they could be perceived as socially beneficial companies while engaging in dubious activities. Ramaswamy suggests that the CEO of Goldman Sachs's comments on the board of

38. Dan S. Dhaliwal, Oliver Zhen Li, Albert Tsang, and Yong George Yang, *Voluntary Nonfinancial Disclosure and the Cost of Equity Capital: The Initiation of Corporate Social Responsibility Reporting*. 86 THE ACCT. REV. 59, 60 (2011).

39. Laura Anne Lindsey, Seth Pruitt, and Christoph Schiller, *The Cost of ESG Investing,* SSRN (Jul. 5, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3975077.

40. We do not attempt to survey this entire literature here due to its magnitude. For example, the paper by Dhaliwal et al. (2011) has over 4300 Google scholar citations.

director diversity at the 2020 Davos forum were timed to distract from a recent scandal in which Goldman Sachs had to pay $5 billion in fines for its contribution to stealing from the Malaysian people.[41] In as much as regulators use ESG scores, rated companies could seek improved ESG scores to avoid regulatory scrutiny (perhaps without mitigation of ESG concerns).

If improvement in ESG scores requires actual improvement in a rated company's ESG outcomes, and the improvements are proportional to the increases in the ESG ratings, then the ESG scores are both informative and provide good incentives. Rated companies would willingly invest in ESG policies up to the point at which the benefits, primarily improved investor sentiment and financing, would equal the cost of the improvement. However, transparency and proportionality are limited.

The rated companies are one of the primary sources of information for ESG raters.[42] This puts the rated companies in the unique position of being able to influence their ESG score without improving their ESG policies. Why wouldn't a company put its best foot forward and limit disclosure of its investments that negatively affect social welfare? This selective disclosure problem is exacerbated by the fact that there are many rating providers and that there is little to no standardization within the rating industry as to what is to be measured or how it should be measured. With little guidance on what should be disclosed, it's not a stretch to imagine a lot of noise in the disclosures.

Aside from the problem of noisy, possibly irrelevant, disclosures muddying the landscape, should we expect that companies intentionally use selective disclosure to influence market participants to gain an advantage in capital markets? We need only to look at the motivations for Regulation Fair Disclosure (Reg FD).

Reg FD limits insiders' disclosure of information on a selective basis to specific groups, primarily financial market intermediaries and related parties. The regulation aims to level the playing field between smaller retail investors and large institutions.

The problems that the SEC wanted to address were focused mainly on conference calls and analysts. Analysts, whose job it is to study publicly traded companies and offer recommendations on

41. Vivek Ramaswamy, *Woke, Inc.: Inside Corporate America's Social Justice Scam*, (Hachette, UK 2021).
42. *See ESG Ratings Process*, MSGI (2024), https://www.msci.com/documents/1296102/34424357/MSCI+ESG+Ratings+Methodology+-+Process.pdf

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whether to buy a security or estimate quarterly earnings, would (and do) attend calls in which executives reveal their financial performance, among other communications. This could give an unfair advantage to the institutions that the analysts worked for and provide perverse incentives.

The SEC described the issues as follows:

> As reflected in recent publicized reports, many issuers are disclosing crucial nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both before making full disclosure of the same information to the general public. Where this has happened, those who were privy to the information beforehand could make a profit or avoid a loss at the expense of those kept in the dark.

Final Rule: Selective Disclosure and Insider Trading, U.S. Securities and Exchange Commission, Action Statement?[43]

More importantly, in this study, there was concern that selective disclosure influenced or biased analysts in favor of companies that provided beneficial selective disclosure.

> Prior to the SEC's adoption of Regulation Fair Disclosure (FD), it was widely believed that analysts traded favorable coverage of an issuer for superior access to information. Analysts expressed concern that issuers would respond to reports of negative information by failing to invite them to analyst conferences, refusing to respond to telephone inquiries, and so forth. Although Regulation FD attempted to respond to this concern by prohibiting selective disclosure by corporate officials, the media continues to describe instances of issuer retaliation for unfavorable coverage.[44]

In short, analysts who were supposed to evaluate companies' financial performance were biased to provide a superior performance estimate in exchange for access to companies' information from

43. 17 C.F.R. §§ 240, 243, 249 (2000).
44. Jill Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. REV. 39, 58 (Oct. 2007).

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corporate insiders. A risk of analogous problems exists with companies receiving ESG ratings due to the similar control of rated companies over information.

Assuming that ESG raters depend on the (to-be-rated) companies for information about their corporate policies and investments tied to environmental, social, and governance goals, gaining access to the ESG information is highly valuable to the rater. If the rated companies recognize this value, it may not be value-maximizing to part with this information gratuitously. Instead, the evaluated companies could establish understandings similar to those that motivated Reg FD. Specifically, rated companies could tacitly or implicitly exchange access to information for superior ratings.

Even without a quid pro quo relationship, rated companies could influence their average rating via selective disclosure. Assume different raters will have a distribution of ratings for a particular company. Assuming that rated companies are generally aware of which raters will give a more or less favorable rating, then some strategic behavior is expected. The rated company will have an incentive to disclose information about its policies primarily to the raters who will give favorable ratings. With such selective disclosure, the company will influence its rating to gain a superior ESG rating.

The combination of control over information, the possibility of quid pro quo, and the choice of raters to whom to disclose all mean the rated companies have a significant opportunity to influence their ESG ratings. Such influence is likely most valuable to companies raising capital or facing external criticism for their ESG policies. In other words, there is ample opportunity for "greenwashing" by those being rated, and the first stage of our framework helps explain this incentive problem.

c. *Measurement Problems and Race to the Bottom*

The issues of selective disclosure and greenwashing also create incentive problems in the second stage of our framework. Catering can corrupt the measurement design.

The rating providers likely recognize their dependence on the rated companies for information about ESG policies. In extreme cases, they cannot create meaningful ESG scores without information from the rated companies. Recognizing the incentives for selective disclosure by the rated companies, the ESG raters will rationally

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design methodologies that provide favorable ratings to those companies that are more likely to provide selective disclosure to the ESG rater.

That is, the ESG methodology is endogenous to the incentives of the rated companies to greenwash. Given that a rating provider's ESG data sales depend on sufficient information to create a rating, a profit-maximizing ESG rater would consider the potential to gain information on ESG policies when designing its methodology. Hence, a rater can integrate rated companies' preferences for greenwashing as they design their system of measurement of ESG ratings. This "catering" via methodological design could compromise the integrity of the ESG rating, at least at the margin, limiting the interpretation of the ESG score and its value to end users.

Competition could have an exacerbating effect on the catering incentive. ESG raters will compete over the selective disclosure from rated companies. The rating providers have an incentive to create a methodology that a rated company finds attractive, and the incentive is to create a methodology that is more attractive to the rated company than what competitors can provide.

This creates a "race to the bottom" in which the raters provide more and more favorable ratings to attract disclosure from the rated companies. However, the greater catering inevitably leads to the ratings becoming less informative, as more noise is introduced to the ESG score from methodological compromises intended to attract information from rated companies. This makes the rating less informative to the end user. In this sense, competition is detrimental to the measurement.

However, there is a check on the limits of the race to the bottom. If the profit incentives overwhelm the ESG scores with noise from excessive catering, they will be uninformative and useless to the end user. With little signal relative to the noise, the end users will find little to no value in the ESG score. This will prevent the sale of the data at the margin, obviously limiting profit from catering.

Hence, a rater must balance catering incentives with providing relevant information to the purchasers of the ESG score data. A few questions arise from this analysis. First, how informative are ratings given these catering incentives? Second, can some externally imposed, perhaps regulatory, constraints improve the signal provided by the raters without overwhelming costs? Also, is competition detrimental to the ESG rankings' informativeness, or can incentives be

adjusted such that competition incentivizes greater informativeness and usefulness in ESG ratings?

d. Competition Among ESG Raters

The concern of the race to the bottom motivates more significant questions. Specifically, what will the competitive environment look like with incentives to sell data to end users, obtain information from rated companies, and design methodologies to maximize profits? One possibility is that companies view the catering problem somewhat one-dimensionally. If all rating providers have a similar idea of how one could create an ESG score for a company, and the only variable is how lax the rater will be in scoring, then the problem becomes relatively simple in terms of optimization.

A rater, perhaps a hypothetical monopoly rating provider, would increase how lax it is with rated companies to benefit from their disclosure. The more favorable the rater is with companies, the more information it will obtain, enabling the production of more ESG ratings that can be sold. However, this decreasing informativeness of the methodology due to catering would limit the rating's usefulness to the end users, reducing revenue at the margin. Hence, a rational profit maximizer in this setting would trade off these effects until an additional increase in the noise of the rating would reduce net profit.

If rating providers must use similar technologies in the creation of ESG scores and only choose how transparent or favorable they are toward the rated companies, the rated companies' selection of the most favorable raters would force the race to the bottom to push the rating to its most favorable without leading to negative profit. Informativeness of ESG scores and profit would suffer.

The second stage of our framework, however, is more dynamic. There are a myriad of methods for building ESG scores. Rating providers can design methodologies that focus on and weigh different subcategories of ESG using different proxies for ESG performance. In short, they can differentiate their products through their methodological choices. This allows each rating provider to distinguish its product from another rater.

This differentiation seems strange given that, as noted above, the end user does not determine the quality of the product. After all, the rating provider informs the end user about the ESG value of the rated company. When selecting from a myriad of ESG providers, how does an investor know which ESG score they prefer? They take them at

face value as a source of information. How does the investor choose without a preference for a particular ESG score? From the ESG rater's perspective, how does one differentiate one's score to maximize profits?

Perhaps the differentiation does not produce gains by better serving the end user's particular preference for a type of methodology. Rather, differentiation in methodologies will create winners and losers for the rated companies that vary by methods. Given the incentive for rated companies to work with raters that will provide them superior ESG ratings, they may be more likely to disclose information to companies that offer higher ratings. Such effects could be compounded by side consulting agreements that produce incentives for the ESG rater to provide a superior rating and increased information flow between the rated company and the rater.

Surprisingly, this logic suggests that the myriad of ESG raters and obscure methodologies can increase ESG ratings' usefulness since there would be more opportunities to achieve a high ESG rating with multiple methodologies, the likelihood of finding an ESG rater that a rated company would want to disclose more information would increase, increasing total disclosure.

For example, imagine an ESG rater who wants to rate an oil company and an electric car company. It would be challenging, to say the least, to devise a methodology that would give them both high scores in terms of their environmental impact. Focusing on the company's environmental gains would likely disadvantage the other. With two ESG raters, however, one rater could focus on carbon impact, and the other rater could concentrate on the effects of mining metals for the batteries. The electric car company would be incentivized to work more closely with the carbon-focused ESG rater, while the oil company would be incentivized to disclose more to the mining-focused ESG rater. This increases the disclosure and set of covered companies in total, though noise is still an issue for any individual measure.

This is consistent with observed empirical relations. ESG ratings have notoriously low correlations despite ostensibly measuring the same thing.[45] Notwithstanding the low correlations, there seems to be meaningful information when there is agreement/controversy *across* rating providers about ESG scores.[46] This information is associated

45. Christensen, et al., *supra*, note 28.

46. *See e.g.*, Bang, J., Ryu, D., & Webb, R. I., *ESG Controversy as a Potential Asset-Pricing Factor* FIN. RESH. LETTERS, 58, Part A (Dec. 2023).

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with stock returns.[47] Due to catering, an individual ESG rating is difficult to gauge. However, if several ESG raters agree on a high/low rating for a company, the agreement likely washes much noise and provides a signal of the underlying ESG performance.

e. Capital Allocation and the Incentive Structure

The preceding discussion notes two significant problems with ESG ratings. The first problem originates in the first stage of our framework. The companies being rated have an incentive to selectively disclose information to either improve their ESG score or select a rater that will provide a better ESG score. The second problem lies with the profit-making incentive of the raters, who have an incentive—at least to some degree—to adapt their methodology to the preferences of the rated companies to gain access to information. This second problem, appropriately, lies in the second stage of our framework.

The third stage has issues related to capital allocation that are tied to these first two stages and their shortcomings. As the end users of ESG ratings are typically investors (or funds working on behalf of investors) interested in either investing based on their preferences for greater ESG investment or incorporating information on risks that ESG scores help evaluate, the ESG ratings are inherently tied to investment decisions. If ESG ratings can influence investor investment decisions on a large scale, the ratings can potentially affect capital allocation and, importantly, the cost of capital.

Recent research describes the allocation of capital between high- and low-ESG (or "green" and "brown") companies.[48] If investors prefer companies with better ESG performance, they will shift investments toward these companies. This will likely be through the purchase of equity (stock) investments and investment in bonds and

47. *See, e.g.*, Laura Anne Lindsey, Seth Pruitt, & Christoph Schiller, *The Cost of ESG Investing,* at 3-4 (July 5, 2023) ("…if there is information upon which more investors increasingly agree, there could be exploitable mispricing. Our empirical findings are consistent with this intuition: we find priced ESG-risk only in the most objectively measurable subcomponent (i.e., 'E', see Gibson et al., 2021), and *only when we combine scores from different providers to reduce noise*. We further show that ESG scores from the seven data providers have cross-correlations close to zero in our sample period." (Emphasis added)).

47. *Id.*

48. Lubos Pástor, Robert Stambaugh & Lucian A. Taylor, *Sustainable Investing in Equilibrium,* 142 J. FIN. ECON. 550, 550-571 (2021).

lending. This increase in demand for high ESG companies' securities will increase their equilibrium price. Correspondingly, the shift away from low ESG companies will decrease their demand and shift resources away from these companies.

Since prices are increased for companies with strong corporate ESG policies, their returns will be lower, as investors are willing to accept lower returns in exchange for satisfying their preferences. From the company's view, this means that they can offer lower returns, that is, sell securities (e.g., stock) at less of a discount. This higher price for equity sales implies that high ESG companies can now get more cash for investment. Hence, more companies will want to be perceived as high ESG companies.

This greater ability to raise capital will likely induce companies to increase ESG investments at the margin. If investors cannot distinguish between actual ESG improvements and symbolic ESG investments that are without substance, there will be an incentive to greenwash. Whether it is due to real ESG investment or greenwashing, the increased capital-raising potential can explain much of the corporate investment in sustainability reports and other disclosed ESG activities.[49]

Suppose ESG ratings signal (correctly or not) the quality of ESG investment activities at companies. In that case, these ratings can significantly affect the allocation of resources in financial markets, which can make or break a company. Hence, it is of first-order importance to understand: 1) if ESG scores alter investment flows and 2) if ESG scores accurately reflect real investments in ESG activities. If the ESG score is not an accurate representation of ESG activities, then investors could be misled and overinvest in companies that have high ESG scores but are not engaging in many activities associated with high ESG performance.

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49. *See e.g. Corporate Responsibility: Reports and Polices*, APPLIED MATERIALS, (accessed May 4, 2024), https://www.appliedmaterials.com/us/en/corporate-responsibility/reports-and-policies.html; *Environmental Footprint: Climate & Carbon Continuous Improvements*, SHERWIN-WILLIAMS, (accessed May, 4 2024) https://corporate.sherwin-williams.com/content/sherwin/corp/corp-aem-sherwin/us/en/sustainability/focus-areas/environmental-footprint/climate-carbon-story.html; *Corporate Social Responsibility*, ADOBE (accessed May 4, 2024), https://www.adobe.com/corporate-responsibility/sustainability-at-scale.html.

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f. Interactions Across Stages and Stakeholders

i. Interactions Between Companies and Rating Providers

The preceding discussion alludes to several problems in ESG ratings. The selective disclosure of information coupled with a lack of standardization on evaluating (measuring and weighing) ESG leads to a combination of incentive problems. The ESG raters likely need to coax information from rated companies. This "carrots" approach incorporates noise into ESG ratings, as raters tempt rated companies into providing information to the rater so the rater can enlarge its data set. This process reduces the value of the rating to the end user, likely an investor, who is trying to evaluate the ESG performance of a company to satisfy their preference for ESG investment or minimization of ESG-related risks.

Hence, one of the most significant problems within the ESG framework stems from the interaction of the ESG rater and the company receiving a rating. It essentially boils down to an information acquisition problem. How can the rater get the information that they need to make an accurate rating? The rated company has a local monopoly on the information about its investments, and there is an incentive to withhold this information. The ESG provider's challenge is to get the information.

In fact, one could argue that this information acquisition is an existential exercise for the ESG rater. If the relevant ESG-related information were widely disseminated amongst market participants, they could individually assess and incorporate the information. If financial markets are largely efficient, the information would be incorporated into stock prices with little need for ESG rating providers. In this sense, the limitation of information and the inability to access it are the rater's reasons for existing.

Hence, it may be in the ESG rating provider's interest to perpetuate the lack of standardization and mandatory disclosure. If all relevant information were disclosed, investors and other users could create their own weighting methodology, which would be more closely aligned with their preferences. This would essentially obviate the need for ESG ratings unless there were some institutional requirements for regulators, funds, or other groups to use ESG ratings from a provider.

Standardization would also solve many interpretation issues. With standardization comes comparability. If we don't know how to

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translate measurements from imperial to metric, it becomes difficult and costly to determine if something is larger, longer, or heavier. The ease of comparison simplifies decision-making. Again, this limits the need for the ESG rater, as their assessments to provide information on a relative basis are largely irrelevant.

ii. Interactions Between Rating Providers and End-users

This information acquisition problem exacerbates communication issues between the ESG rater and the end users. The users want the ESG information to satisfy a preference for greater ESG investment or ESG risk management. However, the noise introduced into the measure from the information acquisition problem hinders an investor's ability to use the ESG scores effectively.

The user of the ESG rating must then filter the noise out of the ESG measure to make it more interpretable. This increases the cost to the investor. Not only must they pay for the information on ESG scores from the ESG rater, but they must engage in some costly activities to reduce the noise. These activities could include buying other ESG ratings in the hopes that commonalities across the datasets provide insights into the non-noisy part of the ESG ratings. Alternatively, investors must engage in their own legwork to uncover information about the rated company and verify its ESG information.

Note that this communication problem undermines the whole notion of an ESG rating. As discussed above, the value of a rating itself is not subjectively determined by the preference of an investor, but it is something to be taken at face value to inform investors about the quality of ESG performance at the rated companies. With this communication problem related to noisy measures, the rating cannot be taken at face value by the end user since the user must first filter the noise.

One way to minimize the cost associated with the communication problem is to ignore the noise and take the ESG score at face value. This would save on the cost of purchasing multiple ESG scores and the labor/administrative cost of filtering the noise or getting the raw data directly from the source.

Why would anyone want to ignore the noise? Perhaps their incentives are designed to use the ESG scores directly without ensuring that any investment is producing results on an actual ESG policy. Such incentives can arise in the funds management industry.

Funds specializing in ESG investing may not have clear mandates as to their specific policies and benchmarks for ensuring their investment decisions adhere to a stated ESG goal. This lack of certainty as to their investment goals can limit oversight of their investment decisions by their investors and can lead to agency problems in which the ESG fund managers may not adhere to ESG objectives in the ways that their investors would prefer.

To mitigate concerns about agency problems, fund managers may use ESG scores to reinforce the notion that their investments are high in ESG performance. However, this could be window dressing. That is, fund managers may use ESG scores as a misdirection from the fact that they put few resources into confirming that their investments do well in terms of actual ESG-related performance by the rated companies. Hence, the agency problem could persist.

iii. *Interactions Between End-users and Rated Companies*

The incentive problem with funds highlights another problem with the interaction of two stages of the three-stage framework. The end users, typically investors and the rated companies, have limited communication about ESG matters. Some methods of communication between rated companies and investors include required SEC filings and non-mandatory disclosures. Some voluntary disclosures prominently comprise a significant footprint on company websites.

For example, Applied Materials, which was rated a top 3 company by ESG score by Dow Jones in 2023, has a section of their website dedicated to "Corporate Responsibility."[50] This provides a vast amount of information about all three components of ESG. Remarkably, they even offer measures of their greenhouse gas (GHG)

50. Anne Stanley, *IBD's 100 Best ESG Companies For 2023,* https://www.investors.com/news/esg-stocks-list-of-100-best-esg-companies; *see also Corporate Responsibility: Reports and Polices*, APPLIED MATERIALS, (accessed May 4, 2024), https://www.appliedmaterials.com/us/en/corporate-responsibility/reports-and-policies.html (focusing on several elements of ESG. For environmental concerns, they state "Driving a Net Zero 2040 Playbook powered by collaboration, clean energy and innovation." There is also a quote from the CEO. "'As I reflect on recent history, I am more convinced than ever that there is no industry better positioned to lead the transition to a more sustainable and inclusive future than ours.' Gary E. Dickerson" They also provide a report on sustainability. For social concerns, they focus on diversity and inclusion for their workforce and community benefits.); *see also Applied Materials Corporate Governance*, APPLIED MATERIALS, https://www.appliedmaterials.com/content/dam/site/company/csr/doc/applied-materials-corporate-governanceaddendum.pdf.coredownload.inline.pdf. (providing information on the board and the board's governance).

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emissions. Assuming it is measured with reasonable accuracy, this disclosure would be easy to interpret and compare with other companies that disclose GHG emissions.

However, some companies do not disclose their GHG emissions. Beazer Homes, instead, focuses on the carbon reduction associated with their building technologies in their sustainability report.[51] This lack of uniformity makes comparability difficult. How should investors trade if they care about the environment but lack a means of translating the disclosed information into a scale incorporating preferences about factors that affect global warming? The cost of accumulating and interpreting the various quantities and qualities of the information disclosed is not insignificant.

In addition to collecting voluntarily publicized ESG information, an investor could attempt to communicate directly with a company about their ESG policies and relevant data. The cost of such an investigation would likely be prohibitive to an individual investor. Perhaps ESG-focused funds could have sufficient size to reach an economy of scale in the collection and processing of this data.

However, empirical evidence suggests that funds of funds (investment funds that invest in hedge funds) often don't achieve sufficient size to incorporate operational risk in their investment choices appropriately.[52] This is insightful for three reasons. First, operational risk is likely to have a higher-order effect on investment outcomes relative to ESG-related risks, suggesting it should get more resources. This brings into question whether funds could reach sufficient scale to make ESG-related research viable. Second, funds of funds are compensated, to some extent, based on return performance, but mutual fund managers are typically compensated based on assets under management. So, there is little incentive to sink the cost of processing ESG-related information unless there is a direct link between sinking those costs and increasing investment flows to the funds. Third, even with resources and investment, it is unclear if a fund can obtain sufficient additional information from companies since there may be no direct benefit to the company (veritably) disclosing their ESG policies.

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51. *2021 ESG Summary,* BEAZER HOMES, https://beazerhomesusainc.gcs-web.com/static-files/89e18d4f-fab6-4329-92a6-37fb82bf817f (the authors were unable to find GHG emissions disclosures in the sustainability report).

52. Stephen J. Brown, Thomas L. Fraser & Bing Liang, *Hedge Fund Due Diligence: A Source of Alpha in a Hedge Fund Portfolio Strategy* (January 21, 2008) https://ssrn.com/abstract=1016904.

g. Policymakers and Current Initiatives

In sum, the three-staged view of the ESG rating process helps explain various issues at each stage. Problems include selective disclosure, greenwashing, measurement problems with noise, a race to the bottom, poor competitive incentives, and issues with capital allocation. The interaction of the three stages presents several limitations to the effective creation and use of ESG ratings.

The aforementioned concerns suggest that policymakers should work to address the problems in the three stages of the framework. It is difficult to know precisely how to address the issues and which problems should get priority. However, it is helpful to note the goals of any such policy, which should focus on alleviating the friction for which ESG ratings exist in the first place.

ESG raters act as information intermediaries, as investors try to access and process information about the company's corporate policies in which they want to invest. Regarding prioritization, policymakers should ask which types of ESG information are most important to investors and which pieces of information are subject to the most constraints that could be alleviated via a policy intervention. Additionally, objectives must be set as to which investor priority should be the focus of any intervention. In particular, should policies be focused on investor preference for risk contribution or risk mitigation?

Currently, several different types of policy interventions are proposed or underway. Some are light, mere recommendations and statements, while others have more teeth and require companies to take substantive actions, sometimes at significant cost.

Some entities have already proposed new laws and regulations to address issues of disclosure and standardization. These are primarily focused on the first stage of our framework: the companies being rated. The idea is to bridge the connection between the rated company and the investor. This would, in effect, bypass the ESG rating providers altogether. If mandatory disclosure about ESG is provided by the rated companies and the disclosures are standardized, this could alleviate the many issues of selective disclosure and provide investors the opportunity to evaluate rated companies directly.

We focus on recent proposals by the U.S. Securities and Exchange Commission (SEC) because these are likely the most significant and debated proposed regulations. They will likely guide the future of ESG disclosures in terms of other regulations, effects on investors,

and the ESG rating industry at large. The proposed regulations have two significant components.

The point for U.S. companies is the SEC's proposal on climate-related disclosure, "The Enhancement and Standardization of Climate-Related Disclosures for Investors," which was announced in Spring of 2022.[53] The proposal intends to provide investors with "disclosure of this [climate-related] information [that] would provide consistent, comparable, and reliable—and therefore decision-useful—information" that would help assess the influence of climate-related risks on covered companies.[54] This suggests that the SEC views the disclosures as aiding risk assessment.

The proposed rule also requires the disclosure of GHG emissions in periodic filings. This information describes contributions to climate risks, not exposure to climate risks (except indirectly). Hence, the rule implicitly incorporates investor climate-related preferences into its underlying rationale and requirements. In short, the proposed regulation encompasses disclosures related to risk and investor preference, suggesting the SEC proposes facilitating communication between the first and third stages of our framework—rated companies and investors—from all angles. The perspective of the SEC is that these climate-related disclosures facilitate investor protection and capital formation.

The proposed rule speaks a bit to the frictions that we discuss in our framework. Specifically, it cites discrepancies and variations in disclosed information. Different issuers (rated companies) provide additional information, besides required disclosures, that vary in completeness, type, and format, limiting comparability and reliability. Such lack of standardization potentially increases the cost of information gathering and processing to investors, which can hinder the ability "to make investment or voting decisions."[55] The limited disclosure environment means that data, methodologies, and assumptions underlying climate disclosures may not be understood.

Additionally, the SEC notes the lack of enforcement mechanisms for disclosures. The proposal states that some climate disclosures are "not subject to the full range of liability and other investor protections that help elicit complete and accurate disclosure by public

53. The Enhancement and Standardization of Climate-Related Disclosures for Investors. 87 Fed. Reg. 21334 (proposed April 11, 2022).
54. *Id.*
55. *Id.* at 7.

companies.”[56] This suggests that investors may be misled under the current disclosure environment. This lack of protection can stem from omitted information. While the antifraud provisions of securities laws still apply, it is likely easier to seek liability from misstatements rather than omissions when there are clear expectations of which information is relevant. Hence, the new rule could create accountability for omissions.

However, there has been substantial pushback against the additional disclosure costs associated with the proposed regulation. The SEC estimated the additional costs of compliance with the regulation to be around $500,000 per year for each company.[57] For comparison, there are about 4,200 companies listed on exchanges in the US as of 2019.[58] That equals (4,200 X 500,000) $2.1 billion. The Biden administration estimates the cost of carbon is around $51 per ton ($5 per ton under Trump). That is around 41.2 million tons of carbon (420 million). A typical combustion automobile emits about 4.6 tons of carbon per year.[59] This annual financial cost is comparable in carbon cost to taking 9 million (91.3 million) cars off the road yearly. This comparison signifies the environmental opportunity cost.

Aside from regulations aiding communication between rated companies and investors, the SEC has proposed additional regulations directly related to ESG scores. The proposed rules for “Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices” focus on funds with ESG-related investment strategies.[60]

The SEC’s motivation is again about consistency and standardization of information. As many funds have stated ESG strategies, this significant and growing group of funds and advisors aim to invest in

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56. *Id.* at 8.

57. Mark Maurer, *Companies Skewer SEC’s Climate-Disclosures Plan in Comment Letters,* WALL ST. J. (Jun. 21, 2022, 2:08 PM), https://www.wsj.com/articles/companies-skewer-secs-climate-disclosures-plan-in-comment-letters11655834912.

58. Darby Joyce, *What Fewer Public Companies Means for You,* AM. UNIV. (Jun. 1, 2023, https://kogod.american.edu/news/what-fewer-public-companies-means-for-you.

59. *Greenhouse Gas Emissions from a Typical Passenger Vehicle,* EPA, https://www.epa.gov/greenvehicles/greenhouse-gas-emissions-typical-passenger-vehicle.

60. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices. 87 Fed. Reg. 63016 (proposed Oct 7, 2022).

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securities with high ESG performance. Still, there is little ability to compare the funds' strategies and measure their ESG-related performance without clear standards and benchmarks. There are three points of focus:

1. Requiring additional specific disclosure regarding ESG strategies in fund prospectuses, annual reports, and adviser brochures

2. Implementing a layered, tabular disclosure approach for ESG funds to allow investors to compare ESG funds at a glance and

3. Generally requiring certain environmentally focused funds to disclose the greenhouse gas (GHG) emissions associated with their portfolio investments.[61]

Again, the focus is on disclosure and standardization to help investors understand their investment decisions and allocate capital according to ESG-related risk and preference. This suggests friction between funds and the investors whose money they manage. Within our framework, this is a breakdown of the information flow between the rated companies and the end users. In this sense, the fund acts as a type of information intermediary, similar to that of a rating provider. Of course, the friction could also come from a breakdown in the flow of information from the rating provider to the investor if the fund does not disclose well how or if it is using ESG ratings in its investment decisions. In short, the SEC also views communication between funds and investors as having significant frictions related to ESG policies. This happens within the third stage of our framework.

As of the date of this article, the SEC voted to approve the ESG disclosures, including GHG emissions, but they scaled back some of the GHG emission disclosure requirements. Overall, these regulations focus on getting more ESG information from (rated) companies and funds into the hands of investors to promote greater access to information and comparability across investments. That is, the focus is on problems in our framework's first and third stages.

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61. *ESG Disclosures for Investment Advisers and Investment Companies,* SEC, https://www.sec.gov/files/ia-6034-fact-sheet.pdf.

Cruz-Lopez et al.: It's Hard to Hit a Target that Doesn't Exist: A Novel Conceptual

IV. CONCLUSIONS AND POLICY RECOMMENDATIONS

This section briefly discusses some recommendations/solutions based on the three-staged approach. In moving forward, we suggest that greater attention needs to be paid to factors that impact noise within each of the three components of the ESG-rating process. This list of solutions is by no means meant to be exhaustive. Instead, we want to highlight that addressing issues with ESG ratings will require a suite of policies that would help move the field away from the current state of "aggregate confusion."[62] In other words, as our framework illustrates, no one policy can address all the issues across the areas of corporate ESG disclosures, measurement of corporate ESG performance by rating providers, and dissemination of ESG scores. Consequently, creating such a suite of policies requires a collective, ideally coordinated, action by various policymakers. Thus, we urge policymakers to interact and consider how they can design complementary policies in this space.

a. On Improving Corporate Disclosure

First, to improve the ratings, policymakers must improve the quality of data inputs that feed into these ratings. Researchers and commentators often draw parallels between the quality of corporate financial reporting and ESG disclosures. Unlike financial reporting, which is mandated for certain companies to be prepared by specific accounting standards, nonfinancial disclosures are mostly voluntary. Despite the strides in the number of (typically large, listed) companies disclosing ESG data,[63] companies decide on the content, format, and frequency of their ESG disclosures. This is often seen as a key driver behind low-quality ESG data, as it tends to be incomplete, inconsistent, boilerplate, or irrelevant. Thus, requiring mandatory disclosure of ESG data is often seen as a key solution.[64] Indeed, thousands of companies will soon be required to provide mandatory ESG

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62. *See generally,* Florian Berg, Julian F. Kolbel & Roberto Rigobon, *Aggregate Confusion: The Divergence of ESG Ratings.* 26 REV. OF FIN. 1315 (2022).

63. *ESG Companies Increasingly Acknowledging ESG Issues Risk Areas*, KMPG (accessed May 4, 2024), https://kpmg.com/xx/en/home/insights/2022/09/survey-of-sustainability-reporting-2022/esg.html.

64. Hans B. Christensen, Luzi Hail & Christian Leuz, *Mandatory CSR and Sustainability Reporting: Economic Analysis and Literature Review,* 26 REV. OF ACCT. STUD. 1176, 1176–1248 (2021).

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disclosures as they fall under the scope of the E.U.'s new Corporate Sustainability Reporting Directive (CSRD) and U.S. SEC requirements.[65]

While the general trend toward greater mandatory disclosure is apparent, we want to stress that it is not the mandatory nature of rules that results in high-quality reporting but the nature of the requirement and enforcement. Existing research shows that mandatory rules mean little when companies can interpret the requirements in any way they wish, with little repercussions.[66] Thus, we suggest that policymakers focus on creating sufficiently specific requirements and ensuring adequate monitoring. Indeed, if the disclosures require companies to reveal costly proprietary information, these disclosures can be made privately to the regulator. However, this defense also has limits, as many companies already disclose key data on their ESG performance.

One of the reasons that companies give for not providing better-quality ESG data is not knowing what to report on. To be useful, companies need to report material ESG data. In terms of corporate sustainability, materiality has been defined in two ways. The first view, known as financial materiality, is focused on identifying ESG risk that might impact enterprise value (i.e., risk exposure). This view is aligned with the interests of capital providers who are most interested in understanding company value. The second view, known as impact materiality, is focused on identifying ESG issues that have significant consequences on society and the environment (i.e., risk contribution). This view is aligned with the interests of other diverse stakeholders, including employees, customers, suppliers, and communities in which the business operates. The CSRD adopts a view that both types of materiality are important, what has become known as a double materiality approach.[67] In practice, the distinction between impact and financial materiality might not be as pronounced, as ESG issues that

65. Elena Philipova, *How Many Companies Outside the EU are Required to Report Under its Sustainability Rules?,* LSEG: LSEG INSIGHTS (Jun. 2, 2023), https://www.lseg.com/en/insights/risk-intelligence/how-many-non-eu-companies-are-required-to-report-under-eu-sustainability-rules.

66. *E.g.,* Carlos Larrinaga et al, *Accountability And Accounting Regulation: The Case Of The Spanish Environmental Disclosure Standard.* 11 EUR. ACCT. REV. 723 (2002), (investigating company compliance with a new mandatory environmental disclosure requirement in Spain, finding the vast majority of companies provide no disclosures and the remainder provide self-serving disclosures that improve their public image).

67. Christensen et. al., *supra* at note 64.

https://scholarship.law.missouri.edu/betr/vol8/iss1/5

are likely to impact enterprise value might be strongly linked to issues of concern for other key stakeholders.

A big part of the challenge in identifying material ESG issues is that these issues are industry-specific.[68] Key ESG issues for a food retailer differ from an oil and gas company, a pharmaceutical company, and so on. There have been several initiatives to map out key issues across industries. The Sustainability Accounting Standards Board (SASB) developed SASB Standards that identify financially material ESG issues for 77 industries. SASB claims to have developed the Standards following a rigorous process informed by scientific research and engagement with investors and experts. Many ESG rating providers, such as MSCI and S&P, have developed their own materiality maps. These maps directly impact the rating methodology by changing the weights assigned to different ESG sub-categories for companies in different industries. However, because the process of creating and updating these materiality maps is not very transparent, their reliability is difficult to establish.

Aside from covering relevant industry-specific ESG issues, good ESG disclosures would use appropriate, consistent metrics with accompanying narrative explanations. Currently, ESG disclosures are largely inconsistent, making any comparisons between companies difficult. This variability in ESG metrics is excessive and only serves to obfuscate corporate performance.

Fortunately, existing ESG frameworks, including the SASB Standards and the GRI Standards, provide companies with specific metrics for most ESG issues and also specify the nature of narrative disclosure that should supplement the quantitative information. For example, the GRI Standard 403: Occupational Health and Safety requires disclosure of the types of injury, injury rate, and work-related fatalities for employees and all non-employee workers, broken down by region and gender. ESG metrics can be divided into inputs and outputs. An example of an input metric would be the existence of a corporate policy on greenhouse gas emissions, and an example of an output metric would be actual greenhouse gas emissions. Good metrics should focus on outputs or the actual outcomes, even though they are more difficult to evaluate than input metrics.[69] Moreover,

68. ESG issues are also likely to vary geographically, such that a company's exposure to ESG risks and opportunities is likely to be a function of geographic breadth of its operations.

69. *E.g.*, Dane Christensen., George Serafeim & Anywhere Sikochi, *Why is Corporate Virtue in the Eye of The Beholder? The Case of ESG Ratings,* 97 THE ACCT.

companies should provide data for both historical performance and relevant targets set for the future.

High-quality disclosures also need to clearly state the relevant time period for both historical outcomes and targets. For example, what is the period over which reported greenhouse gas emissions were produced? The outcomes should be presented as relating to the same time period to improve comparability. Finally, companies should make their disclosures available in a timely and sufficiently frequent manner. Stale information is not neutral but misleading. Similar to financial reporting, companies should produce ESG disclosure within a certain timeframe following the end of the reporting period.

Lastly, companies should provide some assurance over the quality of the data and the reliability of internal controls. Like financial statements, this could take the form of an audit. For example, CSRD requires limited assurance initially (lower threshold of assurance) and reasonable assurance at a later time (higher threshold of assurance). Yet, regardless of the mechanism, high-quality disclosures require companies to demonstrate the reliability and trustworthiness of information.

b. On Improving ESG Measurement

Even if companies are making high-quality disclosures, the rating providers are faced with the challenges of evaluating ESG performance. Unlike the regulation of corporate disclosures, regulating the work of ESG rating providers could appear more challenging. This is because, currently, few mechanisms and precedents are in place to regulate the ratings industry. Indeed, under the current regulatory approach, ESG ratings, similar to credit ratings, are essentially "third-party produced opinions" (p.7), and these opinions are not regulated, regardless of how much importance investors and other stakeholders place on them.[70] However, we encourage policymakers to adopt a different frame with regard to ESG ratings that would help them fulfill their role.

We suggest that ESG measurements should be required to follow a set of broad principles to improve their efficacy. Given the complexity and newness of this field, policymakers should foster a climate

REV. 147 (2022), (finding that ESG providers disagree more about ESG outcomes than about ESG inputs because evaluating outcome measures is more subjective).

70. Alexander Coley, *ESG Ratings: A Blind Spot for U.S. Securities Regulation,* NW. J. OF INT'L L. & BUS. (forthcoming 2024).

of competition, innovation, and transparency. Over the past two decades, the ESG rating industry has undergone massive growth and consolidation.[71] In the process of consolidation, alternative views on ESG definitions and measurement can get lost. For example, when MSCI entered the market, it acquired two of the most important ESG ratings providers at the time: KLD and Innovest. Although these two providers differed in their approach to the measurement of ESG, with Innovest being more value-oriented and KLD being more values-oriented, shortly after, MSCI terminated KLD ratings and, with it, an alternative interpretation of ESG measurement.[72] By spurring competition, policymakers can allow capital providers and other stakeholders, as key users of the ratings, to express their preferences.

A requirement for a certain level of transparency and verifiability of both methodology and data inputs would be key. This transparency would not only help improve the trustworthiness of the ratings but also help identify ratings that better capture the underlying dimensions of corporate social and environmental performance. For example, transparency can help reduce systematic bias in ESG rating methodologies.[73] Indeed, transparency is likely to become even more important as more providers incorporate AI into their methodologies.

Similar to disclosures of ESG data, good ESG ratings should incorporate material, industry-specific metrics that are focused on outputs or actual corporate performance along the environmental and social dimensions. ESG rating providers must be very clear on key decisions made during the rating process, such as data imputation (or how ESG raters fill in the missing data due to incomplete company disclosures) and selecting the relevant peer group. Kotsantonis and Serafeim (2019) highlight how different approaches to these methodological aspects, although seemingly minor and technical, result in different ESG ratings. Without sufficient transparency and clarity of the methodology, the resultant differences in ratings might be interpreted as differences in underlying corporate ESG performance.

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71. Michael Pagano et al, *Understanding ESG ratings and ESG indexes, in* RSCH. HANDBOOK OF FIN. AND SUSTAINABILITY 339, 340 (Edward Elgar Publishing, 2018).

72. Robert Eccles et al., *The Social Origins of ESG: An Analysis of Innovest and KLD*, ORG. & ENV'T, 4 (2020).

73. *E.g.*, Dragon Yongjun Tang et al,, *The Determinants of ESG Ratings: Rater Ownership Matters,* PROCEEDINGS OF PARIS DECEMBER 2021 FINANCE MEETING (2021) (finding that ESG ratings are higher for companies that share the same major shareholders as the rating provider).

c. On Improving Dissemination of ESG Ratings

Lastly, policies need to address the dissemination of ESG ratings. Even if companies disclosed high-quality ESG data and rating providers devised robust methodologies for measuring ESG performance, the efficacy of these ratings would be limited unless their dissemination is considered. Our recommendations for improving the dissemination of ESG ratings go hand in hand with the recommendations for improving ESG measurement. The same policies requiring improved measurement of ESG should simultaneously prescribe ways for better dissemination of the ratings.

For ratings to be useful, they need to be made available on a timely basis. In current practice, rating providers differ significantly in terms of the timeliness of the ratings. Although many claim to update their database frequently (e.g., weekly), the ESG ratings are typically recalculated and released annually (barring a 'major' change). Because ratings use corporate data as a key source of information, they tend to update ratings following corporate disclosures of ESG data in their annual and sustainability reports. However, if the rating provider identifies material information in the interim and updates their database, this should be communicated to the users. This would be similar to current requirements for companies to file disclosures of material information with the SEC.

Lastly, we would also suggest that some aggregate ratings, such as across industries and geographic regions, be made publicly available. This transparency would help improve ratings' reliability and trustworthiness. Overall, the policies put in place to improve ratings' dissemination and methodology should focus on improving their comparability, verifiability, timeliness, and understandability. These characteristics enhance the quality of financial information, and we believe they are likely to do so for ESG ratings as well.

APPENDIX: ESG RANKING METHODOLOGIES

LSEG (Refinitiv ESG)[74]

Overview

A closer look at the framework

ESG scores from LSEG are designed to transparently and objectively measure a company's relative ESG performance, commitment and effectiveness across 10 main themes (emissions, environmental product innovation, human rights, shareholders, etc.) based on publicly reported data.

LSEG ESG scores reflect the underlying ESG data framework and are a transparent, data-driven assessment of companies' relative ESG performance and capacity, integrating and accounting for industry materiality and company size biases.

The LSEG ESG score measures the company's ESG performance based on verifiable reported data in the public domain. It captures and calculates over 630 company-level ESG measures, of which a subset of 186 of the most comparable and material per industry power the overall company assessment and scoring process.

The underlying measures are based on considerations around comparability, impact, data availability, and industry relevance that varies across each industry group.

These are grouped into 10 categories that form the three pillar scores and the final ESG score, which is a reflection of the company's ESG performance, commitment and effectiveness based on publicly reported information.

The category scores are rolled up into three pillar scores – environmental, social and corporate governance. ESG pillar score is a relative sum of the category weights which vary per industry for the

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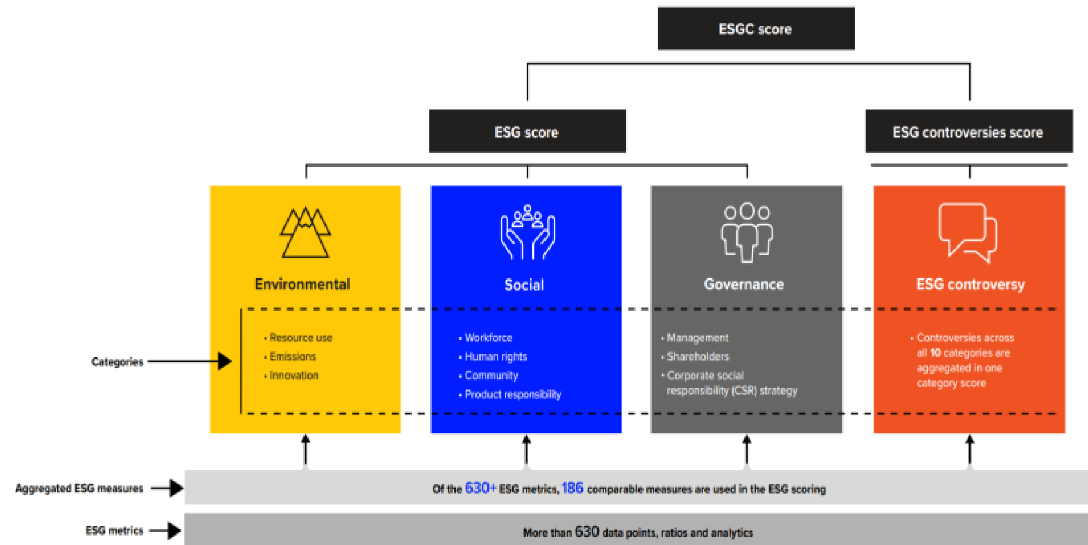
74. *Scoring Methodology: A Closer Look at the Framework*, LSEG DATA AND ANALYTICS (Accessed May 18, 2024), https://www.lseg.com/en/data-analytics/sustainable-finance/esg-scores#methodology. (Detailing an overview of ESG); *see also*, *Environmental, Social and Governance Scores from LSEG*, (Dec. 2023), https://www.lseg.com/content/dam/data-analytics/en_us/documents/methodology/lseg-esg-scores-methodology.pdf?esg=Super+Retail+Group+Ltd; *see also Collecting ESG Data*, LSEG DATA AND ANALYTICS (Accessed May 18, 2024) https://www.lseg.com/en/data-analytics/sustainable-finance/esg-scores#data-process (reporting frequency: database updates released weekly, although most scores are updated annually, consistent with corporate disclosures of ESG information).

'Environmental' and 'Social' categories. For 'Governance', the weights remain the same across all industries.[75]



SustainAnalytics ESG Risk Ratings[76]

Overview

Knowing how exposed and how well your portfolio companies manage their material ESG issues is a critical part of making well-informed investment decisions.

That is why the world's leading investors rely on our ESG research and ratings for a consistent approach to evaluate financially material ESG issues that affect the long-term performance of their investments.

Covering more than 16,000 companies, Morningstar Sustainalytics has the widest coverage of analyst-based ESG Risk Ratings in the market. The newly expanded universe includes public and private companies, fixed-income issuers and listed Chinese companies and allows investors to support diversified investment strategies.

Morningstar Sustainalytics' ESG Risk Ratings

75. *See Scoring Methodology: A Closer Look at the Framework*, LSEG DATA AND ANALYTICS (Accessed May 18, 2024), https://www.lseg.com/en/data-analytics/sustainable-finance/esg-scores#methodology. (Detailing an overview of ESG).

76. *See ESG Risk Ratings A Consistent Approach to Assess Material ESG Risk*, MORNINGSTAR SUSTAINALYTICS (accessed May, 18, 2024) (reporting scores updated annually, consistent with corporate disclosure of ESG information).

Sustainalytics’ ESG Risk Ratings measure a company’s exposure to industry-specific material ESG risks and how well a company is managing those risks. This multi-dimensional way of measuring ESG risk combines the concepts of management and exposure to arrive at an absolute assessment of ESG risk. We identify five categories of ESG risk severity that could impact a company’s enterprise value.

Negligible	Low	Medium	High	Severe
0 - 10	10 - 20	20 - 30	30 - 40	40+

Bloomberg[77]

Overview

Bloomberg provides a variety of proprietary scores that investors can use to assess company or government disclosure and performance on a wide range of ESG and thematic issues. Bloomberg’s ESG and thematic scores can integrate into company research and portfolio construction.

MSCI[78]

Overview

MSCI ESG Ratings aim to measure a company’s management of financially relevant ESG risks and opportunities. We use a rules-based methodology to identify industry leaders and laggards according to their exposure to ESG risks and how well they manage those risks relative to peers. Our ESG Ratings range from leader (AAA, AA), average (A, BBB, BB) to laggard (B, CCC). We also rate equity and fixed income securities, loans, mutual funds, ETFs and countries.

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77. *See ESG Data*, BLOOMBERG PROFESSIONAL SERVICES (accessed May 18, 2024), https://www.bloomberg.com/professional/products/data/enterprise-catalog/esg/#overview; *Environmental & Social Scores*, BLOOMBERG PROFESSIONAL SERVICES (accessed May 18, 2024), https://data.bloomberglp.com/professional/sites/10/ESG_Environmental-Social-Scores.pdf.
78. *See ESG Ratings*, MSCI (accessed May 18, 2024), https://www.msci.com/our-solutions/esg-investing/esg-ratings.

Moody's ESG[79]

Overview

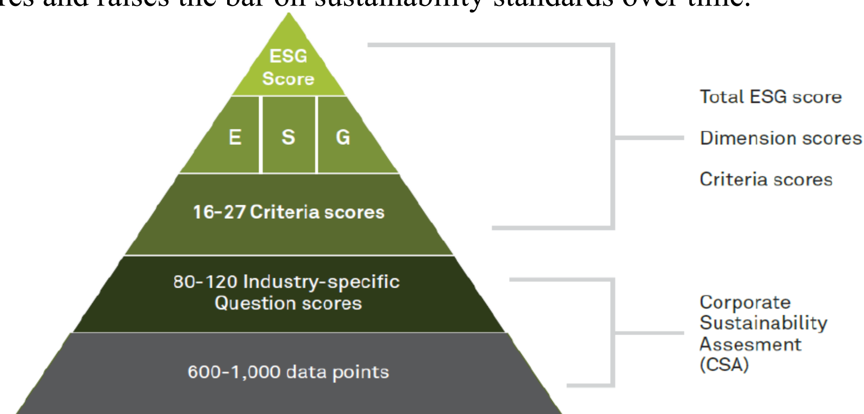
Providing an overview of exposure to environmental, social and governance considerations - and their impact on ratings - for sectors on a regional and global scale.

S&P Global[80]

Overview

Unlike ESG datasets that rely simply on publicly available information, S&P Global ESG Scores are uniquely informed by in-depth company engagement via the S&P Global Corporate Sustainability Assessment (CSA), with ESG datapoints checked against reliable public sources for every company we assess, in addition to media and stakeholder analysis, providing access to detailed ESG insights before they reach others.

Companies collectively contribute hundreds of thousands of hours in every assessment cycle, while S&P Global analysts validate disclosures for both accuracy and relevance, discuss methodologies and measurement best-practices, and provide ongoing feedback. Unlike any other ESG dataset available in the market today, S&P Global ESG Scores – and the CSA research process that underpins them – form the basis of a unique ecosystem that actively drives corporate disclosures and raises the bar on sustainability standards over time.



Source: S&P Global. Chart is provided for illustrative purposes.

79. *See ESG Scores*, MOODY'S RATINGS (accessed May 18, 2024).
80. *See ESG Scores*, S&P GLOBAL (accessed May 18, 2024) https://www.spglobal.com/esg/solutions/data-intelligence-esg-scores.