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The Duality of Variance Among ESG Assessments

Sung Eun (Summer) Kim[*]

ABSTRACT

As more attention is given to environmental, social, and governance ("ESG") considerations of firms, ESG data and ratings providers are serving an increasingly important function in the corporate discourse. It is reported that there were more than 160 ESG data and ratings providers in 2020, and more than 600 ESG ratings and rankings products available globally as of 2018. Even as the ESG provider and product markets have grown exponentially, however, the lack of ESG data has been cited as an impediment to a broader embrace of the ESG movement. One source of this perception of inadequacy originates from the widely reported variance among ESG assessments.

Variance among assessments may be a source of concern if it results from inconsistent application of methodologies, poor quality data, conflicts of interest, error, prejudice, or bias. At the same time, convergence is not necessarily a proxy for reliability and may itself also be the product of inflation, laxity, groupthink, or monopolistic market conditions. This was the case with the credit ratings of structured finance products during the 2007–2008 period, which were highly convergent, yet were later found to have been inflated and believed to have been the catalyst of one of the most devastating financial recessions in recent history.

It is this duality of variance among assessments, that they can be both harmful and desirable, and the implications of this duality on the

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[*]Professor of Law, University of California, Irvine, School of Law. skim@law.uci.edu. I am grateful to Felix Chang for reading a prior version of this Article and providing helpful comments. I have also benefitted from the opportunity to present and receive feedback on this project from presentations at the OSU Moritz College of Law Faculty Workshop (October 2022), the 2022 ESG Forum hosted by UCI Korea Law Center (November 2022), and the Emory University School of Law (December 2022). Deborah Choi, Priya Gambhir, and Linsha Qi provided superb research and editorial assistance, and Noelle Mack, Tate Cooper, Jaycob Simsheuser, and other members of the *Missouri Law Review* provided excellent editorial assistance. Any errors are my own.

ESG movement, that are the subject of this Article. The Article provides an analytical and regulatory framework that can be used to identify and mitigate harmful forms of variance and convergence among ESG assessments.

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I. INTRODUCTION

Traditionally, a firm's success or failure has been measured by its ability to generate financial returns for its shareholders. This financial view of corporate performance—also referred to as the shareholder primacy norm[1]—has been praised for its efficiency, but also criticized for its disregard of shareholders' non-financial interests and the interests of non-shareholder stakeholders, such as consumers,[2] workers,[3] and the environment and society.[4]

The recent growing interest in firms' environmental, social, and governance ("ESG") activities seeks to supplement the shareholder primacy norm with non-financial measures of corporate value and performance. While non-financial assessments of economic activity have been documented as early as the nineteenth century,[5] it is only within the

[1] *See, e.g.*, Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 637–38 (2006); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 278 (1998).

[2] Sung Eun (Summer) Kim, *Consumer Primacy: A Dynamic Model of Corporate Governance for Consumer-Centric Business*, 2022 UTAH L. REV. 235, 237 (2022); David G. Yosifon, *The Consumer Interest in Corporate Law*, 43 U.C. DAVIS L. REV. 253, 255 (2009).

[3] EMPLOYEES & CORPORATE GOVERNANCE (Margaret M. Blair & Mark J. Roe eds., 1999); Lynn A. Stout, *The Toxic Side Effects of Shareholder Primacy*, 161 U. PENN. L. REV. 2003, 2016 (2013) ("[T]he shift toward shareholder primacy . . . further worsens economically significant tensions between shareholders' interests and those of stakeholders like employees . . . ."); George Georgiev, *The Human Capital Management Movement in U.S. Corporate Law*, 95 TULANE L. REV. 639, 642 (2021).

[4] Lynn A. Stout, *New Thinking on "Shareholder Primacy"*, 2 ACCT., ECON. & L. 1, 19 (2012) ("What of community and environmental concerns . . . ? Conventional shareholder primacy theory presumes that investors . . . care only about themselves."); Frederick H. Alexander, *Saving Investors from Themselves: How Stockholder Primacy Harms Everyone*, 40 SEATTLE U. L. REV. 303, 315 (2017) ("There is no room under the stockholder primacy model for a corporation to credibly commit to long-term social and environmental responsibility.").

[5] Robert G. Eccles et al., *The Social Origins of ESG: An Analysis of Innovest and KLD*, 33 ORG. & ENV'T 575, 576 (2019) ("The inclusion of social considerations and restrictions into investment decision has existed since the nineteenth century, especially among faith-based organizations.").

past few years that ESG has begun to receive widespread acceptance as a measure of firm value,[6] particularly among investors.[7]

The UN Principles for Responsible Investment, an international organization that promotes the incorporation of ESG factors into investment decision-making, reports that more than 3,000 investors representing over $100 trillion in assets have committed to integrate ESG information into their investment decisions in 2020.[8]

While investor interest in ESG is an important prerequisite to the success of ESG reforms, it has also been a source of divide, especially in understanding the relationship between ESG and shareholder primacy. Some investors view ESG as a tool of shareholder primacy—a pathway to generate even greater financial returns and reduce risks for a firm's shareholders.[9] Others view ESG as embodying a value of its own, acknowledging that it can even sometimes be in tension with shareholder primacy's norms. This Article refers to the former view as the *financial view* of ESG, and the latter view as the *values-based view* of ESG. The dichotomy between the financial and values-based views of ESG has been

[6] Jonathan R. Macey, *ESG Investing: Why Here? Why Now?* 1 (Oct. 14, 2021) (Yale L. & Econ. Working Paper, Paper No. 22-013, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3942903 [https://perma.cc/Q5BQ-E2HG] ("The last couple of years has seen the ESG investing and governance paradigm make a decisive move from the wings to center stage in discussions of how corporations should be governed.").

[7] *See Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction, and Choice*, MORGAN STANLEY INST. FOR SUSTAINABLE INV. 1 (2019), https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf [https://perma.cc/U2RY-WGUY] ("More than 8 in 10 U.S. individual investors (85%) now express interest in sustainable investing, while half take part in at least one sustainable investing activity."); Witold Henisz, Tim Koller & Robin Nuttall, *Five ways that ESG creates value*, MCKINSEY & CO. (Nov. 14, 2019), https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value [https://perma.cc/VV2J-KANU].

[8] *Annual Report 2020 Foreword*, PRINCIPLES FOR RESP. INV., https://www.unpri.org/annual-report-2020 [https://perma.cc/LVN5-JSZR] ("The collective AUM [assets under management] represented by PRI signatories increased by 20%, from US $86.3 trillion to US $103.4 trillion as of 31 March 2020, representing 3,038 signatories.").

[9] One basis for this view is that ESG uses firm resources and therefore should generate firm value. *See, e.g.*, George Serafeim & Aaron Yoon, *Which Corporate ESG News Does the Market React To?*, 6, 15 (Fin. Analysts J. Working Paper, Paper No. 21-115, 2021) (referring to "an increasing buy-in that ESG issues use firm resources and therefore should be related to shareholder value").

described as ESG's "existential defect,"[10] and fundamentally impacts one's understanding of whether and why ESG matters.

As these debates and overall interest in ESG have intensified, ESG data and ratings providers are serving an increasingly important role in the ESG discourse.[11] According to KPMG, there were 160 ESG ratings and data products providers worldwide in 2020.[12] And according to ERM, a sustainability consultancy, there were more than 600 ESG ratings and rankings products available globally as of 2018.[13] Moreover, UBS estimates that revenues from ESG data and service provision will double its 2020 levels by 2025.[14]

Even as the number and types of ESG providers and products have grown, the lack of ESG data has been cited as an impediment to a broader embrace of ESG considerations. A 2017 BNP Paribas survey of institutional investors, for example, revealed that more than half (55%) of respondents regarded the lack of robust ESG data as the most significant barrier to greater adoption of ESG strategies.[15]

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[10] Stuart Kirk, *Stuart Kirk: ESG Must Be Split in Two*, FIN. TIMES (Sept. 2, 2022), https://www.ft.com/content/4d5ab95e-177e-42d6-a52f-572cdbc2eff2 [https://perma.cc/5JK2-9Q5X].

[11] *See, e.g.*, Jonathan Doh, Shawn Howton & Shelly Howton, *Does the Market Respond to an Endorsement of Social Responsibility? The Role of Institutions, Information, and Legitimacy*, 36 J. MGMT. 1461, 1471–73 (2010) (highlighting the important role that institutional intermediaries (such as Calvert, LexisNexis, and Kinder, Lydenberg, and Domini) play in conferring legitimacy to a firm's social responsibility). Another important information intermediary is news outlets, which are outside the scope of this Article. For studies of the impact of ESG news on stock market returns, see Gunther Capelle-Blancard & Aurélien Petit, *Every Little Helps? ESG News and Stock Market Reaction*, 157 J. BUS. ETHICS 543, 544 (2019) (reporting that on average, firms facing negative events experience a drop in their market value, whereas companies gain nothing from positive announcements) and Caroline Flammer, *Corporate Social Responsibility and Shareholder Reaction: The Environmental Awareness of Investors*, 56 ACAD. MGMT. J. 758, 459–60 (2013) (finding that firms reported to behave responsibly toward the environment experience a significant stock price increase, whereas firms reported to behave irresponsibly face a significant decrease).

[12] *Sustainable Investing: Fast-Forwarding Its Evolution*, KPMG (Feb. 2020), https://assets.kpmg/content/dam/kpmg/xx/pdf/2020/02/sustainable-investing.pdf [https://perma.cc/GE6K-WTWN].

[13] Christina Wong & Erika Petroy, *Investor Survey and Interview Results*, SUSTAINABILITY INSTITUTE BY ERM, https://www.sustainability.com/thinking/rate-the-raters-2020/ [https://perma.cc/S5UZ-DRH4] (last visited Aug. 17, 2022).

[14] *Future Reimagined: Will ESG Data and Services Demand Accelerate Post-COVID & Who Will Win?*, UBS (June 18, 2020), https://www.ubs.com/global/en/investment-bank/in-focus/covid-19/2020/esg-data-and-services.html [https://perma.cc/5FKC-4FJ8] [hereinafter *Future Reimagined*].

[15] *Great Expectations for ESG: What's Next for Asset Owners and Managers*, BNP PARIBAS (2017), https://www.bnpparibas.nl/app/uploads/sites/6/2017/05/great-expectations-for-esg---survey-infographic-final.pdf [https://perma.cc/GL5W-82XX]

This perception of inadequacy of ESG data stems in part from the widely reported variance among ESG assessments. Variance among ESG assessments has been a key focus of the academic research on ESG data providers. The emerging consensus is that variance among ESG assessments is a reason to doubt their accuracy and validity.[16] Credibility is the lifeblood of gatekeeping,[17] and these studies have led to a legitimacy crisis for ESG gatekeepers and, furthermore, the ESG movement.[18]

This Article's main contribution to the ESG literature is its emphasis that convergence among assessments is not always an indicator of their accuracy or reliability. As a recent example, the credit ratings of structured finance products among credit ratings agencies during the 2007–2008 period were highly convergent yet were later revealed to have been inflated.[19] The inflated ratings were blamed for catalyzing one of the most devastating financial recessions in recent history.[20] Inflated ratings were also at the heart of the dotcom bubble,[21] the East Asian Financial Crisis,[22] and the accounting scandals of 2001 and 2002 that led to the collapse of Enron and other landmark corporations.[23]

[hereinafter *Great Expectations*]. The "Great Expectations for ESG" report is a global survey of 461 asset owners and asset managers conducted by BNP Paribas in early 2017. *Id.*

[16] See *infra* Part II.C.

[17] For a gatekeeper to perform its truth-revealing function, it needs to have sufficient reputational capital to lose, net of any private benefits it has to gain, from lying. An important prerequisite to the gatekeeping function, then, is for a user to be able to verify, after the fact, whether a gatekeeper has told the truth. On the flipside, the premise of gatekeeper liability is that the gatekeeper has the ability to monitor and determine whether the client is telling the truth. *See, e.g.*, Reinier H. Kraakman, Gatekeepers: *The Anatomy of a Third Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 62–66 (1986).

[18] *See infra* Part II.C.

[19] Robert Rich, *The Great Recession*, FEDERAL RESERVE HISTORY (Nov. 22, 2013) https://www.federalreservehistory.org/essays/great-recession-of-200709 [https://perma.cc/K8LY-Y8Q5].

[20] NATIONAL CRISIS INQUIRY COMMISSION, FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 3–4 (2011).

[21] Karel Lannoo, *Credit Rating Agencies: Scapegoats or Free-Riders?*, 20 EUR. CAP. MKTS. INST. COMMENT. 1, 1 (2008) ("Rating agencies rapidly emerged as one of the first villains, but also victims of the financial crisis . . . Doubts had already emerged on the role of [credit rating agencies] after . . . the dot-com bubble such that policy-makers could no longer stand aside.").

[22] G. Ferri et al., *The Procyclical Role of Rating Agencies: Evidence from the East Asian Crisis*, 28 ECON. NOTES 335, 336 (1999) ("International financial institutions unanimously blamed rating agencies for their inability to forecast the East Asian crisis.").

[23] Amanda J. Bahena, *What Role Did Credit Rating Agencies Play in the Credit Crisis?*, UNIV. OF IOWA CTR. FOR INT'L FIN. AND DEV., at 6 (2010),

Recognizing this duality of convergence and variance among assessments—i.e., that neither are categorically harmful or desirable—this Article provides a framework that can be used to distinguish between healthy and harmful forms of variance among ESG assessments. *Variance* among assessments is harmful when it is the product of poor-quality data, inconsistencies in methodology (within the same assessor), *ex post* rewriting (to fit a desired narrative), or prejudice and bias. On the other hand, *convergence* among assessments is harmful when it is the product of inflation, capture, groupthink, or monopolistic market conditions.

After analyzing these harmful and optimal forms of variance and convergence among ESG assessments, this Article surveys market and regulatory interventions that can be used to foster optimal forms of variance and to mitigate harmful forms of variance.

The rest of the Article proceeds as follows. Part II provides an overview of the growing ESG movement and the corresponding growth in ESG gatekeeping. Special attention is paid to how variance among ESG assessments has created a legitimacy crisis for ESG gatekeepers. Part III supplements the general trend in the literature raising the alarm on variance among ESG assessments with a contrasting account that views variance as potentially indicative of a healthy forum for diverse ideas and opinions. Both accounts are applicable to the ESG context, and Part III provides an analytical framework that can be used to distinguish between harmful and healthy forms of variance among ESG assessments. Part IV surveys market and regulatory interventions that can be used to mitigate harmful forms of variance and convergence among ESG assessments. Part V concludes.

II. THE RISE AND FALL OF ESG GATEKEEPING

As more attention is given to ESG considerations of corporations, ESG data and ratings providers are serving an increasingly important function in the ESG discourse. This Part describes the growing prominence of ESG and ESG gatekeepers in the corporate landscape, and the legitimacy crisis of ESG gatekeeping that has been fueled by the widely documented variance among ESG assessments.

http://www.spaeth.ru/HS20152016/artikel_16.pdf [https://perma.cc/KMC7-VAUP] (noting that in 2001, credit rating agencies failed to downgrade Enron from investment grade when Enron already had poor credit, and when Enron was finally downgraded, the downgrade destroyed what remained of Enron's stock, causing Enron to file for bankruptcy).

A. The Rise of ESG

Historically, corporations have been evaluated on their ability to generate financial returns for their investors. This financial view of corporate performance—also referred to as the shareholder primacy norm—has been praised for its efficiency but also criticized for its potential detriment to non-shareholder stakeholders, such as consumers, workers, the environment, and society.[24] The embrace of ESG considerations of firms seeks to supplement this traditional perspective of firm value with environmental, social, and governance considerations.

While non-financial valuations of firms can be traced back to as early as the nineteenth century, the modern roots of the ESG movement were planted in the 1970s, when the United Nations Environment Programme ("UNEP") was established at the UN Conference on the Human Environment in Stockholm.[25] The UNEP is the global authority for the environment, focusing on climate, nature, and sustainable development.[26]

In 2005, the UNEP published *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (referred to as the Freshfields Report), which encouraged ESG integration into investment decisions.[27] Furthermore, in 2015, all UN Member States adopted the UN Sustainable Development Goals ("SDGs"), a collection of seventeen goals that create a "shared blueprint for peace and prosperity for people and the planet, now and into the future."[28] In the United States, the Forum for Sustainable and Responsible Investment was founded in 1984 with the mission of shifting investment practices toward sustainability.[29]

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[24] *See supra* notes 2–4 and accompanying text.

[25] For a detailed history, see *The Rise of ESG Investing*, CFA INST., https://interactive.cfainstitute.org/ESG-guide/esg-past-and-present-238UB-188148.html [https://perma.cc/4PG4-CMNU] (last visited Mar. 1, 2023).

[26] *Funding and Partnerships*, UN ENVIRONMENT PROGRAMME, https://www.unep.org/ [https://perma.cc/9PSV-54T8] (last visited Mar. 1, 2023).

[27] U.N. ENVIRONMENTAL PROGRAMME FINANCIAL INITIATIVE, A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT, (Oct. 2005), https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf [https://perma.cc/NS3U-8WPD].

[28] U.N. Office for Sustainable Development, *Sustainable Development Goals*, UNITED NATIONS, https://unosd.un.org/content/sustainable-development-goals-sdgs [https://perma.cc/29DX-EQYY] (last visited Mar. 1, 2023).

[29] HONG KONG EXCHANGE, ESG EQUITY INDEX FUTURES: MEETING THE INCREASING NEEDS FOR ESG INVESTMENT 2 (April 12, 2021), https://www.hkex.com.hk/-/media/HKEX-Market/News/Research-Reports/HKEx-Research-Papers/2021/CCEO_ESGIdxFutures_202104_e.pdf?la=en [https://perma.cc/84ZQ-WES6].

The *Environmental* (E) pillar among ESG considerations examines a firm's efforts to conserve nature and includes a firm's impact on climate change, carbon emissions, air pollution, water pollution, biodiversity, deforestation, energy efficiency, waste management, and water scarcity.[30] The *Social* (S) pillar examines a firm's relationships with its stakeholders, and includes customer satisfaction, data policies, commitment to gender and diversity issues, employee engagement, community relations, human rights, and labor standards.[31] The *Governance* (G) pillar examines how a firm is run, and includes its board composition, audit committee structure, bribery, corruption, executive compensation, lobbying, political contributions, and whistleblower policies.[32]

While these categorizations might suggest that each pillar is distinct, the three pillars are often intertwined. For example, the issue of greater diversity on corporate boards implicates both the Social (S) and Governance (G) pillars of ESG.

A common critique of ESG is that it is too amorphous to be used as a measure of value and thus limited in its ability to motivate or discipline managerial and firm performance.[33] One response to these concerns has

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[30] *ESG Investing and Analysis – ESG Factors*, CFI INSTITUTE, https://www.cfainstitute.org/en/research/esg-investing [https://perma.cc/X77S-XHL6] (last visited Apr. 29, 2023).

[31] *Id*.

[32] *Id.*

[33] Macey, *supra* note 6 (noting that the long-term focus of ESG "serves the private interests of important political groups such as organized labor and corporate management because it takes pressure off of management to focus on profit maximization or on objective criteria such as share prices for evaluating managerial performance"). Macey also characterizes ESG governance as "a new form of antitakeover device and a convenient tool for enabling ineffective management to escape accountability." *Id*. at 2. The relationship between ESG and corporate performance has also recently been the subject of political debate, particularly among Republican lawmakers. *See* Brenna Goth, *State Lawmakers Push Texas-Style Business Penalties Against ESG (1)*, BLOOMBERG LAW (Jan. 30, 2023), https://www.bloomberglaw.com/bloomberglawnews/esg/XDSJQ4SG000000?bna_news_filter=esg#jcite [https://perma.cc/N8KG-JYGY]. Many are pushing for laws that would discourage and even penalize companies' and funds' use of ESG factors in their decision-making. *Id.*; *see also* Ryan McGlashan, *The Rise of State Anti-ESG Legislation*, FORDHAM J. CORP. & FIN. L. BLOG (Nov. 11, 2022), https://news.law.fordham.edu/jcfl/2022/11/11/the-rise-of-state-anti-esg-legislation/ [https://perma.cc/YN4T-CL6A]. For example, in Florida, Governor Ron DeSantis effectively adopted a ban on ESG considerations by preventing state fund managers from evaluating ESG factors when investing state funds. Press Release, Ron DeSantis, Governor of Florida, *Governor Ron DeSantis Eliminates ESG Considerations from State Pension Investments*, (Aug, 23, 2022), https://www.flgov.com/2022/08/23/governor-ron-desantis-eliminates-esg-considerations-from-state-pension-investments/ [https://perma.cc/9SYB-Y5TE]; *see also* Andrew Ross Sorkin et al., *DeSantis Claims Win in Campaign Against E.S.G.*, N.Y. TIMES (Aug. 25, 2022),

been to link ESG factors to financial performance.[34] In this Article, I refer to this view as the *financial view* of ESG. More specifically, this perspective views ESG activities as valuable to the extent that they enhance a firm's financial performance.[35] One's view of ESG also necessarily drives one's view of ESG gatekeeping. Those who adopt the financial view of ESG rely on ESG gatekeepers to help them identify ESG activities that are correlated to improvements in a firm's financial performance.

Consistent with the financial view of ESG, funds that invest based on ESG principles have attracted significant investor interest. The UN Principles for Responsible Investment reported in 2020 that more than 3,000 investors representing over $100 trillion in assets have committed to integrate ESG information into their investment decisions.[36] Morningstar reported that global sustainable funds attracted $32.6 billion in new money in the second quarter of 2022, reaching a total of $2.47 trillion.[37]

According to the United States Forum for Sustainable and Responsible Investment, there were more than 1,000 ESG indices in 2020.[38] The first such index was the Domini 400 Social Index, now the MSCI KLD 400 Social Index, which was created in 1990.[39] Another widely used index is the FTSE4Good Index Series, which was launched in 2001 by the Financial Times Stock Exchange-Russell Group ("FTSE"),

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https://www.nytimes.com/2022/08/24/business/dealbook/desantis-florida-esg-investing.html [https://perma.cc/KD8A-X6V9].

[34] *See, e.g.*, *The Rise of ESG Investing*, *supra* note 25.

[35] The following are some examples of the financial view of ESG:

"At State Street . . . we believe that ESG factors can be used to mitigate risk and identify potential alpha signals." *The ESG Data Challenge*, STATE STREET (Mar. 2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/03/esg-data-challenge.pdf [https://perma.cc/WA3Z-ERY8].

"Corporate executives and investors alike are starting to be more open to considering ESG factors in conjunction with companies' primary objective of maximizing shareholder value." Michael Kozlov et al., *Using AI to Tackle the ESG Data Challenge*, WORLDQUANT (Dec. 15, 2021), https://www.worldquant.com/ideas/using-ai-to-tackle-the-esg-data-challenge/ [https://perma.cc/H2MH-LTZH].

[36] *Annual Report 2020 Foreword*, *supra* note 8.

[37] *Global Sustainable Fund Flows Report*, MORNINGSTAR 2 (Jan. 2023), https://www.morningstar.com/lp/global-esg-flows [https://perma.cc/4NS7-U8X7].

[38] Farzana Hoque, The Rise of ESG in Passive Investments, USSIF FOUND. 3, https://www.ussif.org/files/Publications/Rise_of_ESG_%20passiveinvestments_2020.pdf [https://perma.cc/T9WR-BCFP].

[39] *See* MSCI KLD 400 Social Index, *Index Factsheet* (Feb. 28, 2023), https://www.msci.com/documents/10199/904492e6-527e-4d64-9904-c710bf1533c6 [https://perma.cc/EE86-DE3U].

and provides benchmark and tradable indices for ESG-driven investors.[40] FTSE4Good's ESG rating criteria are developed through market consultation processes and are reviewed and approved by an independent committee of experts.[41] While each index has its own investment strategy and methodology, these ESG indices generally aim to offer products that can satisfy investors' financial objectives.[42]

In contrast with the financial view that has propelled the exponential growth in investor interest in ESG, a *values-based view* of ESG embraces ESG as a standalone measure of firm value that is independent of, and at times even counter to, financial considerations. Under this view, ESG's significance primarily lies in imbuing corporations with a social responsibility to uphold ESG priorities which may mean different things to different stakeholders.

Board diversity offers a helpful example to distinguish between the financial and values-based views of ESG. Those who adopt a financial view of ESG might view efforts to improve the diversity of a firm's board as valuable only to the extent that such efforts enhance the firm's financial performance.[43] On the other hand, those who adopt a values-based view of ESG might view efforts toward greater board diversity as valuable primarily because such efforts signal a firm's commitment to provide more sustainable and equitable access to key positions and opportunities within the organization.[44]

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[40] *FTSE4Good Index Series Fact Sheet*, FTSE RUSSELL 1 (Jan. 31, 2023), https://www.ftserussell.com/products/indices/ftse4good [https://perma.cc/B788-4VRX] (under heading "Factsheets" select FTSE4Good Index Series for download).

[41] *Id.*

[42] For a study of the variance in ESG index funds' investment strategies, portfolios, voting records, and fees, see Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921, 1935–38 (2020). For a critical view of this variance, see Ryan Clements, *Why Comparability is a Greater Problem Than Greenwashing in ESG ETFS*, 13 WM. & MARY BUS. L. REV. 441, 444 (2022).

[43] For examples of this financial view of board diversity, also referred to as the "business case" for board diversity, *see, e.g.*, VIVIAN HUNT ET AL., *Delivering Through Diversity*, MCKINSEY & CO. 12 (2018) ("[C]ompanies with the most ethnically/culturally diverse executive teams—not only in terms of absolute representation, but also of the variety or mix of ethnicities—are 33% more likely to outperform their [less diverse] peers on profitability."); Rocío Lorenzo et al., *How Diverse Leadership Teams Boost Innovation*, BOS. CONSULTING GRP. (Jan. 23, 2018), https://www.bcg.com/publications/2018/how-diverse-leadership-teams-boost-innovation [https://perma.cc/L4XH-7JBF] (noting that companies with above-average diversity at the management level generate 19% higher innovation revenues than companies with below-average diversity); David A. Carter et al., *Corporate Governance, Board Diversity, and Firm Value*, 38 FIN. REV. 33, 51 (2003) (finding a positive correlation between firm value and board diversity).

[44] *See, e.g.*, Valeria Naciti, *Corporate Governance and Board of Directors: The Effect of a Board Composition on Firm Sustainability Performance*, 237 J. CLEANER

A recent development at automotive and clean energy company Tesla offers another illustrative example of the difference between the financial and values-based views of ESG.[45] In May 2022, Tesla CEO Elon Musk wrote an email to all employees requiring them to spend a minimum of forty hours physically in the office per week,[46] effectively eliminating a remote work option amid the COVID-19 pandemic. The financial impact of this decision can be determined by assessing the change in the key performance indicators ("KPIs") such as profitability, liquidity, solvency, efficiency, and valuation before and after the Tesla remote work policy email was distributed.

However, assessing the values-based impact of Tesla's remote work policy is more challenging. To assess the impact of the remote work policy on the most directly impacted stakeholders—the employees—one could refer to the general preferences of workers for and against returning to the office to work and use that preference distribution to calculate the impact of the policy on employee satisfaction.[47] A more precise indicator would be to survey the preferences of the affected employees, although this data may be difficult for a third party to obtain.

Stuart Kirk, former head of responsible investment at HSBC Asset Management, describes this dichotomous understanding of ESG as ESG's "existential defect."[48] Kirk wrote in an opinion piece for the *Financial Times*:

> The flaw is that ESG has carried two meanings from birth. Regulators have never bothered disentangling them, so the whole industry speaks

PROD. 1, 7 (2019) (noting that board diversity is positively correlated with a corporation's social performance and commitment to environmental investments).

[45] Tesla offers another helpful example of the subjective nature of ESG assessments. While it is a leader in the electric car space (outperforming in the E pillar of ESG), there have been multiple reports of its mistreatment of workers (negatively impacting its S and G pillars of ESG). *See, e.g.*, Julia Carrie Wong, *Tesla Factory Workers Reveal Pain, Injury and Stress: 'Everything Feels Like the Future But Us'*, GUARDIAN (May 18, 2017), https://www.theguardian.com/technology/2017/may/18/tesla-workers-factory-conditions-elon-musk [https://perma.cc/ZT3Q-4XM6].

[46] *See, e.g.*, Chris Isidore, *Elon Musk Tells Tesla Employees: Return to the Office, or Else*, CNN BUS. (June 2, 2022) https://electrek.co/2022/06/01/elon-musk-tesla-employees-come-back-office-or-quit/ [https://perma.cc/X74M-DCPG] ("Remote work is no longer acceptable. Anyone who wishes to do remote work must be in the office for a minimum (and I mean *minimum*) of 40 hours per week or depart Tesla. This is less than we ask of factory workers.").

[47] A Gallup poll reports that among the workers they surveyed, 37% prefer to continue working fully from home, 54% prefer a hybrid remote/in person model, and 9% prefer to return to work full time. Lydia Saad & Ben Wigert, *Remote Work Persisting and Trending Permanent*, GALLUP (Oct. 13, 2021), https://news.gallup.com/poll/355907/remote-work-persisting-trending-permanent.aspx [https://perma.cc/56ZE-YJLJ].

[48] Kirk, *supra* note 10.

> and behaves at cross purposes. One meaning is how portfolio managers, analysts and data companies have understood ESG investing for years. That is: "taking environmental, social and governance issues into account when trying to assess the potential risk-adjusted returns of an asset." Most funds are ESG on this basis. Weather, corporate culture or poor governance always influence valuations to some degree.
>
> But this approach is very different to investing in "ethical" or "green" or "sustainable" assets. And this second meaning is how most people think of ESG – trying to do the right thing with their money. They prefer a company that doesn't burn coal, eschews nepotism and has diverse senior executives.
>
> Two completely different meanings then. One considers E, S and G as inputs into an investment process, the other as outputs—or goals to maximise.[49]

Kirk argues that the only solution to address this dichotomous understanding of ESG is to split ESG in two (by making a distinction between ESG-input funds and ESG-output funds) and emphasizes that standardized ESG scores are an important prerequisite to implementing this solution.[50]

Unsurprisingly, many financial economists who study ESG and ESG gatekeepers have adopted a financial view of ESG. For example, Robert Daines, Ian Gow, and David Larcker, in their study of corporate governance ratings (which make up the governance (G) pillar of ESG), emphasize that the ability of ratings users "to earn superior risk-adjusted returns by either investing in firms with good governance or avoiding firms with poor governance" is an important function of governance ratings.[51]

And indeed, several empirical studies have demonstrated a positive relationship between ESG efforts and financial returns. For example, a study comparing the "best-in-class" U.S.-headquartered firms based on ratings from the MSCI ESG Stats Database with the "worst-in-class" firms finds that "best-in-class" firms outperform "worst-in-class" firms from an accounting perspective and are also valued more highly by investors than "worst-in-class" firms.[52]

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[49] *Id*.

[50] *Id.* ("Investors can disagree whether a future carbon tax will hurt car company profits, but everyone should have the same emissions numbers. Standardised scores are a regulatory priority.").

[51] Robert M. Daines, Ian D. Gow, & David F. Larcker, *Rating the Ratings: How Good are Commercial Governance Ratings?*, 98 J. FIN. ECON. 439 (2010).

[52] Amrou Awaysheh et al., *On the Relation Between Corporate Social Responsibility and Financial Performance*, 41 STRATEGIC MGMT. J. 965 (2020).

Other authors have explored the impact of the *quality* of ESG activities on financial returns. For example, Mozaffar Khan, George Serafeim, and Aaron Yoon construct a materiality score (based on data from the Sustainability Accounting Standards Board) for a firm's performance on sustainability issues. They find that firms that do well on *material* sustainability issues significantly outperform firms with poor ratings on these issues.[53] They also find that firms that do well on *immaterial* sustainability issues do not significantly outperform firms with poor ratings on those issues.[54]

However, the studies that report a positive relationship between ESG activities and financial returns have reached varying conclusions about the direction of causality. It is not always clear whether firms with strong ESG policies do better financially due to their ability to attract higher quality employees, suppliers, etc.,[55] or if financially strong firms have more funds to invest in ESG policies.[56] A study of the organizational processes within firms reports that companies that voluntarily adopt sustainability policies (which the authors define as policies relating to the environment, employees, community, products, and customers) also adopt distinct organizational processes.[57] These processes include assigning formal responsibility for sustainability issues to the board and tying executive compensation to sustainability metrics.[58] The authors conclude that it is the companies with these *sustainability processes* in place that significantly outperform their counterparts in terms of stock market and accounting performance in the long-term.[59]

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[53] Mozaffar Khan, George Serafeim & Aaron Yoon, *Corporate Sustainability: First Evidence on Materiality*, 91 ACCT. REV. 1697 (2016).

[54] *Id.*

[55] Violeta Diaz et al., *Reconsidering Systematic Factors During COVID-19*, 38 FIN. RSCH. LETTERS, 1, 1–2 (2021) ("According to recent research, firms that neglect social responsibilities or lack efficient governance have significant 'hidden' risks. For example . . . environmentally unfriendly firms are more likely to experience the costly settlements of environmental lawsuits. A high ESG score may indicate a better chance of avoiding such incidents, suggesting that ESG indirectly speaks to a firm's capability of mitigating stakeholder-related risks.").

[56] Margarita Tsoutsoura, *Corporate Social Responsibility and Financial Performance*, UC BERKELEY CTR. FOR RESP. BUS. 17–18 (2004).

[57] Robert G. Eccles, Ioannis Ioannou & George Serafeim, *The Impact of Corporate Sustainability on Organizational Processes and Performance*, 60 MGMT. SCI. 2835 (2014). These companies are termed *High Sustainability* companies. *Id.* at 2836.

[58] *Id.*

[59] *Id.* ("*High Sustainability* companies significantly outperform their counterparts over the long-term, both in terms of stock market as well as accounting performance.").

Others are skeptical that any relationship between ESG activities and financial returns exists at all.[60] They are critical of the studies that demonstrate a positive relationship between the two, pointing to the fact that measures of both financial performance and ESG are inconsistent across studies.[61] For example, a particular activity may have a negative short-term financial impact but a positive long-term financial impact, in which case the choice of time frame will drive the results of the study.[62]

To summarize, the financial view of ESG is only partially supported by the empirical literature. These mixed conclusions reveal that relying on a financial view of ESG to sustain the ESG movement can be precarious.

Furthermore, while the financial view of ESG may be helpful in persuading investors to pay more attention to other stakeholder considerations, the idea that ESG matters only if it can be translated into financial gain undermines one of the underlying goals of ESG, which is to move away from short-term, profit-oriented thinking toward long-term sustainability and resilience. Valuing only what can be measured with precision has led us to overvalue those things that are measurable (e.g., profits) compared to other things that are equally, if not more, important but more complicated to measure (e.g., sustainability).

This Article calls forward this delicate relationship between ESG and shareholder value. It recognizes that while ESG considerations emerged as a response to the growing recognition that firms' pursuit of financial performance alone has had a destructive effect on our society, investors' embrace of ESG considerations is necessary for its success. As such, this Article seeks to diversify the primarily financial orientation of the ESG literature by also including the complications and opportunities created by values-based ESG assessments.[63]

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[60] Bradford Cornell & Aswath Damodaran, *Valuing ESG: Doing Good or Sounding Good?*, J. OF IMPACT AND ESG INV., Fall 2020, at 76.

[61] *Id.*

[62] Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. COLO. L. REV. 731, 784 (2019) ("The long-term benefits of a company's E, S, and G factors seem to be the reason that studies showing positive results for ESG integration are those conducted over a longer timeframe. Executives recognize the need for longer-term thinking but feel constrained by the emphasis on quarterly reports. If investors and analysts shift to longer-term thinking, the companies' performance may improve, and external, systems-level benefits can be generated.").

[63] Other departures from the purely financial view of ESG in the literature include Josephine Balzac's account, which views corporate efforts to reduce the adverse impacts of climate change as a matter of survival. Josephine M. Balzac, *Corporate Responsibility: Promoting Climate Justice Through the Divestment of Fossil Fuels and Socially Responsible Investment*, 47 ENV'T L. REP. NEWS & ANALYSIS 10151, 10157 (2017). Notably, the COVID-19 pandemic revealed that companies with strong ESG fundamentals were more resilient, which has become a

B. The Rise of ESG Gatekeeping

As more attention is given to ESG considerations of corporations, ESG data and ratings providers are serving an increasingly important gatekeeper role in the ESG discourse.

Gatekeepers are intermediaries that neither own nor trade in a good but make profits by providing information about the quality of the good.[64] Gatekeepers fulfill an important information-provision function, particularly in novel and complex markets where users are unable to identify the true quality of a good for a low cost or without expert training. Gatekeepers are also useful in markets where there are large differences in the quality of goods, such that the failure to properly assess the quality of a good could have a significant impact on a user's satisfaction. At the same time, users' excessive reliance on gatekeepers can lead to moral hazard, and gatekeepers themselves have been the source of various market failures.[65]

One of the largest data providers in the ESG space, Morningstar, is a public investment research and management company with more than 9,500 employees and $1.7 billion in revenue annually.[66] As of December 31, 2021, Morningstar rated more than 20,000 companies worldwide and offered more than 14,000 ESG Risk Ratings free to the public. Morningstar articulates its ESG methodology as follows:

> Analysts identify valuation-relevant risks for each company using Sustainalytics' ESG Risk Ratings, which measure a company's

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new and important measure of corporate well-being. *ESG Demand: What is Driving Interest in ESG Principles?*, CFA INSTITUTE, https://interactive.cfainstitute.org/ESG-guide/esg-demand-238UB-188248.html [https://perma.cc/HC3K-PW7Z] (last visited Mar. 1, 2023) ("For example, the outperformance of four MSCI ESG indexes in global markets during the crisis was attributable mainly to equity style tilts of which ESG factors were the strongest contributor."). Relatedly, a growing number of business ethicists view companies' ESG activities as an ethical obligation. *See* E. Lynn Grayson & Gary P. Kjelleren, *The Business Case for Environmental Sustainability*, 2015 BUS. L. TODAY 1, 5 (2015) ("While not all investors and financial market analysts are convinced that environmental sustainability delivers shareholders value, there is growing belief that companies that are successful in avoiding environmental risks while taking advantage of ESG opportunities will outperform over the long term . . . . It is an added bonus that addressing these business challenges not only will enhance financial performance over time, but is simply the right thing to do as well."); Luluk Widyawati, *A Systematic Literature Review of Socially Responsible Investment and Environmental Social Governance Metrics*, 29 BUS. STRATEGY & ENV'T 619, 619 (2020) ("Socially responsible investment (SRI) encompasses both ethical and financial paradigms.").

[64] *See, e.g.*, Kraakman, *supra* note 17.

[65] JAMES P. HAWLEY, SHYAM J. KAMATH & ANDREW T. WILLIAMS, CORPORATE GOVERNANCE FAILURES 6 (2011).

[66] Morningstar, Inc., Annual Report (Form 10-K), at 6, 89 (Feb. 25, 2022).

> exposure to material ESG risks, and then evaluate the probability that those risks materialize and the associated valuation impact . . . . Built on a transparent rules-based methodology, the ratings introduce a single measurement unit to assess ESG risks across material ESG topics. Unlike other ESG ratings that are based on a relative, best-in-class approach, Sustainalytics' ESG Risk Ratings consist of ESG data that provides a powerful signal of a company's absolute ESG risk that is comparable across peers and sub-industries while allowing for aggregation at the portfolio level.[67]

For Morningstar, as well as many other providers, ESG data provision is not its central business but an ancillary service that it provides alongside other business units. Morningstar in particular grew its ESG division by acquiring Sustainalytics, a dedicated ESG provider, in 2020.[68]

Another example of a generalist (i.e., a provider for whom ESG is one of its many ancillary divisions) is Calvert, an investment management company, which provides comprehensive ESG data through its materiality-focused platform.[69] Calvert has a five-step process for calculating a firm's ESG score.[70] First, Calvert defines a peer group based on shared, financially-material ESG risks; second, Calvert develops an investment thesis to identify current and emerging ESG risks and opportunities; third, Calvert builds a structural model that measures ESG issues using proprietary key performance indicators; fourth, Calvert calculates an ESG score; and fifth and finally, Calvert validates its recommendations.[71] It is worth emphasizing that Calvert is measuring the risk and return impact of ESG on a firm, which is consistent with the financial view of ESG.

In contrast to Morningstar and Calvert, some ESG providers are specialists (i.e., a provider for whom ESG assessments are its primary business). An example of a specialist ESG provider is MSCI, a public, comprehensive ESG data provider. MSCI's dedicated ESG business was formed as an acquisition of RiskMetrics, an ESG ratings provider specializing in environmental issues, and KLD, an ESG investment

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[67] *Id*. at 5 (describing Morningstar's ESG methodologies).

[68] *See infra* Parts III.A.3 and III.A.4, respectively, for a discussion of the impact of specialization and competition on ESG gatekeeping.

[69] *Differentiated Research*, CALVERT, https://www.calvert.com/differentiated-research.php [https://perma.cc/82YN-9L3A] (last visited Mar. 1, 2023).

[70] *Id.*

[71] *Id.*

research firm.[72] MSCI's ESG Ratings assess the resilience of the rated companies to long-term, financially-relevant ESG risks.[73]

Another specialist ESG provider is RepRisk, a private, comprehensive ESG data provider headquartered in Zurich, Switzerland.[74] RepRisk covers more than 200,000 public and private companies and more than 55,000 infrastructure projects across all sectors.[75] The company screens risk incidents daily.[76] RepRisk has made its methodology public, explaining that it uses artificial intelligence (AI) and machine learning to inform its flagship product, the RepRisk ESG platform.[77] RepRisk searches for ESG risk incidents in 23 languages and focuses on 101 ESG factors, broken down into 28 primary ESG issues and 73 hot topics.[78] RepRisk also uses a proprietary algorithm, called the RepRisk index, to evaluate a company's reputational risk exposure to ESG issues.[79]

Notably, generalist providers like Morningstar and Calvert tend to focus primarily on the financial impact of a subject company's ESG activities, whereas ESG specialists, like MSCI and RepRisk, tend to focus on both the financial and values-based impact of a subject company's ESG activities. MSCI and RepRisk offer a values-based perspective by offering insights on the relationship between a company's ESG activities and its long-term resiliency and reputation, respectively.

In addition, asset managers and advisory services are beginning to develop their own proprietary ESG ratings.[80] According to SquareWell, thirty of the fifty top asset managers have developed their own proprietary ESG ratings.[81] For example, Institutional Shareholder Services Inc. ("ISS"), a private proxy advisory firm, has developed a dedicated ESG Methodology Team and has publicized its mission, mandate, and methodology (referred to as ISS ESG) as follows:

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[72] News Release, *MSCI Completes Acquisition of RiskMetrics*, MSCI INVESTOR NEWS (June 1, 2010), https://ir.msci.com/news-releases/news-release-details/msci-completes-acquisition-riskmetrics#:~:text=NEW%20YORK%20%E2%80%93%20June%201%2C%202010,acquisition%20of%20RiskMetrics%20Group%2C%20Inc.

[73] *ESG Industry Materiality Map*, MSCI (Jan. 31, 2022), https://www.msci.com/our-solutions/esg-investing/esg-industry-materiality-map [https://perma.cc/8L67-ZCFE].

[74] *About*, REPRISK, https://www.reprisk.com/about [https://perma.cc/T69X-EL35] (last visited Mar. 1, 2023).

[75] *RepRisk Methodology Overview*, REPRISK (July 2022), https://www.reprisk.com/news-research/resources/methodology [https://perma.cc/8AKZ-JPC8].

[76] *Id.*

[77] *Id.*

[78] *Id.*

[79] *Id.*

[80] *The Playing Field*, SQUAREWELL (Mar. 3, 2021), https://squarewell-partners.com/insights/ [https://perma.cc/Z3LV-R3CZ].

[81] *Id.*

> ISS ESG has created a dedicated ESG Methodology team with the mission and mandate to stay abreast of trends, developments and existing and emerging client and prospect needs. ESG Methodology works closely with product and research teams, a team that focuses on public affairs and additional stakeholders to initiate, develop and agree upon proposed and required methodology developments and enhancements. To ensure a robust and consistent methodology development process and structure, an internal Methodology Review Board (MRB), consisting of experienced methodology and research leaders, has been established by ISS ESG to guide, steer and vet the methodology development strategy and process, setting and agreeing upon overall objectives and strategic targets, clarifying, reviewing and reassessing priorities as well as initiating and confirming specific new methodology developments or adjustments.[82]

As the above summary reveals, there is a great diversity of methodologies, frequencies, coverage, staffing, and specialization among ESG gatekeepers. The ESG gatekeeping market is growing and also experiencing some growing pains, which are addressed in the next subpart.

C. Variance Among ESG Assessments: The Fall of ESG Gatekeepers?

Even as the ESG data provider market has grown exponentially, the lack of ESG ratings data has been seen as an impediment to a broader embrace of ESG strategies. As an example, a 2017 BNP Paribas survey of institutional investors revealed that more than half (55%) of the respondents regarded the lack of robust ESG data as the most significant barrier to greater adoption of ESG strategies.[83]

One perception of inadequacy can be traced to the variance among different providers' ESG assessments. Indeed, variance among ESG assessments has been the focus of the academic discourse on ESG. This subpart summarizes the methodology, findings, and prescriptions of some of this research.

The most recent among this work at the time of writing is a 2022 study by Florian Berg, Julian Kölbel, and Roberto Rigobon, which investigates the variance among ESG ratings based on data from six ESG ratings providers (KLD, Sustainalytics, Moody's ESG (Vigeo-Eiris), S&P Global (RobecoSAM), Refinitiv (Asset4), and MSCI) and 709 underlying

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[82] Kristina Rüter, *Methodology Information*, ISS, https://www.issgovernance.com/esg/methodology-information/#1614783853074-1ef10df0-c360 [https://perma.cc/3QR5-ZMH6].

[83] *See*, *Great Expectations*, *supra* note 15.

indicators.[84] The authors report correlations between ESG ratings ranging from 0.38 to 0.71.[85]

Berg et al. also develop a taxonomy of divergence of methodologies to explain the variance among ESG ratings. The first is scope divergence, which refers to the situation where ratings are based on differing sets of attributes.[86] The second is measurement divergence, which refers to the situation where ratings providers measure the same attribute but use different indicators.[87] The third is weight divergence, which refers to the situation where ratings providers use the same attributes, but place different weights on them.[88] The authors report that 56% of the divergence they find in their sample can be explained by measurement divergence, 38% by scope divergence, and 6% by weight divergence.[89]

Based on these findings, the authors explain that ratings divergence is difficult to resolve because much of the divergence comes from measurement divergence.[90] In their view, ratings divergence would be easiest to address if most of the divergence came from weight divergence.[91] Then, "[t]wo ratings could be made consistent by aligning their weighting schemes."[92] Implicit in the authors' conclusions is the principle that variance among assessments is a matter that requires resolution.

Another widely cited study is a 2016 study by Aaron Chatterji and co-authors, in which the authors study the ratings of six ESG raters (KLD, Asset4, Calvert, FTSE4Good, DJSI, and Innovest).[93] They find that these third-party ESG providers' ratings diverge substantially.[94] They view the phenomenon of divergence as a validation problem and encourage the rating agencies to regularly validate their data.[95] Ultimately, the authors conclude that ESG and social responsibility are challenging to measure

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[84] Florian Berg et al., *Aggregate Confusion: The Divergence of ESG Ratings*, 26 REV. FIN. 1315 (2022).

[85] *Id.* at 1316.

[86] *Id.* at 1317.

[87] *Id.*

[88] *Id.*

[89] *Id.* at 1317. Other studies have emphasized differences in weighting as the main driver of divergence. *See, e.g.*, Elroy Dimson, Paul Marsh & Mike Staunton, *Divergent ESG Ratings*, 47 J. PORTFOLIO MGMT. 75, 75 (2020) (reporting that the weightings given to each pillar of an ESG rating vary across agencies).

[90] Berg et al., *supra* note 84, at 1318.

[91] *Id.*

[92] *Id*.

[93] Aaron K. Chatterji et al., *Do Ratings of Firms Converge? Implications for Managers, Investors and Strategy Researchers*, 37 STRATEGIC MGMT. J. 1597, 1598 (2016).

[94] *Id.* at 1604.

[95] *Id.* at 1608.

reliably and caution users against drawing conclusions about firms based on this data.[96] In particular, the authors express concern that "trillions of dollars of capital is potentially being misallocated and numerous academic findings may also not be valid."[97] These concerns reveal the authors' beliefs that ESG activities primarily function as a driver of capital allocation, and secondarily as an input factor into academic research studying the relationship between the two.

A 2010 paper by Robert Daines, Ian Gow, and David Larcker studies the quality of four commercial rating services (ISS Corporate Governance Quotient ("CGQ"), GovernanceMetrics International ("GMI"), The Corporate Library's TCL rating, and rankings produced by Audit Integrity ("AGR")) that rate the corporate governance practices of firms, which falls under the "G" pillar of ESG.[98] The authors view superior performance under the "G" pillar as a pathway to superior financial returns.[99] The authors look to predictive value as an important measure of utility and find that: "Commercial ratings do not predict governance-related outcomes with the precision or strength necessary to support the bold claims made by most of these firms."[100] In the authors' view, the variance potentially indicates significant measurement error in some of the ratings,[101] particularly given that firms use the same governance data and examine similar governance dimensions.[102]

A 2020 study compares the performance dispersion of two U.S. portfolios constructed from two different ESG ratings providers but using the same portfolio construction process.[103] Comparing the ESG ratings of 708 companies commonly rated by the two U.S. providers, the authors report a correlation of 0.72 for the environmental score, 0.67 for the social score, and 0.56 for the governance score.[104] And comparing the ESG ratings of the twenty largest market-cap companies in the United States (as of the end of 2017) of the two U.S. providers, they find that four companies' ESG scores have ratings differences greater than 25%, three companies' environmental scores have ratings differences greater than 25%, ten companies' social scores have ratings differences greater than

[96] *Id.* at 1598.

[97] *Id.* at 1597.

[98] Daines et al., *supra* note 51, at 439.

[99] *See supra* note 51 and accompanying text.

[100] *Id*.

[101] *Id*. at 441 ("This [minimal correlation] suggests that either the ratings are measuring very different corporate governance constructs or that there is substantial measurement error in at least some of the ratings.").

[102] *Id*. ("Thus, we believe our results are produced by substantial measurement error in the commercial corporate governance ratings.").

[103] Feifei Li & Ari Polychronopoulos, *What a Difference an ESG Ratings Provider Makes!*, 2020 RSCH. AFFILIATES 1–2.

[104] *Id.* at 9.

25%, and eight companies' governance scores have ratings differences greater than 25%.[105]

From a portfolio perspective, the authors find that the two U.S. portfolios have a performance dispersion of 130 basis points (a cumulative performance difference of 24.1%) over the eight-year period they analyzed.[106] They report an even greater performance dispersion (ranging from 70 basis points to 220 basis points per year) between portfolios constructed using individual environmental, social, and governance scores, with the greatest dispersion observed in the portfolios constructed using governance scores alone.[107] The authors report that, from an investment perspective, the two portfolios "produce quite different outcomes for investors even though they are meant to capture the same ESG exposure."[108] This differential is problematic for those who adhere to the financial view of ESG and seek clarity on the investment impact of ESG activities.

Another working paper examines the extent to which a rated firm's disclosure practices might affect a rater's assessment.[109] The authors hypothesize that a firm's ESG disclosures might explain some of the "substantial disagreement" across rating agencies and conclude that more ESG disclosure leads to greater ESG rating disagreement.[110] They assert that these findings are consistent with the sociology literature, which theorizes that a plurality of evaluations is more likely to arise in emerging fields where rules and norms for evaluation are less developed.[111] The authors view ESG ratings divergence with some skepticism, reporting that ESG ratings divergence is associated with higher return volatility, larger price movements, and a lower likelihood of obtaining external financing.[112]

This relationship between more disclosure and greater ratings variance was also shown in a study of Chinese companies.[113] This study of ESG data of Chinese A-share listed companies finds that greater quantitative ESG disclosure, especially disclosure on environmental and social pillars, results in greater variance of ESG ratings.[114] The author

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[105] *Id.* at 10.

[106] *Id.* at 6.

[107] *Id.* at 8.

[108] *Id.*

[109] Dane Christensen, George Serafeim & Anywhere Sikochi, *Why is Corporate Virtue in the Eye of The Beholder? The Case of ESG Ratings* 2 (Harv. Bus. Sch., Working Paper No. 20-084, 2021).

[110] *Id.* at 4–5.

[111] *Id.* at 3.

[112] *Id.* at 35.

[113] Min Liu, *Quantitative ESG Disclosure and Divergence of ESG Ratings*, FRONTIERS PSYCH. 1 (2022).

[114] *Id.* at 1.

reports less variance among ratings when ESG disclosure is standardized and more numerical information is provided.[115] Interestingly, the author finds that the lack of agreement among ESG assessments is related to lower ratings for that firm in the future.[116]

In contrast to the studies finding that more disclosure tends to lead to greater ratings variance, a recent 2022 study reports that disagreement among ESG ratings agencies is lower for firms that voluntarily issue lengthier ESG reports.[117] Using textual analysis, the authors find that reports that are longer in length are associated with more convergence among different providers' ratings.[118] They report that there is a stronger association between ESG disclosure and ESG disagreement under specific circumstances, such as when firms obtain third-party attestations on their ESG reports (e.g., from accounting firms), when firms adopt advanced levels of Global Reporting Initiative ("GRI") reporting standards, and when there is greater uncertainty in the capital markets.[119] These results show that the research on ESG ratings variance itself has given rise to divergent findings.

Another recent study investigates the ratings provided by four leading rating agencies (ISS, MSCI, S&P, and Sustainalytics) and reports that these ESG ratings exhibit a low level of reliability (18.3%) and agreement (5.4%).[120] The authors measure reliability across several dimensions. For example, construct validity refers to how accurately the measurement captures what it claims to measure.[121] Another dimension of reliability is inter-rater reliability, which refers to the equivalence of scores that different judges or observers assign to a behavior, event, or attribute.[122] Noting that the reliability and consistency across ESG raters is much lower compared to other contexts (such as bond ratings and wine ratings), the authors view the state of ESG assessments to be in "disarray."[123] They

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[115] *Id.* at 8–9.

[116] *Id.* at 15. On the other hand, a study by Rajna Gibson Brandon, Philipp Krueger, and Peter Steffen Schmidt (which studies the ESG ratings of seven different data providers for a sample of firms in the S&P 500 Index between 2010 and 2017) finds that stock returns are positively related to ESG rating disagreement, and primarily disagreement about the environmental dimension. Rajna Gibson Brandon, Philipp Krueger & Peter Steffen Schmidt, *ESG Rating Disagreement and Stock Returns*, 77 FIN. ANALYSTS J. 104, 105 (2021).

[117] Michael D. Kimbrough et al., *Does Voluntary ESG Reporting Resolve Disagreement Among ESG Rating Agencies?*, 31 EUR. ACCT. REV. 1, 27 (2022).

[118] *Id.*

[119] *Id.*

[120] Ventura Charlin, Arturo Cifuentes & Jorge Alfaro, *ESG Ratings: An Industry in Need of a Major Overhaul*, 12 J. SUSTAINABLE FIN. INV. 1, 15 (2022).

[121] *Id.* at 3.

[122] *Id.*

[123] *Id.* at 1, 15.

suggest two alternative responses. One is for users of the ratings to rely on an average of several ratings, and the other (their preferred alternative) is for users to identify a rating agency that relies on factors that one considers relevant (e.g., carbon footprint, board diversity, or use of renewable energies) and to rely primarily on the assessment of that particular agency.[124] The study's approach is an outlier in the literature, in that they encourage users to adopt the methodology that most aligns with their values rather than discourage their use altogether.

A 2015 review of the ESG scores of three sustainability ratings providers for more than 8,500 companies worldwide finds a lack of convergence among ESG measurement concepts, including distribution and risk.[125] The authors encourage stakeholders to critically evaluate the validity of a particular ESG scoring model.[126] Similarly, a study of six sustainability indices and ten ESG agencies finds that the methods currently used by ESG agencies and sustainability indices show a lack of standardization.[127] An examination of the measurement quality of four ESG ratings providers on the basis of their dimensionality, reliability, and validity finds significant differences across measurement constructs, despite some commonalities.[128] What is clear from the studies of ESG assessments is that there is significant variance in terms of both the inputs and outputs of ESG assessments, the implications of which are discussed in the next Part.

III. THE DUALITY OF VARIANCE AND CONVERGENCE AMONG ESG ASSESSMENTS

Variance among assessments is concerning if it results from poor quality data, conflicts of interest, error, prejudice, or bias. Furthermore, this variance can create comparability challenges for ratings users and produces conditions that are ripe for ratings shopping. At the same time, convergence is not necessarily a proxy for reliability and may itself also be the product of inflation, capture, groupthink, or other shortcomings. This Part provides a framework that can be used to distinguish between

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[124] *Id.* at 16.

[125] Gregor Dorfleitner, Gerhard Halbritter & Mai Nguyen, *Measuring the Level and Risk of Corporate Responsibility – An Empirical Comparison of Different ESG Rating Approaches*, 16 J. ASSET MGMT. 450, 450 (2015).

[126] *Id.*

[127] Elena Escrig-Olmedo, María Jesús Muñoz-Torres & María Ángeles Fernández-Izquierdo, *Socially Responsible Investing: Sustainability Indices, ESG Rating and Information Provider Agencies*, 2 INT. J. SUSTAINABLE ECON. 442, 442 (2010).

[128] Luluk Widyawati, *Measurement Concerns and Agreement of Environmental Social Governance Ratings*, 61 ACCT. & FIN. 1589 (2021).

optimal and harmful forms of variance and convergence among ESG assessments.

A. Harmful Convergence (Optimal Variance)

There are some conditions under which variance among assessments naturally arises, and thus convergence is observed only if it is artificially manufactured. Each of these conditions are discussed in this subpart.

1. Weak Theorization and Commensurability

The literature on ratings establishes two preconditions for convergence: theorization and commensurability. Aaron Chatterji and co-authors were the first to introduce this construct to the ESG context,[129] and Subhash Abhayawansa and Shailesh Tyagi reported that divergence among ESG providers could be attributed to both a lack of theorization and low commensurability.[130]

The first precondition—theorization—refers to clarity on what is being assessed and why it matters.[131] Theorization creates the foundation upon which an entity being rated can understand how improved behavior leads to better rankings and be assured that better rankings will lead to better outcomes.[132] High theorization requires a coherent definition of what improved behavior and better outcomes look like.[133]

In the ESG context, theorization is relatively clear to those who adopt a financial view of ESG. The financial view regards ESG as a pathway to generate additional returns for the assessed firm's shareholders. However, under a values-based view of ESG, one's view of improvements and better outcomes will vary according to the priorities and preferences of the assessor and the user of the assessments. As such, a values-based analysis of ESG lends itself to a diversity of theorizations.

The second precondition—commensurability—refers to the extent to which different raters measure the same construct similarly. At present, commensurability among ESG providers is low, as established by the studies on ratings divergence.[134]

The case of Wells Fargo offers an illustrative example of low commensurability in the ESG context. Wells Fargo received significant

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[129] Chatterji et al., *supra* note 93, at 1597–98.

[130] Subhash Abhayawansa & Shailesh Tyagi, *Sustainable Investing: The Black Box of Environmental, Social and Governance (ESG) Ratings*, 24 J. WEALTH MGMT. 49 (2021).

[131] Hayagreeva Rao et al., *Institutional Change in Toque Ville: Nouvelle Cuisine as an Identity Movement in French Gastronomy*, 108 AM. J. SOCIO. 795, 816 (2003).

[132] *Id.*

[133] *Id.*

[134] *See supra* Part II.C.

negative attention for its fake account scandals in 2016.[135] A study of two U.S. ESG providers reports that the ESG ratings impact of this scandal varied significantly across the two providers.[136] Most significantly, one provider (Provider 1) viewed the scandal as having a social (S) impact, whereas the other (Provider 2) saw the scandal as having a governance (G) impact.[137] As a result, Provider 1 ranked Wells Fargo's governance score in the top-third among the companies rated, whereas Provider 2 ranked it in the bottom 5%.[138]

Both conditions—theorization and commensurability—are only weakly observed under a values-based understanding of ESG. In these contexts, divergence among assessments is to be expected and is not, on its own, a reason to doubt the reliability of the assessments. Rather, divergence should be understood as evidence of the relativism, complexity, and subjectivity of the subject matter being assessed and the diverse preferences and priorities of the user and assessor.

2. Value Plurality

While some aspects of corporate data (e.g., the address of a company's headquarters or the number of its employees) are easy to verify, particular aspects relating to ESG (such as the environmental footprint of a company's headquarters or the satisfaction of its employees) are much more difficult to ascertain and assess with uniformity. This is because many aspects of ESG depend on a complex array of factors that involve subjective judgments, which can result in a range of opinions that are far from unanimous.

Robert G. Eccles, Linda-Eling Lee, and Judith C. Stroehle show how different origins, philosophies, and purposes of ESG have shaped the methods and data characteristics of ESG data providers.[139] The ESG activities that a consumer-facing provider cares about will generally differ from the ESG activities that an environmental agency cares about. We should expect ESG providers to reach different assessments depending on which stakeholder perspective they align with most.

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[135] *See* Maryam Kouchaki, *How Wells Fargo's Fake Accounts Scandal Got So Bad*, FORTUNE (Sept. 15, 2016), https://fortune.com/2016/09/15/wells-fargo-scandal/ [https://perma.cc/4JA6-C2YE]; Emily Flitter, *The Price of Wells Fargo's Fake Account Scandal Grows by $3 Billion*, N.Y. TIMES (Feb. 21, 2020), https://www.nytimes.com/2020/02/21/business/wells-fargo-settlement.html [https://perma.cc/7A9R-FS66].

[136] Li & Polychronopoulos, *supra* note 103, at 1.

[137] *Id.*

[138] *Id.*

[139] Robert G. Eccles, Linda-Eling Lee, and Judith C. Stroehle, *The Social Origins of ESG? An Analysis of Innovest and KLD*, 33 ORG. AND ENV'T 575 (2019).

Furthermore, diversity of methodologies among gatekeepers leaves room for innovation and improvement and the ability to adapt to changing circumstances. Indeed, a study by Emmanuel Farhi, Josh Lerner, and Jean Tirole examining product quality certifiers speaks to one benefit of diversity in assessments.[140] These authors report that heterogeneity among product quality certifiers encourages sellers to seek a more ambitious certification strategy by approaching certifiers with higher standards first.[141] In addition, it has been suggested in the educational institutions context that variation among assessment criteria can discourage suboptimal behavioral modifications that could otherwise lead to excessive uniformity.[142]

In such contexts, forced convergence may be counterproductive. Yet, we are seeing some evidence of convergence in the ESG context. Emily Barman's article, *Of Principle and Principal: Value Plurality in the Market of Impact Investing*, provides an account of such convergence in the field of impact investing.[143] Impact investing, which refers to investors providing capital to companies with the intention of generating social and environmental impact alongside financial return, is one form of ESG-driven decision making. Barman begins with the recognition that impact investing is premised on the concurrent co-existence of different valuations,[144] but recognizes that this value plurality also creates some confusion and necessitates compromise.[145]

Interestingly, as noted by Barman, financial value was also riddled with indeterminacy of value, but, over time, users came to coalesce around a set of criteria of quality and calculative devices.[146] Barman traces how the impact investment community applied the lessons learned from these prior experiences to develop calculative tools and conventions to bring more clarity to the impact investment movement.[147] In particular, Barman

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[140] Emmanuel Farhi, Josh Lerner & Jean Tirole, *Fear of Rejection? Tiered Certification and Transparency*, 44 RAND J. ECON. 610 (2013).

[141] *Id.*

[142] Jonathan Remy Nash, *Allocation and Uncertainty: Strategic Responses to Environmental Grandfathering*, 37 ECOLOGY L. Q. 809, 849–50 (discussing how random variation of assessment criteria might lead to desired outcomes).

[143] Emily Barman, *Of Principle and Principal: Value Plurality in the Market of Impact Investing*, 3 VALUATION STUD. 9, 17 (2015).

[144] *Id.* ("value depends on how valuation is done, when, by whom, and for what purpose") (citing Fabian Muniesa, *A Flank Movement in the Understanding of Valuation*, 59 SOCIO. REV. 24, 28 (2012)).

[145] *Id.*

[146] *Id.* at 13 ("The determination of the value in the nascent financial industry, for example, was beset by the indeterminacy of value but eventually, as the result of contestations and negotiations between members of the field, came to coalesce around a particular criterion of quality and set of calculative devices.").

[147] *Id.*

shows how the institutions with the most power won and shaped the bargain for compromise among a plurality of value regimes that undergird impact investing.[148]

One such institution was the Rockefeller Foundation, which viewed impact investing as a promising private-sector solution to social and environmental problems.[149] The Rockefeller Foundation recognized that investor buy-in was crucial to the growth of this new market, and found that the main barrier to investor participation was transaction costs.[150] The Foundation thus invested heavily in building an "enabling infrastructure" to reduce the transaction costs of impact investing by committing $38 million to market design and implementation in 2008.[151]

This enabling infrastructure included two components. The first was a reporting standard, Impact Reporting Investing Standard ("IRIS"), which included over forty existing taxonomies and reporting standards of social and environmental value from established impact investing markets.[152] IRIS is used to measure different objects with common metric and can be seen as analogous to the Generally Accepted Accounting Principles ("GAAP") that provide a common set of accounting rules, standards, and procedures issued by the Financial Accounting Standards Board ("FASB").[153] IRIS resolved some of the confusion created by value plurality by introducing an inclusive reporting standard that incorporated multiple existing meanings and metrics of social or environmental value as they were already enacted in practice to create commonly reported impact terms.[154]

The second was a ranking system, Global Impact Investing Reporting System ("GIIRS"), created by B-Lab, an independent nonprofit which received funding and sponsorship from The Rockefeller Foundation.[155] Its goal was to create "credible social ratings . . . to enable mainstream investors to convert their growing interest in impact investing into action" and can be seen as analogous to Moody's credit ratings or Morningstar's ratings of mutual funds.[156] These ratings had the benefit of reduced

[148] *Id.*
[149] *Id.* at 20.
[150] *Id.* at 26–27 ("without someone doing it for them, impact investing would never get to scale" and "without standards and ratings, investors can't distinguish between good investments and bad ones").
[151] *Id.* at 22.
[152] *Id.* at 31.
[153] *Id.* at 28.
[154] *Id.* at 31.
[155] *Id.* at 32.
[156] *Id.* at 32–33.

complexity and ambiguity and increased accessibility.[157] Furthermore, they were seen as an objective, third-party source that made it easier to compare different firms using a standardized system.[158] Some levers of credibility of the system were that they were based on IRIS indicators, there was an audit and assurance process, and they were reviewed by an accounting firm and were overseen by a separate board.[159]

Barman's case study of The Rockefeller Foundation's investment and efforts to harmonize various impact investment metrics illustrates the tradeoffs between clarity and diversity. Returning to the dichotomy between financial and values-based views of ESG, it shows how investors (particularly institutional and high-net-worth investors, fund managers, and entrepreneurs) could use their power to consolidate a plurality of values around their preferred framework, the financial view of ESG.

3. Inflation and Groupthink

Importantly, convergence is not always an indicator of accuracy or reliability. As an extreme example, in the nineteenth century, doctors who did not yet fully understand the addictive and harmful effects of cocaine routinely prescribed the substance to treat depression and migraines.[160] To provide a more contemporary example, the credit ratings of structured finance products among credit ratings agencies during the 2007–2008 period were highly convergent yet were later revealed to have been inflated and were blamed for catalyzing one of the most devastating financial recessions in recent history.[161] Inflated ratings were also at the heart of the dotcom bubble, the East Asian Financial Crisis, and the accounting scandals of 2001 and 2002 which led to the collapse of Enron and other landmark corporations.[162]

One source of ratings inflation can be attributed to conflicts of interest that arise from how gatekeepers are compensated. The way gatekeepers are paid has an important impact on how they behave. In the case of credit ratings agencies ("CRAs"), the standard practice is for the CRAs to be paid by the issuer at the time of issuance and every year thereafter while the issue is outstanding (according to a schedule of prices

[157] *Id.* at 33 ("The idea is for investors who don't want to go deep into the data to have a service that does that on their behalf to scale this industry and allow it to grow.").

[158] *Id.*

[159] *Id.* at 33–34.

[160] HOWARD MARKEL, AN ANATOMY OF ADDICTION (2012) (writing about Sigmund Freud and William Hasted, the two medical revolutionaries of the nineteenth century, with the drug).

[161] *See* NATIONAL CRISIS INQUIRY COMMISSION, *supra* note 20.

[162] *See supra* notes 20–22 and accompanying text.

which are subject to negotiation).[163] The CRA funding model has been criticized for giving rise to an obvious conflict as the gatekeeper is being paid by the party that it is supposed to assess. In the words of John Coffee, "the watchdogs are turned into the pets of those that feed them."[164]

In contrast to CRAs, ESG gatekeeping is largely based on a subscriber-pays model.[165] While this avoids the obvious conflicts, it puts smaller and cost-constrained subscribers at a disadvantage, and it also tends to pressure providers to prioritize quantity over quality.[166] It should be noted that CRAs, too, originally relied on a user-pays model but started to charge issuers for ratings when regulators adopted legal rules that made ratings more important for issuers.[167]

In addition to the funding model, the extent to which a gatekeeper relies on a particular activity for revenues could also create potential conflicts of interest. While there are benefits to specialization, excessive reliance on ESG assessment activities as the primary source of revenue may increase the likelihood that a gatekeeper's assessments could be compromised.

In particular, Jérôme Mathis, Jamie McAndrews, and Jean-Charles Rochet report that CRAs tend to be too lax, and even agencies with a good reputation will inflate ratings when most of an agency's income comes from rating a particular product.[168] The authors also find that reputational

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[163] Lawrence J. White, *The Credit Rating Industry: An Industrial Organization Analysis*, *in* RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM 41–48 (Richard M. Levich, et al. eds., 2002).

[164] JOHN C. COFFEE, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 335 (2006).

[165] INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) RATINGS AND DATA PRODUCTS PROVIDERS: FINAL REPORT 18 (2021) ("Feedback from respondents to the fact-finding exercise indicates that the fee model for ESG ratings and data products is largely, although not exclusively, based on a 'subscriber pays' basis.") [hereinafter INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS].

[166] *Id*. ("[T]he 'subscriber pays' model potentially creates pressure for the provider to prioritise quantity of information over quality of information. Indeed, users of ESG ratings and data products will seek access to broad coverage across geographies and sectors, possibly putting pressure on the provider to deliver this coverage even where availability and robustness of underlying data are not sufficient or lead to declining overall quality of analysis.").

[167] Milosz Gudzowski, *Mortgage Credit Ratings and the Financial Crisis: The Need for a State-Run Mortgage Security Credit Rating Agency*, 10 COLUM. BUS. L. REV. 245, 254–55 (2010).

[168] Jérôme Mathis, Jamie McAndrews & Jean-Charles Rochet, *Rating the Raters: Are Reputation Concerns Powerful Enough to Discipline Rating Agencies*?, 56 J. MONETARY ECON. 657, 657 (2009).

concerns can discipline rating agencies when a sufficiently large fraction of an agency's income comes from other sources.[169]

There are also concerns that a gatekeeper that provides both data/rating services and other ancillary services (e.g., consulting, providing second-party opinions, and advisory services) could be susceptible to conflicts of interest, such as engaging in unfair data-sharing practices across its different divisions.

Presently, such conflicts of interests in ESG gatekeeping are managed internally and voluntarily. Some companies, like Sustainalytics (a part of Morningstar), have established and published their own conflicts of interest management policies on their website and other publications.[170] Recognizing a potential conflict of interest between its other business units (and the business units of Morningstar affiliates),[171] and its ESG research, Sustainalytics has created a conflict management framework to ensure analyst independence, consistency of process, data protection, and systems separation. This includes a commitment to apply research frameworks consistently across all subject companies, whether private or public, or whether the company is a business partner or not.[172] There are also limits on the activities that personnel may engage in if that engagement may impair the management of conflicts of interest or create the appearance of a conflict of interest.[173]

4. Competition

Generally speaking, reduced competition tends to lead to lower quality and/or higher prices. The academic literature on the impact of competition on ratings quality is, however, mixed. One set of studies confirms that increased competition leads to higher quality ratings. For example, the above-referenced study by Mathis and co-authors demonstrates the tendencies of a monopoly rating agency to inflate its ratings.[174] A study by Alessandro Lizzeri additionally shows how competition among intermediaries leads to fuller revelation of information.[175]

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[169] *Id.*

[170] SUSTAINALYTICS, MANAGING POTENTIAL INSTITUTIONAL CONFLICTS OF INTEREST 3–6 (2021).

[171] *Id.* In particular, Sustainalytics has a separate business unit called Sustainable Corporation Solutions (SCS), which offers second party opinions and reviews ESG rating licenses and frameworks of their corporate clients.

[172] *Id.*

[173] *Id.*

[174] Mathis et al., *supra* note 168, at 657–74.

[175] Alessandro Lizzeri, *Information Revelation and Certification Intermediaries*, 30 RAND J. ECON. 214, 214 (1999) ("competition among intermediaries can lead to full information revelation").

Another set of studies, however, finds that competition leads to lower quality ratings. For example, a 2011 study of the effect that the entry of a third rating agency (Fitch) had on credit rating agency markets that were previously dominated by two agencies (Moody's and Standard & Poor's) found that increased competition coincided with lower quality ratings (i.e., the ability of ratings to predict default deteriorated).[176] As another example, a 2005 study derives the conditions under which reputational concerns drive certifiers to resist capture, and finds that honest certification is derived from higher prices, which arise under conditions that favor concentration.[177]

These studies highlight the challenges of drawing clear conclusions about whether more or less competition is ideal in the ESG gatekeeping context. As such, regulatory interventions that impact market concentration should be introduced with caution. These challenges also highlight the need for ESG-specific studies regarding the impact of competition on assessment quality. This is an especially fruitful and urgently needed area of research as there has been a notable flurry of mergers and acquisitions in the ESG ratings and data provider market.[178]

B. Harmful Variance (Optimal Convergence)

The foregoing established that some level of variance among ESG assessments is to be expected and variance is not, on its own, a reason to doubt the reliability of the assessments. In fact, forced convergence under these conditions may even be counterproductive to achieving the goals of ESG reform which is premised in part on value plurality. However, these conditions do not immunize assessments from harmful variance. Some variance may emanate from error, bias, and conflicts, which are discussed in this subpart.

1. Inconsistencies Over Time

Variance among assessments is problematic if it is the result of a gatekeeper's inconsistent application of methodology over time. The familiar trope that case outcomes depend on what the judge ate for breakfast, or the study reporting that cases heard early in the morning are more likely to have favorable outcomes than those heard immediately

176 Bo Becker & Todd Milbourn, *How Did Increased Competition Affect Credit Ratings?*, 101 J. FIN. ECON. 493, 493 (2011).

177 Roland Strausz, *Honest Certification and the Threat of Capture*, 23 INT'L J. INDUS. ORG. 45 (2005).

178 INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, *supra* note 165, at 12 tbl.2.

before lunch, raise similar concerns.[179] Setting aside the truth of these adages and reports, even the notion or suspicion that an assessor's assessments might depend on factors outside of the merits of the case being decided can lead to distrust.

In the ESG context, there is some evidence of data rewriting that raises concerns of inconsistent application of methodologies over time. A working paper by Florian Berg and co-authors documents widespread changes to the historical ratings of Refinitiv ESG (formerly ASSET4) which led to large retroactive changes in firms' ESG scores.[180] The rewriting changed rankings and classifications and lowered the median overall score by eighteen percent.[181] These changes originate from announced one-off adjustments as well as ongoing unannounced changes.[182]

The authors observe a positive link between rewritten ESG scores and firms' stock market performance but fail to observe such a relationship in the initial data. This observation suggests that score changes may have been "data-mined" and leads to a plausible argument that the data rewriting is motivated by the rating vendor's incentive to *retroactively* strengthen the correlation between ESG scores and financial returns.[183] This incentive is driven by the current funding model of the ESG gatekeeping market which is an investor-pays model, and investors' desires for a correlation between the ESG assessment and positive returns.[184]

This is a striking example of manufactured convergence. While data rewriting is productive if used to correct or supplement incomplete data, it is harmful when driven by incentives to rewrite the data to fit a desired narrative and degrades its reliability and consistency. This issue calls for disclosure requirements about sources of data (i.e., public or private; time stamp; internal processes to ensure quality, timeliness, accuracy, and reliability of data; how controversies are treated; frequency of updates; whether forward-looking), methodology, and intended use of products.

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[179] Dan Priel, *Law is What the Judge Had for Breakfast: A Brief History of an Unpalatable Idea*, 68 BUFF. L. REV. 899, 927 (2020).

[180] Florian Berg et al., *Is History Repeating Itself? The (Un)predictable Past of ESG Ratings* 2–3 (Eur. Corp. Governance Inst., Fin. Working Paper No. 708, 2020). Authors refer to this phenomenon of data rewriting as "history is repeating itself" as the practice of widespread data mining and rewriting to achieve desired outcomes is prevalent in the finance community, *see, e.g.*, Alexander Ljungqvist et al., *Rewriting History*, 64 J. FIN. 1935 (2009).

[181] *Id.*

[182] *Id.*

[183] *Id.* at 22 (". . .firms that performed better in a given year experienced ex-post upgrades in the scores for that year").

[184] *Id.* (". . .the data rewriting plausibly originates form the rating vendor's incentive to retroactively strengthen the link between ESG scores and returns.").

2. Inconsistencies Across Firms

Variance among assessments is problematic if the variance is attributed to bias, favoritism, or error.

In the ESG context, one study reports that firms sharing the same major shareholders with the rater ("sister firms") receive higher ESG ratings.[185] The authors make a causal inference for the ownership effect by studying acquisition events that exogenously create sister firms to study this particular form of favoritism.[186] Other forms of favoritism include the preferential treatment of firms that are clients of other services offered by an ESG data provider. Variance arising from favoritism degrades the credibility of ESG assessments, and calls for disclosure requirements about ownership structure and ancillary businesses and how conflicts of interest are identified and mitigated.

A weaker but still problematic type of prejudice takes the form of what is sometimes referred to as a "halo effect." This refers to the phenomenon where a firm that receives a high score in one category by one rater is more likely to receive high scores in other categories by that same rater. Berg et al. found that measurement divergence is partly driven by a rater's overall view of a firm, which they view as evidence of such a halo effect.[187] Some bias may also arise from the size (preference for larger firms) or jurisdiction (preference for proximate firms) of a rated company due to the comparative acquisition costs of ESG data, with a preference for and overweighting of data that can be acquired at a lower cost. As evidence of such preference, an exploratory factor analysis of the S&P Global 1200 index found that the degree of consistency across ESG data depends significantly on the industry type and the country of domicile.[188]

Inconsistent ratings across firms may be the result of error due to a lack of engagement between the rater and rated companies. Companies often do not even know that they are being rated and are not given the opportunity to review or correct inaccurate information. This issue calls for improved engagement between providers and rated companies.

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[185] Dragon Yongjun Tang, Jiali Yan & Yaqiong Yao, *The Determinants of ESG Ratings: Rater Ownership Matters*, PROC. PARIS DEC. 2021 FIN. MEETING EUROFIDAI-ESSEC (June 6, 2022).

[186] *Id.*

[187] Berg et al., *supra* note 84, at 1338.

[188] Lucie Gyönyörová, Martin Stachoň & Daniel Stašek, *ESG Ratings: Relevant Information or Misleading Clue? Evidence from the S&P Global 1200*, 12 J. SUSTAINABLE FIN. & INV. 1, 1 (2021).

3. Manufactured Complexity

Gatekeepers are especially useful when assessing complex products.[189] One way to measure complexity is by the degree of ease with which an assessor can create a methodology that can rely solely on mathematical formulations.[190] The more difficult it is to rely on mathematical manipulations alone, as is the case with ESG, the more variance we should expect to see among opinions. This suggests that some level of variance is to be expected among ESG assessments.

However, complexity has at times been linked to inflation of assessments. Vasiliki Skreta and Laura Veldkamp, showed that the combination of increased complexity and the ability of issuers to shop for ratings can produce ratings inflation, even in the absence of bias.[191] This is because when assets are complex, ratings differ in ways that create conditions that are conducive to ratings shopping.[192] The relationship between complexity and ratings failures was also established by a paper reporting that complex collateralized debt obligations had significantly higher default rates than identically rated simple corporate bonds.[193]

Based on our past experiences with ratings inflation,[194] it can be said that there is a threshold level of complexity beyond which variance among ratings can become harmful.[195] Of particular concern is the incentive of rated subjects to make their assets more complex than is necessary in order

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[189] *See supra* notes 68–69 and accompanying text.

[190] *See, e.g.*, *The Role of the Credit Rating Agencies in the Structured Finance Market: Hearing Before the Subcomm. On Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. On Financial Services*, 110th Cong. 5–6 (2007) (statement of Mark Adelson, Director of Structured Finance Research, Nomura Securities) ("The complexity of a typical securitization is far above that of traditional bonds. It is above the level at which the creation of the methodology can rely solely on mathematical manipulations . . . Despite the outward simplicity of credit-ratings, the inherent complexity of credit risk in many securitizations means that reasonable professionals starting with the same facts can reasonably reach different conclusions.").

[191] Vasiliki Skreta & Laura Veldkamp, *Ratings Shopping and Asset Complexity: A Theory of Rating Inflation*, 56 J. MONETARY ECON. 678, 679 (2009) ("We show that the combination of an increase in asset complexity and the ability of asset issuers to shop for ratings can produce ratings inflation, even if each rating agency produces an unbiased rating.").

[192] *Id.* at 679.

[193] JOSEPH R. MASON & JOSHUA ROSNER, WHERE DID THE RISK GO? HOW MISAPPLIED BOND RATINGS CAUSE MORTGAGE BACKED SECURITIES AND COLLATERALIZED DEBT OBLIGATION MARKET DISRUPTIONS 39 (May 3, 2007) (unpublished manuscript).

[194] *See supra* notes 19–22 and accompanying text.

[195] Skreta & Veldkamp, *supra* note 191, at 680 ("If assets become very complex, then ratings are so noisy that investors largely ignore them.").

to generate variance and therefore the ability to shop for the best ratings. This concern can be addressed by requiring, on the input side, that the information provided by firms to gatekeepers remain consistent, and on the output side, that all the ratings assigned to firms are disclosed once received.

IV. FOSTERING OPTIMAL VARIANCE AMONG ESG ASSESSMENTS

Acknowledging that variance among ESG assessments is neither categorically harmful nor categorically optimal, this Part provides a survey of regulatory efforts that can be used to cultivate optimal variance and mitigate harmful variance among ESG assessments.

A. Disclosures

Diversity of methodologies across providers can be a strength of the ESG gatekeeping market by encouraging innovation and respecting value plurality.[196] An important prerequisite for methodology diversity to serve its intended purpose, however, is for users who engage with providers to be able to understand the methodologies of each provider. In addition, there needs to be internal consistency in the methodologies' use and application.

One pushback to methodology disclosure is that a provider's assessment methodology is proprietary and confidential information. However, many providers already disclose their assessment methodologies.[197] The scope of the required disclosure would be limited to information that a user would find useful in deciding whether to engage a provider.

The International Organization of Securities Commissions ("IOSCO") has outlined one disclosure framework that could provide a useful template.[198] IOSCO proposes that ESG gatekeepers be required to disclose the following: (1) the measurement objective of the ESG rating or data product; (2) the criteria used to assess the entity or company; (3) the key performance indicators used to assess the entity against each criterion; (4) the relative weighting of these criteria to that assessment; (5) the scope of business activities and group entities included in the assessment; (6) the principal sources of qualitative and quantitative information used in the assessment as well as information on how the

[196] *See supra* notes 146–51 and accompanying text.

[197] *See supra* notes 73–74 and accompanying text.

[198] INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, *supra* note 165, at 39.

absence of information was treated; (7) the time horizon of the assessment; and (8) the meaning of each assessment category (where applicable).[199]

In a solicited response to the IOSCO proposal, one respondent suggested that as a minimum level of disclosure, gatekeepers should be required to also provide the following: (1) a reference to the relevant methodology used; (2) where one can find the methodology and any relevant supporting documents; (3) a list of relevant data sets or information used to create the product; (4) the provider's governance process for the product; (5) whether the product is based on any information that is not public; (6) the terms and conditions of the product's use; (7) any potential conflicts of interest; and (8) whether the rating was solicited or paid for by the subject entity.[200] Further input from market participants building upon these existing efforts will be useful in designing an optimal and workable disclosure regime.

When it comes to the problem of data rewriting or data mining, the solution requires an affirmative obligation to disclose any updates to the methodology, including the reasons therefor.[201] Some have gone further to suggest the creation of an Independent Oversight Committee to assure that providers are meeting best practices (akin to the proxy advisor industry for asset management).[202]

B. Standardizing Inputs

Currently, there is no common market practice for the method by which ESG information is gathered from firms, leading to redundancies and gaps in data collection practices. There is a wide range of information-gathering practices, including through publicly available sources accompanied by quality checks against government databases, peer group data, and prior years' data. For example, MFS, an investment management company, recommends advisors evaluating investment managers' ESG investment decisions to look to various other sources of information, including qualitative assessments of investment managers and investment manager due diligence interviews discussing their philosophy and commitment to ESG investing.[203]

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[199] *Id.*

[200] *Id.* at 51.

[201] Notably, credit rating agencies are required to disclose not only the application of methodologies but also performance statistics, data and assumptions about underlying credit ratings, third party due diligence, and ratings related to structured products. Imad A. Moosa, *The Regulation of Credit Rating Agencies: A Realistic View*, 18 J. BANKING REG. 180, 192 (2017).

[202] Berg et al., *supra* note 180.

[203] *Handle With Care: The Role of Third-Party ESG Ratings Providers in the Fund Selection Process*, MFS INVESTMENT MANAGEMENT (Feb. 2023), https://www.mfs.com/en-us/investment-professional/insights/sustainable-

One recommendation from IOSCO that has been favorably received by market participants is for providers and firms to work together to develop one master report that is used to gather ESG data.[204] Such an effort would ensure a more streamlined and predictable data gathering process for the assessed firms. The International Sustainability Standards Board that was formed by The International Financial Reporting Standards Foundation in November 2021 to provide global disclosure standards on climate and other ESG matters could offer one such template.[205]

C. Regulating Ratings Shopping

As discussed above in Part III.B.3, the variance among ESG assessments creates opportunities for ratings shopping. In response to concerns about credit ratings shopping, the SEC proposed a rule in 2009 that would require issuers to disclose all solicited ratings obtained by or on behalf of the issuer, even if the rating is not used in connection with any registered offering.[206] Furthermore, the proposed rule would have required the disclosure of any changes to a previously disclosed rating.[207] While the proposed rules were not ultimately adopted, they offer an example of a regulatory attempt to curb ratings shopping that could be tailored and applied to the ESG context.

D. Gatekeeper Governance and Pricing Policies

Regardless of whether one adopts an issuer- or subscriber-pays (or other) model, at a minimum, gatekeepers should not tie fees to ratings, such as by asking issuers to pay more for a higher rating. This was a part of the "Cuomo plan" for credit rating agencies under which then-State Attorney General Andrew Cuomo reached a three-year agreement with Standard & Poor's, Moody's, and Fitch to change their ratings process for

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investing/the-role-of-third-party-esg-ratings-providers-in-the-fund-selection-process.html [https://perma.cc/8E43-BFE8].

[204] INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, *supra* note 165, at 32.

[205] *About the International Sustainability Standards Board*, INT'L FIN. REPORTING STANDARDS FOUND. (Nov. 2021), https://www.ifrs.org/groups/international-sustainability-standards-board/ [https://perma.cc/Z368-38QM].

[206] *SEC Votes on Measures to Further Strengthen Oversight of Credit Rating Agencies*, U.S. SECURITIES & EXCHANGE COMMISSION (Sept. 17, 2009), https://www.sec.gov/news/press/2009/2009-200.htm [https://perma.cc/89SX-8GKA].

[207] *Id.*

structured finance products.[208] The agreement prohibited issuers from paying for specific ratings and required issuers to pay up front, before any ratings analysis.[209]

While ESG gatekeepers presently employ a user-pays model, pricing practices can change over time. As such, ESG gatekeepers should be required to disclose their pricing practices and schedules, and any subsequent changes thereto.

In addition, a gatekeepers' reliance on a rated firm for other business as well as overlapping ownership stakes may also give rise to conflicts of interest.[210] In response to these concerns about conflicts of interest, IOSCO recommends separation of staff who are responsible for data/ratings products from those providing such ancillary services.[211]

Some notable regulatory precedents from conduct regulation of credit rating agencies that could be applied to the ESG context include SEC rules prohibiting ratings-related consulting activity by credit rating agencies and a Dodd-Frank Act requirement that ratings be separate from sales and marketing activities.[212]

V. CONCLUSION

For the ESG movement to reach its desired scale, it needs the participation of shareholders. At the same time, for the ESG movement to reach its desired peaks, it needs to transcend the bounds of shareholder primacy. The very impetus of the ESG movement was the recognition that shareholder return alone is an incomplete measure of firm value. This challenge of needing buy-in from shareholders, yet also needing to break away from relying on shareholder preferences alone, is at the heart of the ESG crisis that is the subject of this Article.

The solutions to this crisis require greater transparency. In particular, there is an urgent need for all participants (gatekeepers, end users, as well as regulators) to be clear about why and how ESG matters to them.[213]

For example, a fund manager may wish to use ESG information about firms as a way to construct an investment portfolio that generates better

[208] *See* Aaron Lucchetti, *Big Credit-Rating Firms Agree to Reforms*, WALL ST. J. (June 6, 2008, 12:01 AM), https://www.wsj.com/articles/SB121268203224348921 [https://perma.cc/9AV9-XNEH].

[209] *Id.*

[210] *See supra* note 159, at 248 and *supra* note 172 and accompanying text.

[211] INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, *supra* note 164, at 33.

[212] 15 U.S.C.A. § 78o-7(h)(3).

[213] This need for transparency has become more urgent by the fact that ESG has recently been the subject of strong political debate. *See supra* note 36.

returns for the fund's beneficiaries.[214] In engaging a gatekeeper, they will look to that gatekeeper to collect and organize information about a firm's ESG activities that can potentially lead to higher returns. The effectiveness of that gatekeeper will be evaluated by these managers by reference to the correlation between the ESG assessment and its impact on the manager's investment portfolio's performance.

An eco-investor may wish to use ESG information about firms as a way to screen out firms that have an excessive carbon footprint.[215] In engaging a gatekeeper, they will look to that gatekeeper to collect and organize reliable information about the climate impact of a firm. The effectiveness of that gatekeeper will be evaluated by these investors by reference to the ability of that gatekeeper to collect and analyze climate impact data utilizing the state-of-the-art modeling technologies.

In a different context, a firm may wish to work with an ESG data provider to ensure that they are compliant with new ESG disclosure mandates.[216] In this case, the gatekeeper's function is to help a company assess and disseminate information about the categories of information required by regulators and the effectiveness of that gatekeeper will be evaluated by whether the disclosure was compliant with evolving global disclosure and reporting regimes.

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[214] This is a classic example of the *financial view* of ESG. Other examples might include creating sustainability-linked bonds, loans, derivatives (used to determine payouts of ESG-linked derivatives), guarantee facilities, hedging agreements, accounts receivables, supply chain finance (and identifying sustainability risks and opportunities in foregoing contexts).

[215] This is a classic example of the *values-based view* of ESG.

[216] *See, e.g.*, Tahmina Day, *How Your Compliance Team Can Get Ready for ESG Developments*, 114 ABA BANKING J. 16, 16–17 (2022) ("[B]anks that are already practicing climate and ESG disclosures … soon may embark on a new journey—compliance with climate disclosure regulation.. … The world of ESG is broad and changing fast. … It is well worth developing at least one ESG champion within your compliance team who will work on expanding the team's knowledge of climate risk and ESG."); KPMG, *KPMG and Workiva Expand Alliance to Assist Companies in Unlocking ESG Value* (Feb. 8, 2023), https://info.kpmg.us/news-perspectives/ industry-insights-research/kpmg-workiva-alliancepartner-esg-value.html [https://perma.cc/Y74H-RV7D] (describing KPMG's collaboration with Workiva Inc., aimed at integrating "into existing workstreams to simplify increasingly complex ESG reporting. As global sustainability disclosure requirements continue to evolve, there is an expectation that all ESG disclosures are of 'investor grade' – based on complete, accurate and consistent data."); Aideen O'Dochartaigh, *The Regulation Revolution: How Firms Can Prepare for ESG Disclosure Requirements*, CAL. MGMT. REV. (Oct. 31, 2022), https://cmr.berkeley.edu/2022/10/the-regulation-revolution-how-firms-can-prepare-for-esg-disclosure-requirements/ [https://perma.cc/NN4U-X2QJ] (enumerating steps for ESG firms to take in response to increasing disclosure requirements, including relying on assurance providers and "non-accounting assurance providers" which can "provide expertise on specific issues and can boost legitimacy with external stakeholders.").

The strength of the ESG movement lies in its ability to encompass different views about why and how ESG activities of firms matter to different stakeholders. Some users care about investment returns and risk management, others care about sustainability, and yet others care about compliance, among many other possibilities, with the common thread being their interest in environmental, social, and governance factors. As varied as are the views about ESG, assessments of a firms' ESG activities will also necessarily diverge.

This Article recognizes that viewing ESG as a pathway to financial returns is an important perspective, but is just one among many possible motivations. As such, this Article is critical of the current trend in the ESG literature which seeks to converge ESG assessments toward the financial view of ESG and is thus critical of the prevalent divergence among ESG assessments. This trend ignores the values-based view which is an important pillar of the ESG movement. Regulation can serve as an important counterweight to the reversion of the ESG movement to shareholder primacy norms, the shortcomings of which necessitated the rise of the ESG movement in the first place.