June 12, 2021

The Honorable Gary Gensler, Chairman
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: Request for Public Input on Climate Change Disclosure

Dear Chairman Gensler,

I appreciate the opportunity to provide input in response to the U.S. Securities and Exchange Commission's (SEC) April 15, 2021 public request for input[1].

I am submitting a comment regarding the third-party standard and framework setters, rating and ranking services, and industry-lead efforts regarding climate-risk and ESG related disclosures. The third-party standard and framework setters have seen a noticeable growth in the past few years and have recently been working together on efforts to make their data more comparable. Industry-lead efforts, especially in the energy sector, appear to exhibit a sector-wide increased commitment to disclosure on climate-related risks. Lastly, while third-party raters and rankers perform a valuable service for both companies and investors, some of the concerns raised in the attached paper from 2018 are still relevant and should be considered in your assessment of ESG disclosure issues. However, in the three years since the release of the paper, ratings services have improved as more and more companies have increased their disclosure through the increased use of sustainability reports, third-party standard setters, industry-lead disclosure efforts, and under the current SEC regulatory framework.

Third-party Standard and Framework Setters

When it comes to consistency and comparability, companies have a multitude of standards and frameworks to choose from in deciding how to disclose their ESG data. Companies have been using various combinations of the Group of Five[2] ("The Group"), the key third-parties that provide standards and frameworks, for disclosing non-financial data. While the Group has different approaches to their standards and reporting, there is an acknowledged overlap that the Group itself considers complementary. In fact, the Group has recently moved toward their vision of a global corporate reporting system. Additionally, the Group also incorporates the 11 recommendations on climate-related financial disclosures from the Task Force on Climate-related Disclosures (TCFD) into their combined standards and frameworks, asserting that it helps stakeholders "understand how reporting organizations assess climate-related risks and opportunities."[3]

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[1] *Public Input Welcomed on Climate Change Disclosures* (15 March 2021); *available at* https://www.sec.gov/news/public-statement/lee-climate-change-disclosures.

[2] The Group includes: The Global Reporting Initiative (GRI); CDP (formerly, the "Carbon Disclosure Project"); The Climate Disclosure Standards Board (CDSB); The International Integrated Reporting Council (IIRC); and The Sustainability Accounting Standards Board (SASB).

[3] CDP, CDSB, GRI, IIRC, and SASB [The Group of Five] "Reporting Enterprise Value" (December 2020), *available at* https://29kjwb3armds2g3gi4lq2sx1-wpengine.netdna-ssl.com/wp-content/uploads/Reporting-on-enterprise-value_climate-prototype_Dec20.pdf

Of the Group, GRI and SASB are arguably the most prominent with U.S. based companies. GRI's purpose is to assist organizations and government entities evaluate, and ultimately communicate, the impacts they have on the broader environment. GRI, differentiates itself from the others of the Group in that it covers the broadest range of impacts to include those on the economy, environment, and people. The full breadth of disclosure under GRI appears to be outside the scope of the SEC's statutory jurisdiction, though nonetheless helpful for those companies who choose to use it.

SASB was created in 2011 to develop sustainability accounting standards initially with a focus on U.S. based companies. SASB has worked with businesses and other stakeholders to create 77 industry-specific ESG disclosure standards. The standards are intended to help investors and other stakeholders asses the materiality of reported sustainability information and be able to compare companies on their disclosed information under a broad range of metrics. SASB differentiates itself from the others in the Group in that their standards focus on capturing data that is financially material for each industry standard. Of the Group, SASB's disclosure and framework appear to be those closest to the jurisdictional parameters of the SEC.

It is worth noting that in 2021, SASB and IIRC merged and renamed themselves the Value Reporting Foundation (**VRF**)[4]. The merger is touted as a response to both global investors and corporations calling for a simplified corporate reporting structure. The merger brings together IIRC's integrated reporting and SASB's sustainability disclosure standards. SASB has also collaborated with GRI on a guide for companies to disclose under both standards. The guide[5] focuses on the similarities and differences in their individual reporting standards including materiality, scope of disclosure, intended audiences, and their standard setting process.

In addition to the merger of SASB and IIRC, and collaboration with GRI, all three organizations recently collaborated with CDP and CDSB on a paper[6] titled "Reporting on Enterprise Value." The collaboration embraced a vision for a global corporate reporting system using a common language. The conceived reporting system would not replace sustainability reporting or industry-lead efforts on disclosure, but rather specifically called for global standards for "sustainability-related financial disclosure." In addition, they recommend using International Accounting Standards Board (IASB)'s Conceptual Framework for Financial Reporting as a starting point to bring together both financial accounting standards and sustainability-related financial disclosure standards.

In addition, as the SEC evaluates updating their disclosure standards, it should maintain the current *materiality* standard so that investors receive only financial material data. Maintaining the current materiality standard also serves the purpose of protecting the reasonable investor from the inadvertent interjection of political issues into the SEC's disclosure framework. Otherwise, corporations and investors will have to contend with market uncertainty and unwarranted costs and burdens in a

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[4] Global NewsWire, "IIRC and SASB form the Value Reporting Foundation, providing comprehensive suite of tools to assess, manage and communicate value" (June 9, 2021) *available at* https://www.globenewswire.com/news-release/2021/06/09/2244505/0/en/IIRC-and-SASB-form-the-Value-Reporting-Foundation-providing-comprehensive-suite-of-tools-to-assess-manage-and-communicate-value.html

[5] SASB and GRI's "A Practical Guide to Sustainability Reporting Using GRI and SASB Standards"; *available at* https://www.globalreporting.org/media/mlkjpn1i/gri-sasb-joint-publication-april-2021.pdf

[6] *See id* at note 2.

disclosure framework that has the potential to change with each succeeding new Administration as they pursue their preferred policy goals.

Also, while companies of different sectors use third-party standards in various ways to disclose ESG data, the SEC should create its own broad standard that allows companies to continue to use these standards as they apply to each individual company. As such, I would recommend that the SEC maintain a principles-based approach to disclosure that allows companies the flexibility to use third-party standard and framework setters.

Industry – Lead Climate-related and ESG Disclosure Efforts

As for industry-lead efforts, the Edison Electric Institute (EEI), which represents all U.S. investor-owned electric companies, created a pilot program in 2017 as the first "industry-focused and investor-driven" effort to create a reporting template on ESG and sustainability-related information. In 2018, EEI partnered with the American Gas Association (AGA), which represents over 200 local energy companies, to create an "ESG/Sustainability" reporting template for their member companies to use so that investors and the broader financial sector would have a way to effectively compare companies within their industry sector. The template was a "stakeholder driven process" to provide both quantitative data and qualitative information. EEI meets semi-annually with investors, proxy services, trade associations, credit ratings agencies, ESG data providers, and various interested groups to help revise their template.

Other energy trade associations have followed suit. The American Exploration and Production Council (AXPC), which represents independent oil and gas exploration and production companies, responded to stakeholders who wanted more consistent information on the affect their membership's operations had on the environment. As a result, in February of 2021, they released an ESG Metrics Framework and Template that included five key metrics: Greenhouse Gas (GHG) Emissions, Flaring, Spills, Water Use, and Safety.[7] The American Petroleum Institute (API), which represents all segments of the oil and natural gas industry has, over the past 90 years, developed over 700 various standards on sustainability including safety, environmental issues, and efficiency. API indicates that it understands the risks and opportunities of global climate change. As such, API is working on a new template to establish a transparent and comparable reporting framework for core GHG emissions data. In addition, API, AXPC, and other trade associations have partnered for years with the International Petroleum Industry Environmental Conservation Association (IPIECA), which was founded in 1974 to address environmental and social issues in the oil and gas sector, to create the "Sustainability Reporting Guidance for the Oil and Gas Industry"[8] currently in its fourth edition to help companies with their sustainability reporting. IPIECA, API, and other trade associations, which support the Paris Agreement, have also worked with the UN[9] on implementing their Sustainability Development Goals (SDGs) by 2030.[10]

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[7] The American Exploration and Production Council's (AXPC) ESG Metrics Framework and Template; *available at* https://www.axpc.org/esg/

[8] International Petroleum Industry Environmental Conservation Association's (IPIECA) "Sustainability Reporting Guidance"; *available at* https://www.ipieca.org/our-work/sustainability/performance-reporting/sustainability-reporting-guidance/

[9] IPIECA engaging with the UN since its creation in 1974; *available at* https://www.ipieca.org/our-work/sustainability/engaging-with-the-un/

[10] *See* IPIECA's SDG Roadmap; *available at* https://www.ipieca.org/our-work/sustainability/supporting-the-sdgs/sdg-roadmap/

Just as with the third-party standard setters, the SEC should create their own standards that allow companies to continue to use these industry-lead efforts and give companies the flexibility to use both third-party standard setters and industry-created standards and frameworks as tool to meet the SEC's disclosure requirements.

Corporations should be allowed to use these standards and frameworks to tell their story in a way that simultaneously provides investors with the data they need without burdening corporations and ultimately investors with unnecessary costs associated with disclosure. The SEC should work on developing standards based on principles that can be used in a comparable disclosure framework. This will allow corporations to individualize their disclosure in a way that will be most helpful to their investors but does not overwhelm them with unnecessary data and costs.

Third-party Raters and Rankers

Once disclosure is addressed the concerns contemplated in the attached paper should be assessed as the SEC reviews the entire ESG disclosure framework. As was the case back in 2018, corporate performance on ESG issues has become increasingly utilized in how investors evaluate companies. Investors and money managers continue to rely on a growing number of ESG rating services to assess public companies' performance and asses how they compare to others. It is vitally important that the SEC have a clear understanding of how these ratings providers operate in the market. The attached paper explored the role these rating providers had in that process, including the standardization of criteria, consistencies in ratings, ability to identify risk, and potential biases in the ratings process.

The paper found a system fraught with problems including inconsistent metrics and ratings which continually failed to account for different regulatory regimes across distinct geographies. Perhaps of greatest concern was that each of the providers used their own proprietary methodologies, metrics, weighting, and even definitions of what constituted ESG.

As an example, a company may have rated well below its peers according to one ratings provider while simultaneously outperforming them according to another. In addition to inconsistent methodologies, our analysis found that ratings providers did not control for externalities as tightly as they should have done. For example, they used the same fixed scoring criteria for companies in different countries, despite the fact that they were subject to varying regulatory and disclosure regimes. As a result, American companies were at an immediate disadvantage to their European counterparts who were subject to more stringent disclosure requirements.

As we discovered, more often than not, providers assigned ratings to companies based on industry, without actually factoring in company-specific risks. The utilities sector, for example, was given the highest mean ESG score by Sustainalytics, while healthcare was assigned the worst.

Our research suggested that these ratings were likely to reflect the availability of information, more than actual ESG practices in their own right. The problem was the information provided in sustainability reports, which were unaudited, were often more about building corporate reputations than disciplined ESG reporting. The rating system was found to be overdependent on disclosure and therefore those that had the resources to produce the best disclosure reports correspondingly had better ratings. While deficiencies in the process did not render ESG investment meaningless, they did indicate that the providers' influential findings must be viewed through a critical lens.

Moving forward, it is imperative that investors understand what these types of ratings were: largely subjective and prone to serious methodological problems. They were not infallible, scientific measures of companies "doing good." Greater oversight and reform of the ratings system must be seriously considered. Universal standards for ratings should be required in order to provide a level and transparent playing field for companies and investors alike. And ratings providers need to disclose how they reach their decisions, and their success rate in actually protecting investors from large-scale risks.

Conclusion

All investors need consistent and reliable guidance. A meaningful reform of the ESG ratings system would provide an important step toward ensuring they receive it. The SEC should be a leader in helping understand all that encompasses ESG and should set the standards and that give companies the flexibility to disclose under those standards based on clear principles. The SEC should strive to ensure any standard and framework brings clarity to corporations and better informs investors with comparable data. The SEC should maintain the materiality standard that has provided stability to the capital markets for decades. Lastly, the SEC should strive for a regulatory framework that can be relied on by corporations for years to come by developing it with as much practical input as possible.

I appreciate the opportunity to submit comments to this important request for public input and look forward to working with you and your team in the days ahead to help ensure any new or adopted standard and framework protects investors and facilitates robust capital markets.

Sincerely,

Timothy M. Doyle

Author of attached 2018 ESG Ratings Report and formerly Vice President of Policy and General Counsel of the American Council for Capital Formation and its affiliate the Center for Policy Research

RATINGS THAT **DON'T RATE**

THE SUBJECTIVE WORLD OF ESG RATINGS AGENCIES

July 2018

Timothy M. Doyle

Vice President of Policy & General Counsel

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ACCF AMERICAN COUNCIL FOR CAPITAL FORMATION

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Timothy M. Doyle

Tim Doyle is Vice President of Policy and General Counsel of the American Council for Capital Formation and its affiliate, the Center for Policy Research. Doyle has a diverse policy and legal background in multiple areas including energy, environment, oversight, corporate governance, and regulatory issues.

Prior to joining the ACCF, Doyle served as Senior Counsel for the House Science, Space, & Technology Committee and Staff Director for its Oversight Subcommittee. There he successfully managed oversight staff involving multiple investigations. In addition, he established, developed, and maintained strategic relationships at the senior levels in Congress regarding energy policy and its corresponding regulatory framework. Doyle also served as Senior Counsel and Director of Investigations for the House Committee on Natural Resources.

Doyle holds a JD from Michigan State University as well as a BA with a dual major in Political Theory & Constitutional Democracy and Criminal Justice. During law school, he clerked for the Department of Justice in Washington D.C. at the U.S. Attorney's Office. He also worked his way through law school at the Senate Majority Policy Office in the Michigan Senate.

RATINGS THAT **DON'T RATE**

THE SUBJECTIVE WORLD OF ESG RATINGS AGENCIES

CONTENTS

EXECUTIVE SUMMARY

As the trend of Environmental, Social, and Governance ("ESG")[1] investing has risen, so too has the influence and relative importance of ESG rating agencies. With an increasing focus on social corporate responsibility, the ability to project a positive image around ESG-related topics is critical. As such, more companies have begun making select and unaudited disclosures in an effort to attract ESG-investing capital. The arbiters for obtaining this capital are the major ESG rating agencies.

However, individual agencies' ESG ratings can vary dramatically. An individual company can carry vastly divergent ratings from different agencies simultaneously, due to differences in methodology, subjective interpretation, or an individual agency's agenda. There are also inherent biases: from market cap size, to location, to industry or sector – all rooted in a lack of uniform disclosure.

Tellingly, many of the issues highlighted in this paper mirror failings we found in the proxy advisory industry (explored in a previous ACCF report, 'The Conflicted Role of Proxy Advisors'). There, a history of conflicts of interest, inadequate voting guidance, and opaque business practices, raise serious questions about the ability of the industry to provide impartial and accurate recommendations. Taken in conjunction with the issues identified here, the two papers collectively suggest that there are substantial challenges with the quality of information that investors are using to both deploy ESG focused capital and vote stock options.

This paper seeks to evaluate ESG ratings agencies to support investors in understanding the current state of play in the ESG ratings industry. Ultimately, we found significant disparities in the accuracy, value, and importance of individual ratings, for reasons including:

- **Disclosure Limitations and Lack of Standardization**: There are no standardized rules for Environmental and Social disclosures, nor is there a disclosure auditing process to verify reported data; instead, agencies must apply assumptions, which only adds to the subjective nature of ESG ratings. The lack of transparency and reliance on unaudited data is not dissimilar to the findings presented in a previous ACCF report on the conflicted nature of proxy advisors.

- **Company Size Bias:** Companies with higher market capitalization tend to be awarded ratings in the ESG space that are meaningfully better than lower market-cap peers, such as mid-sized and small businesses.

- **Geographic Bias:** Regulatory reporting requirements vary widely by region and jurisdiction – with two companies active in the same industry, doing the same general thing, often assigned different scores based on where they are headquartered. Companies domiciled in Europe, in particular, often receive much higher ESG ratings than peers based in the United States and elsewhere.

- **Industry Sector Bias:** Company-specific risks and differences in business models are not accurately captured in composite ratings. Because of significant differences in business models and risk exposure, companies in the same industry are unfairly evaluated under the same model.

- **Inconsistencies Between Rating Agencies:** Individual company ratings are not comparable across agencies, due to a lack of uniformity of rating scales, criteria, and objectives.

- **Failure to Identify Risk:** One of the purposes of ESG ratings is to evaluate risk and identify misconduct. ESG ratings do not properly function as warning signs for investors in companies that experience serious mismanagement issues.

1 ESG investing presumes that considering sustainability and ethical impact into investment analysis may offer investors potential long-term performance advantages.

INTRODUCTION:
THE GROWING INVESTOR FOCUS ON ESG

INTRODUCTION

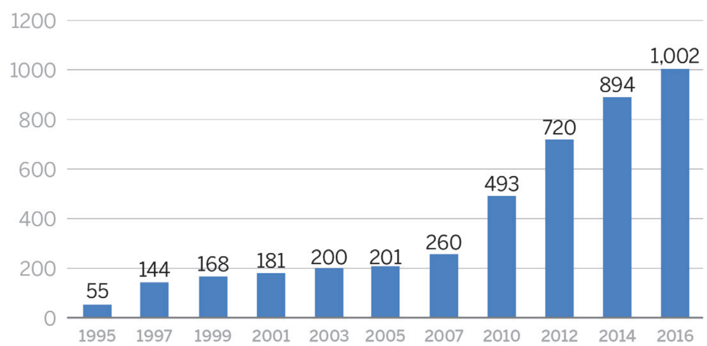
Socially responsible investing has taken place for centuries among faith-based organizations.[2] The practice gained momentum during the 1960s as societal concerns surrounding civil rights, women's rights, the Vietnam War, and the environment all empowered political activists to align their investment strategies with their political and social beliefs. As the fund management industry grew over the following decades, the public increasingly saw how its investments could affect corporate behavior, which in turn had a societal impact. For example, efforts to avoid investment in South Africa during the 1980s is viewed as one factor that helped to end apartheid.[3]

From these roots, modern ESG investing took shape following the 2005 publication of the United Nations-supported Principles for Responsible Investment. These principles aimed to develop a more sustainable global financial system by incorporating ESG issues into investment practices, and laid the groundwork for ESG investing as a common practice.[4]

Despite noble beginnings, the implementation of ESG investing by fund managers in employer and public pensions funds has the potential to conflict with their fiduciary duty to maximize investment returns. As outlined in a recent ACCF article about the Department of Labor guidance on ESG based investment strategies, the political or social motivations of a financial institution or its managers should not supersede their fiduciary responsibility to grow investments. As the Department of Labor clearly stated, "fiduciaries may not sacrifice returns or assume greater risks to promote collateral environmental, social, or corporate governance (ESG) policy goals when making investment decisions."[5] ESG investment strategies must be shown to have material economic value, lest the fund managers risk violating their fiduciary duty to the investor.

Highlighting the need for fund managers to continue prioritizing returns over political motivations is especially important, given that ESG investing has grown significantly over the last decade. According to the Forum for Sustainable and Responsible Investment, the number of funds incorporating ESG criteria grew from 260 in 2007 to more than 1,000 in 2016.[6] Increasing investor interest in ESG investments has created a corresponding market for more ESG information. Therefore, it's no surprise that an increasing number of investors interested in ESG investment strategies want accurate data to support the ESG evaluation process.

Investment Funds Incorporating ESG Factors[7]



Policies and requirements for environmental and social disclosure can vary significantly. Currently there is no jurisdiction that has any auditing practice on these varying non-financial investment factors. While it is beyond the scope of this paper to engage in an in-depth analysis of specific disclosure reforms, it is apparent that the lack of consistency in the metrics used for disclosure distorts the information available to both ratings agencies and investors.

2 Grace Wong, Investors Bet On Their Faith, CNN Money. (March 23, 2006), http://money.cnn.com/2006/03/23/markets/religious_funds/index.htm?cnn=yes
3 William MacAskill, Does Divestment Work?, The New Yorker. (October 20, 2015), https://www.newyorker.com/business/currency/does-divestment-work
4 About the Principles for Responsible Investment, PRI. https://www.unpri.org/pri/about-the-pri
5 U.S. Department of Labor Releases Field Assistance Bulletin Clarifying Issues Regarding Proxy Voting, Shareholder Engagement, And Economically Targeted Investments, Department of Labor. (April 23, 2018), https://www.dol.gov/newsroom/releases/ebsa/ebsa20180423
6 U.S. Sustainable, Responsible and Impact Investing Trends, USSIF. (2017), http://www.ussif.org/files/SIF_Trends_16_Executive_Summary(1).pdf
7 U.S. Sustainable, Responsible and Impact Investing Trends, USSIF. (2017), http://www.ussif.org/files/SIF_Trends_16_Executive_Summary(1).pdf

BACKGROUND ON RATINGS AGENCIES

Before diving into the problematic and subjective nature of current ESG ratings, it is important to understand the growing importance these ratings have on the investment landscape. ESG rating services are now used by many of the world's largest investment firms, including BlackRock, State Street Global Advisors, and many others. In fact, MSCI, a leading provider of ESG ratings, claims to provide ratings for 46 of the top 50 global asset managers.[8] The wide adoption of ESG ratings is the result of asset managers signing the United Nations Principles for Responsible Investment (PRI). PRI, which as of 2017 had 1,800 signatories, encourages asset managers to incorporate ESG factors into their investment decisions.[9] These new commitments bring added cost and time for asset managers, many of whom do not have the resources to conduct in-house ESG research and now rely on third-party ESG ratings providers to fill the gap.

This asset manager reliance on outsourced data, to comply with their fiduciary duty or new mandates, is similar to the rise of the proxy advisory industry. Proxy advisors have gained prominence in line with fiduciary requirements that asset managers vote their proxies in the best interests of clients. To save costs they've turned to proxy advisors to take on that responsibility, and the proxy advisors Institutional Shareholder Services (ISS) and Glass Lewis have seized upon the government mandate. ACCF previously published a paper about the conflicted role of proxy advisors and the influence they have over shareholder proposals. Many of the lacking elements within the proxy advisory industry (i.e., transparency, oversight, and unaudited disclosures) are also present in the ESG ratings industry.

Further, there is little diligence in how investors apply ESG ratings. As explained in a 2017 McKinsey and Company article on sustainable investing, "Among institutional investors who have embraced sustainable investing, some have room to improve their practices. Certain investors—even large, sophisticated ones—integrate ESG factors into their investment processes using techniques that are less rigorous and systematic than those they use for other investment factors."[10] This inconsistent application and understanding of ESG ratings leads asset managers to hasty and ill-advised adjustments to their methodology as they seek to distinguish their investment strategy. This is not to say that one particular method of ESG investment is right or wrong, only that the application of ESG-related metrics and ratings into complex investment decisions remains much more an art than a science.

While dozens of companies evaluate ESG factors, four major rating agencies dominate this market: MSCI, Sustainalytics, RepRisk, and new entrant ISS. This paper reviews individual company events related to ESG factors and ACCF acknowledges this is not a comprehensive analysis, only reflecting a small portion of publicly available information.

Overview of Major ESG Rating Agencies

ESG Agency	Overview	Rating Scale
MSCI	Launched in 2010, MSCI ESG Research is one of the largest independent providers of ESG ratings. As part of the MSCI Group, MSCI provides ESG ratings for 6,000+ global companies and 400,000+ equity and fixed-income securities.	AAA (highest) to CCC (lowest)
Sustainalytics	Sustainalytics is the 2008 consolidation of DSR (Netherlands), Scores (Germany) and AIS (Spain). Sustainalytics now covers 7,000+ companies across 42 sectors and has an international presence. In July 2017, Morningstar acquired a 40% ownership stake in Sustainalytics.	100 (highest) to 0 (lowest) using sector and industry based comparisons
RepRisk	Founded in 1998, RepRisk provides ESG reports for 84,000+ private and public companies in 34 sectors globally.	AAA (highest) to D (lowest)
ISS Environmental & Social QualityScore	Launched in February 2018, it covers an initial set of 1,500 companies across multiple industries. An additional 3,500 companies spanning 18 industries will be added later in 2018.	10 (highest) to 0 (lowest) for overall Environment and Social, as well as sub-issues.

8 Eric Moen, MSCI ESG Ratings, MSCI. (2018), https://www.msci.com/documents/1296102/1636401/MSCI+ESG+Rating+Brochure-V3.pdf/f2b4a27a-58f5-42c7-880b-cf8201039eaa
9 Principals for Responsible Investment, About the PRI. https://www.unpri.org/pri/about-the-pri
10 Sara Bernow, From 'Why' to 'Why Not': Sustainable Investing as the New Normal, McKinsey & Company. (October 2017), https://www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/from-why-to-why-not-sustainable-investing-as-the-new-normal

Each rating agency has a customized scoring method which evaluates different non-financial metrics and frequently disagree about the components of ESG. Determining which ESG topics and metrics to evaluate is not a straightforward exercise – certainly not when compared to traditional financial metrics.[11] Further, ESG rating agencies do not fully disclose the indicators they evaluate or the material impact of selected indicators. SustainAbility, a think tank focused on enabling businesses to lead the way to a sustainable economy, has called on rating agencies to offer greater transparency:

> "Raters expect transparency from companies, yet they too often fail to live up to the same expectation themselves...While we recognize the proprietary nature of many ratings, and that limiting disclosure may be commercially necessary for organizations, the need for greater transparency persists."[12]

Core ESG metrics vary from as few as 12 performance indicators[13] to as many as 1,000 for other agencies.[14] Below is a brief overview of each:

- **MSCI** evaluates *37 key ESG issues*, divided into three pillars (environmental, social, and governance) and ten themes: climate change, natural resources, pollution & waste, environmental opportunities, human capital, product liability, stakeholder opposition, social opportunities, corporate governance, and corporate behavior.[15]
- **Sustainalytics** looks at what it defines as key ESG issues and indicators. It splits them into three pillars: environmental, social, and governance. Sustainalytics examines at least *70 indicators* in each industry. It also breaks down ESG indicators into three distinct dimensions: preparedness, disclosure, and performance.[16]
- **RepRisk** focuses on *28 ESG issues* connected to the Ten Principles of the UN Global Compact, which encourages global businesses to adopt socially responsible policies and report on their implementation. It divides these into environmental, community relations, employee relations, and corporate governance issues. RepRisk also includes ESG risk exposure for both a two-year and a ten-year timeframe using a scope of 28 ESG issues and 45 "hot topic" tags.[17]
- **ISS E&S Quality Score** evaluates *380+ factors* (at least 240 for each industry group) divided into environmental and social factors. Areas include management of environmental risks and opportunities, human rights, waste and toxicity, and product safety, quality, and brand. The offering is touted as being very similar to the company's well-known governance score.

While each agency has a distinctive approach to the ESG landscape, the variance of these methodologies – along with the dozens of others in this space – demonstrates that this is an ever-changing, inconsistent, and subjective analysis.

DISCLOSURE LIMITATION AND LACK OF STANDARDIZATION

In general, ESG rating systems reward companies with more disclosures. It is possible for companies with historically weak ESG practices, but robust disclosure, to score *in line with or above peers despite having more overall ESG risk*. BlackRock, the world's largest asset manager, shared a report in 2016 that contradicted the presumption that more ESG disclosure and the corresponding higher ratings were an indicator of a good investment strategy. The report stated:

> "It is widely believed that ESG (Environmental, Social, Governance) investing reduces regulatory and reputational risks. In a large global panel, we find that business ethics controversies and regulatory issues are more likely for firms that disclose a richer set of ESG-friendly policies ...
>
> "Like most observers, we expected that an ESG-friendly profile would be associated with better social performance. We were wrong." [18]
>
> **- Gerald Garvey - Head of Long Horizon Research, BlackRock**

11 Traditional financial metrics include auditable items including sales, costs, earnings, and free-cash-flow.
12 Michael Sadowski, Kyle Witaker & Alicia Ayers, Rate the Raters Phase Three Uncovering Best Practices, SustainAbility. (February 2011), http://www.aristastandard.org/content_files/rtrphase3report3.pdf
13 2016 Global 100 Methodology, Corporate Knights. (January 21, 2015), http://www.corporateknights.com/reports/2015-global-100/methodology-14218046/
14 Eric Moen, MSCI ESG Ratings, MSCI. (2018), https://www.msci.com/documents/1296102/1636401/MSCI+ESG+Rating+Brochure-V3.pdf/f2b4a27a-58f5-42c7-880b-cf8201039eaa
15 MSCI ESG Ratings Methodology, MSCI. (April 2018), https://www.msci.com/documents/10199/123a2b2b-1395-4aa2-a121-ea14de6d708a
16 Betty Moy and Michael Comstock, ESG Reports and Ratings: What They Are, Why They Matter, Harvard Law School. (July 27, 2017), https://corpgov.law.harvard.edu/2017/07/27/esg-reports-and-ratings-what-they-are-why-they-matter/
17 RepRisk's Approach, RepRisk. https://www.reprisk.com/our-approach
18 Gerald Garvey, Joshua Kazdin, Joanna Nash, Ryan LaFond & Hussein Safa, A Pitfall in Ethical Investing: ESG Disclosures Reveal Vulnerabilities, Not Virtues, SSRN. (September 20, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2840629

In short, the practice of increased disclosure is given more value by the ratings agencies than the underlying risks those disclosures address.

As a result of these non-standardized disclosures, ESG ratings have limited usefulness to institutional investors.

> It is not surprising then that a Deloitte study showed over 80% of investors are dissatisfied with how risks and opportunities are identified and quantified in financial terms.[19]

Further, ESG ratings fail to represent a global marketplace. Private or state-owned companies are often excluded from ratings and do not disclose critical non-financial data, yet these companies play a vital role in the global market.[20] The absence of these companies from rating agencies' measurement of ESG performance serves to distort the marketplace and its corresponding impact on investors.

Moreover, disclosure-based rating methodology provides ample room for companies to manipulate the disclosure process. Self-reported and unaudited sustainability reports invariably present companies in the best possible light, and rarely do they alert investors of looming problems. According to the Sustainability Accounting Standards Board,[21] roughly **75%** of the information reported in sustainability reports is already addressed by issuers in their SEC filings. However, **90%** of known negative events are not disclosed in either the SEC filings or sustainability reports.[22] Furthermore, the examination of over 4,000 sustainability reports done by the consulting firm Deloitte from 2005–2009 found a significant number of data omissions, unsubstantiated claims, and inaccurate figures.[23]

An example of the limitations of disclosure can be seen in looking at the Goodyear Tire & Rubber Company. Goodyear is a tire manufacturer with a Sustainalytics score of 68, which is 15 points better than both its industry average and the overall Sustainalytics average.[24] Goodyear's ESG disclosure is prominent throughout its annual corporate responsibility report,[25] and the company's Environmental, Health, Safety & Sustainability organization claims to reduce the company's environmental impact.[26]

However, the company has been fraught with ESG issues and exposure, such as asbestos-related claims, various OSHA fines, and litigation settlements.[27] Each of these suggest potential shortcomings, yet the company receives better-than-average ESG ratings as a result of its comprehensive disclosure.

EXPLORING RATINGS BIASES

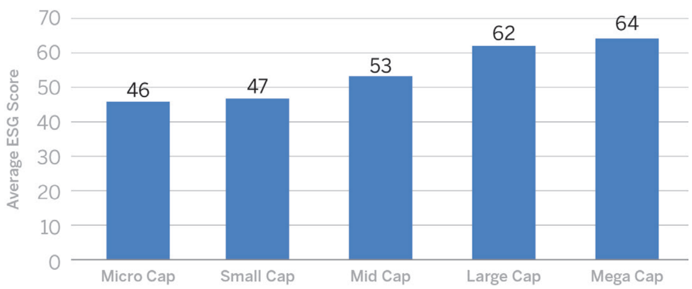
A major concern with ESG ratings is institutional bias.[28] Ratings agencies attempt to apply a one-size-fits-all approach which has created consistently skewed benefits for large and multi-national companies. This bias ignores industry and company specific differences in risk profiles.

BIAS #1: LARGER COMPANIES[29] OBTAIN HIGHER ESG RATINGS

An analysis of over 4,000 Sustainalytics ESG ratings show that larger companies tend to obtain better ESG ratings.[30] Is this the result of stronger ESG alignment or simply the ability to dedicate more resources to preparing non-financial disclosures? MSCI addresses the imbalance indicating that "Companies with higher valuations might be in better financial shape and therefore able to invest more in measures that improve their ESG profile; such investments might lead to higher ESG scores."[31]

19 Sustainability Disclosure: Getting Ahead of the Curve, Deloitte. (2016), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/risk/us-risk-sustainability-disclosure.pdf
20 The State of Governance at State-Owned Enterprises, International Finance Corporation. (2018), https://www.ifc.org/wps/wcm/connect/ab4c7154-9e9a-4549-bc8e-30bf8f4e88e0/PSO40.pdf?MOD=AJPERES
21 Established in 2011, the Sustainability Accounting Standards Board (SASB) is an independent, private-sector standards setting organization dedicated to enhancing disclosure of material sustainability information. (Source: https://www.sasb.org/)
22 Jean Rogers, Five Market Problems the SEC Can Help Solve Through Regulation S-K, The Huffington Post. (December 6, 2017), http://www.huffingtonpost.com/jean-rogers/five-market-problems-the-_b_9959338.html
23 Eric J. Hespenheide and Dr. Dinah A. Koehler, Disclosure of Long-Term Business Value, Deloitte University Press. (2013), https://dupress.deloitte.com/content/dam/dup-us-en/articles/disclosure-of-long-term-business-value/DUP150_Reporting_What_Matters.pdf
24 Data sourced from subset 4,150 Sustainalytics companies.
25 Corporate Responsibility Reports, Goodyear Corporate. https://corporate.goodyear.com/en-US/responsibility/corporate-responsibility-reports.html
26 Corporate Responsibility Reports, Goodyear Corporate. https://corporate.goodyear.com/en-US/responsibility/corporate-responsibility-reports.html
27 In 2015, Goodyear agreed to a settlement of more than $16 million related to illicit profits after violating bribery standards of the Foreign Corrupt Practices Act. (Source: https://www.nytimes.com/2015/02/25/business/goodyear-agrees-to-settle-bribery-case.html)
28 Seb Beloe, What do ESG ratings really tell us?, WHEB Group. (April, 12, 2016), http://www.whebgroup.com/what-do-esg-ratings-actually-tell-us/
29 Companies with higher market capitalization receive higher ESG scores. Market capitalization is the market value of a company's outstanding shares calculated by multiplying the stock price by the total number of outstanding shares.
30 Review conducted of 4,150 individual Sustainalytics ESG Ratings.
31 Guido Gese, Linda-Eling Lee, Dimitris Melas, Zoltan Nagy & Laura Nishikawa, Foundations of ESG Investing, MSCI. (November 2017), https://www.msci.com/documents/10199/03d6faef-2394-44e9-a119-4ca130909226

Average ESG Score by Market Cap [32]



As a result, small and mid-sized companies are at a competitive disadvantage when it comes to ESG ratings, even though these companies create the most jobs and tend to be the most innovative.[33]

Bias can be seen in favor of large companies resulting in higher ESG ratings. Take for example the Bristol-Myers Squibb Company, a pharmaceuticals company with an $83 billion market capitalization. It has a Sustainalytics ratings score of 73, which is 20 points better than the healthcare industry average and 25 points above the overall Sustainalytics average.[31] As a large cap company, Bristol-Myers implements GRI Sustainability Reporting Standards[34] and has established high-profile ESG goals.[35] Despite ambitious ESG aspirations, disclosures, and corresponding high ESG ratings, the company has been tied to recent high-profile controversies including questionable experimental testing methods and Foreign Corrupt Practices Act violations.[36] As discussed earlier in the paper, these are the types of factors that should have a substantial downward impact on ESG ratings, but in this case, there appears to be little correlation.

Bias can be seen against small companies resulting in lower ESG ratings. In this case, we looked at Phibro Animal Health, a pharmaceutical company that operates as a diversified animal health and mineral nutrition company with a $1.7 billion market capitalization. It has a Sustainalytics score of 46, which is 3 points worse than the healthcare industry average and 8 points below the overall Sustainalytics average.[31] As a small cap company, Phibro employs over 1,400 professionals and "has a responsibility to deliver safe, effective, sustainable products and to provide expert guidance about their use."[37] In addition, the company runs the educational website animalantibiotics.org to engage stakeholders about animal health issues, including responsible antibiotic use and resistance. Yet, despite its mission statement, track record, and alignment with ESG issues, the company receives a below average ESG rating.

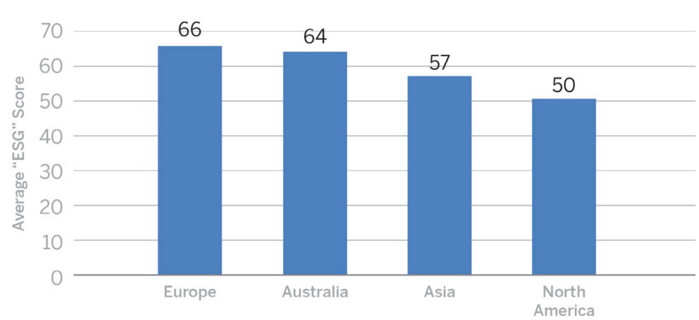
The juxtaposition between how these companies actually engage on ESG issues and their Sustainalytics score highlights how subjective these ratings can be. By rewarding larger companies that have the ability prepare and publish annual ESG disclosures, while penalizing those smaller companies that instead devote limited resources to fulfilling their ESG goals, these rating systems are working in contradiction to their original purpose of providing accurate assessments of risk and opportunity. Instead of providing transparency, this bias shows how such ratings systems are not only subjective, but can also leave investors in the dark about the actual strength of a company's ESG practices.

BIAS #2: GEOGRAPHICAL BIAS TOWARD COMPANIES IN REGIONS WITH HIGH REPORTING REQUIREMENTS.

Comparing ESG ratings across geographies is no easy task, especially in a global market. Though the observable differences between company ratings show a clear distinction – most notably between Europe (the best) and North America (the worst). But the source of this bias may not fully reflect the quality of ESG practices, but instead the quality of reporting.

Disclosure requirements vary significantly by country and region, and several divergent regulatory requirements have been introduced to induce the disclosure of corporate ESG information – the primary source of information for ESG research and rating providers.

Sustainalytics ESG Rating by Geography [32]



32 Data sourced from subset 4,150 Sustainalytics companies.
33 Michael Evans, Job Creation in the New Political Economy: Small Companies, Not Big Companies, Create Jobs, Forbes. (February 8, 2017), https://www.forbes.com/sites/allbusiness/2017/02/08/job-creation-in-the-new-political-economy-small-companies-not-big-companies-create-jobs/#1e7acde39e6e
34 GRI is an international independent standards organization that helps businesses, governments and other organizations understand and communicate their impacts on social and ethical issues. (Source: https://www.globalreporting.org/Information/about-gri/Pages/default.aspx)
35 Sustainability 2015 Goals Final Report, Bristol-Meyers Squibb. (August 2016), https://www.bms.com/assets/bms/us/en-us/pdf/sustainability-2015-goals-final-report.pdf
36 SEC Charges Bristol-Myers Squibb With FCPA Violations, SEC. (October 5, 2016), https://www.sec.gov/news/pressrelease/2015-229.html
37 Corporate Responsibility, Phibro Animal Health Corporation. https://www.pahc.com/responsibility/

In Europe, the EU requires companies with 500 employees or more to publish a "non-financial statement" as well as additional disclosures around diversity policy.[38] North America has no such requirement for disclosure, which is one source for the positive bias toward European companies.

In addition to disclosure requirements, investors in Europe are more convinced of the materiality of ESG investing. A 2016 study by Schroders found that 58% of European fund managers view ESG as an important investment consideration while only 14% of US managers said the same.[39] The geographical split between investor sentiment and corporate reporting is driving distinct differences in ESG rating performance.

A telling example of geographic bias is evident when comparing the BMW Group and Tesla. BMW has a high rating (93rd percentile) despite a slew of controversies, including anti-competitive practices, illegal marketing practices, business ethics violations relating to intellectual property, employee and human rights violations along their supply chain, and even animal rights violations.[40] The company is facing accusations of collusion with Volkswagen, Audi, Porsche, and Daimler on various technological issues and systems to evade environmental and safety regulations.[41]

In contrast, Tesla (38th percentile) is below every single European auto manufacturer, including the companies named in the collusion accusations above. Most notably, Tesla's score even lags Volkswagen, which as previously discussed has been implicated in a major environmental violation.[42] Meanwhile, Tesla is the world leader in technology to reduce carbon emissions from automobiles.[43]

	BMW	TESLA
Sustainalytics Score	**74**	**54**
Score Percentile	**93rd**	**38th**
Relative Score	**Well Above Average**	**Average**

The stark contrast between Tesla's score and the scores of European manufacturers typifies the lack of objectivity in these scores. Despite the myriad environmental and ethical violations committed by BMW and other European automakers, this comparison makes clear that the score is more a reflection of the amount of information disclosed – a requirement in Europe – than a company's adherence to ESG practices. The extent to which geographical disclosure requirements factor into ESG ratings effectively distorts an investor's ability to understand a company's true commitment to ESG practices.

BIAS #3: ESG AGENCIES OVERSIMPLIFY INDUSTRY WEIGHTING AND COMPANY ALIGNMENT.

Ratings agencies claim to *normalize* ratings by industry. However, more often than not, agencies assign E, S, and G weights to companies without factoring in company-specific risks. This can result in a biased rating for a company based on their industry, as opposed to company specific risks. We agree that it is important to standardize disclosures and metrics within an industry, especially considering how materiality changes by industry, but the standardization of *industry weighting* can bias ratings and mislead investors.

38 Reporting Directive 2014/95/EU on disclosure of non-financial and diversity information – also known as EU NFR – required companies with 500 employees or more to publish a "non-financial statement" as well as additional disclosures around diversity policy as of January 2017.(Source: https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en)

39 Shroders Global Investor Study 2016- Plan Sponsors, Shroders. (2016), http://www.schroders.com/en/sysglobalassets/digital/insights/2016/pdfs/global-investors-study-pension-funds.pdf

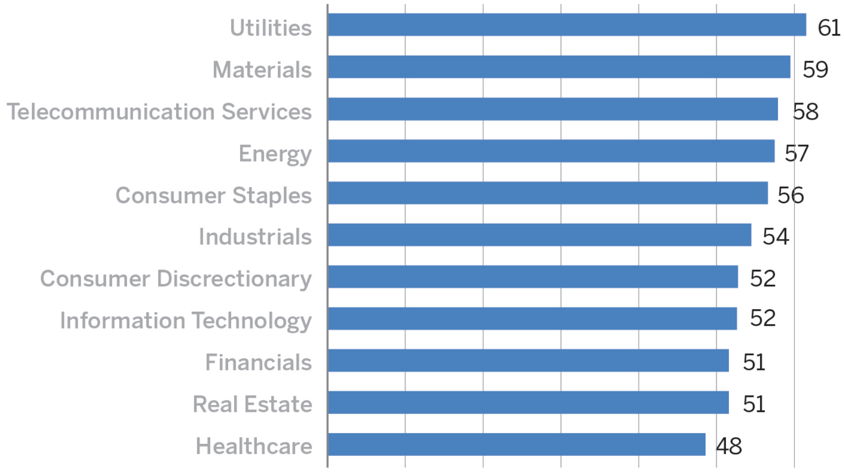
40 Corporate Research Project, Violation Tracker. https://www.goodjobsfirst.org/violation-tracker

41 Edward C. Baig, Emissions Scandal? BMW 'Categorically Rejects' Colluding with Rivals, USA Today. (July 23, 2017), https://www.usatoday.com/story/money/2017/07/23/emissions-scandal-bmw-categorically-rejects-colluding-rivals/503230001/

42 Guilbert Gates, Jack Ewing & Karl Russell, Investing with 'green' ratings? It's a gray area, The New York Times. (March 16, 2017), https://www.nytimes.com/interactive/2015/business/international/vw-diesel-emissions-scandal-explained.html

43 Mike Barnard, The Carbon Footprint of Tesla Manufacturing, Forbes. (April 22, 2016), https://www.forbes.com/sites/quora/2016/04/22/the-carbon-footprint-of-tesla-manufacturing/#543e1de60964

Average ESG Score by Industry[44]



Industry ratings can vary significantly for ESG rating agencies. On average Sustainalytics gives the utilities industry an ESG rating of 61.3 out of 100, the best average ESG rating, while giving healthcare 49 out of 100, the worst. Industry rating differences can be the result of unequal information availability so it is perhaps unsurprising that large, mature, dividend-focused companies like utilities score better than less mature companies that focus on reinvesting through R&D.

Why is industry bias a problem? A portfolio manager or investor evaluating companies and attempting to apply these "normalized" ratings might falsely under- or over-weight a company – or worse yet, a whole industry – miscalculating the bias that is implicit in the ratings. One example of unbalanced industry exposure is iShares MSCI KLD 400 Social ETF, the largest ESG focused ETF fund. Currently the fund invests heavily in information technology companies. In fact, information technology investments account for 31% of the $1 trillion in assets under management, with the top three investments being Microsoft, Facebook, and Google. [45, 46]

Categorizing all companies the same within each industry, while common for ESG ratings, highlights the need for a more tailored approach to the ratings process. In its own evaluation of ESG investing, MSCI acknowledges that *company-specific risks* are not a focus and the systematic issues that face a given industry play a more important role: "In essence, the MSCI ESG Rating is a reflection of companies' residual risk exposure to **their industry's** most significant key issues after taking into account companies' risk-mitigation techniques."[47]

> A study found that **79% of investors** indicated dissatisfaction with the comparability of ESG reporting between companies in the same industry. [48]

Companies within the same industry do not have the same risks. Rather, companies have unique structures and risk models. One example is General Electric, a widely known industrial conglomerate. It shares the exact same E, S, and G weightings as fellow industrial company Waste Management Inc., despite drastically different ESG issue exposure. General Electric operates as an infrastructure and technology company with eight different and wide-ranging reporting segments. The company generated 2016 revenues of $118 billion, which is roughly 68% from the sale of goods and 32% from the sale of services. The company reports revenue across the globe, with 43% of revenues from the U.S., 17% from Europe, 17% from Asia, 8% from Americas, and 14% from Middle East/ Africa. In contrast, Waste Management, Inc., provides waste management environmental services to residential, commercial, industrial, and municipal customers in North America. The company generated 2016 revenues of $13 billion, predominately through waste or recycling services, and 100% of revenues were generated in the U.S and Canada. Yet, because the two companies operate within the same industry their weights and factors are applied the same.

44 Data sourced from subset 4,150 Sustainalytics companies.
45 Comparatively, the S&P 500 average weighting for information technology is roughly 24%. (Source: http://siblisresearch.com/data/sp-500-sector-weightings/)
46 iShares MSCI KLD 400 Social ETF, iShares. https://www.ishares.com/us/products/239667/ishares-msci-kld-400-social-etf
47 Foundations of ESG Investing, MSCI. https://www.msci.com/www/research-paper/foundations-of-esg-investing/0795306949
48 Sustainability Disclosure: Getting Ahead of the Curve, Deloitte. (2016), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/risk/us-risk-sustainability-disclosure.pdf

These examples highlight the limitations of combining subjective criteria with a one-size-fits-all approach. Despite rating agencies claiming to perform in-depth analysis on each company to generate their ratings, the uniform use of weighting and lack of focus on company-specific risks and factors exemplifies oversimplification of a complex topic.

INCONSISTENCIES BETWEEN RATING AGENCIES

Analysis conducted by CSRHub[49] shows that ESG rating agencies frequently disagree when evaluating the same company.

> When comparing MSCI's and Sustainalytics' ratings for companies in the S&P Global 1200 index,[50] CSRHub found a weak correlation [51] (0.32) between the two firms' ratings.

Rating agencies in other capital markets are much more closely aligned. For example, Moody's and S&P's credit ratings have a very strong positive correlation (0.90).[52] The difference between credit ratings and ESG ratings can be attributed to consistent information. One reason for this consistency is the fact that credit agencies use standardized financial disclosures.

Inconsistency across ESG agencies can be problematic for both investors and companies working to improve their performance. Investors are understandably concerned with the inconsistency and lack of rigor in the ratings. In addition, they view agencies as data providers, rather than part of a comprehensive and reliable ratings systems.[53] Yet even with these apparent deficiencies, many large institutions nevertheless use the ratings systems to screen for or exclude investments, and in building ESG focused mutual funds.[54]

In turn, companies find themselves building and adjusting disclosure resources, not to mention answering countless ESG surveys, to meet the many needs of the rating agencies. Given that disclosures are unaudited, unlike financial statements used for investment analysis, there is a large incentive for companies to pander to rating methodologies. This inevitably leads to the use of boilerplate language in response to ESG inquires, to merely increase one's rating score.

One example of a ratings inconsistency can be found at one of the largest banks in the world. Bank of America (BofA) has a significant amount of exposure to ESG-related risks, most notably those involving business ethics. The company faces exposure to litigation, sensitivities around mortgage-backed securities, and a political loan scandal involving Countrywide Financial.[55] These issues, while captured by both RepRisk and Sustainalytics, ultimately led the agencies to produce conflicting ratings.

49 CSRHub provides access to corporate social responsibility and sustainability ratings and information on 17,913+ companies from 135 industries in 133 countries. (Source: https://esg.csrhub.com/about-csrhub)

50 A global index composed of seven regional indices which covers 31 countries and 70% of the global stock market. (Source: https://www.spindices.com/index-family/global-equity/global-1200)

51 Correlation values range from -1 to +1 and measures the strength of the relationship between two variables where -1 is perfectly negative and +1 is perfectly positive. 0 indicates no relationship between variables.

52 Ross Kerber and Michael Flaherty, Investing with 'green' ratings? It's a gray area, Reuters University. (June 26, 2017), https://www.reuters.com/article/us-climate-ratings-analysis/investing-with-green-ratings-its-a-gray-area-idUSKBN19H0DM

53 Dan Esty and Todd Cort, Corporate Sustainability Metrics: What Investors Need and Don't Get, Journal of Environmental Learning. (2017), https://cbey.yale.edu/sites/default/files/Corporate%20Sustainability%20Metrics%20-%20What%20Investors%20Need%20and%20Don%E2%80%99t%20Get.pdf

54 Michael Corkery, 2017 Prospectus, BlackRock. (September 8, 2016), https://www.blackrock.com/investing/resources/regulatory-documents/stream-document?stream=reg&product=IUS-SUSA&shareClass=NA&documentId=925822~926099~926263~1474672&iframeUrlOverride=%2Finvesting%2Fliterature%2Fprospectus%2Fp-ishares-msci-usa-esg-select-etf-4-30.pdf

55 Countrywide was found guilty of defrauding federal mortgage giants Fannie Mae and Freddie Mac as the height of the housing crisis. (Source: https://www.nytimes.com/interactive/2014/06/10/business/dealbook/11bank-timelime.html#/#time333_8803

Bank of America	RepRisk	Sustainalytics
Score	**CCC**	**70**
Relative Score[56]	**Below Average**	**Well Above Average**
Issues Cited	• Fraud • Corruption, bribery, extortion, money laundering • Poor employment conditions • Anti-competitive practices • Impacts on ecosystems and landscapes • Human rights abuses, corporate complicity • Global pollution • Violation of international standards	• Coal mining funding • Financing to foreign ESG violators • Enabling tropical deforestation • Gender discrimination • Faulty mortgage backed securities • Lending discrimination • DAPL financing • Financing cluster munitions

Even though both agencies factored many of the same issues facing BofA into their ratings, the final scores are dramatically different due to inconsistencies in how the ratings providers interpreted these issues. Without a standardized, comprehensive rating system, such inconsistencies unjustly expose investors to risk and cast doubt on the overall legitimacy of a company's score.

Another example of ratings inconsistency deals with USG Corporation. RepRisk and Sustainalytics ESG ratings for USG Corporation show a clear discrepancy. Looking closely at each agency's ratings methodology, RepRisk provides a grade based on "exposure" to ESG issues, while Sustainalytics grades ESG based on "preparedness, disclosure, and performance." Depending on which agency you follow, the issues weighed by each rating agency can be drastically different. This disagreement reveals the inherent subjectivity employed by ratings agencies when selecting relevant ESG issues to consider.

USG	RepRisk	Sustainalytics
Score	**AA**	**50**
Relative Score[56]	**Above Average**	**Below Average**
Issues Cited	• Price fixing on gypsum board • Asbestos exposure • Violation of national legislation	• Disclosure is weak and not in accordance with GRI reporting standards • Price fixing on gypsum board • Poor management of waste emissions, fleet energy, impact of product and services

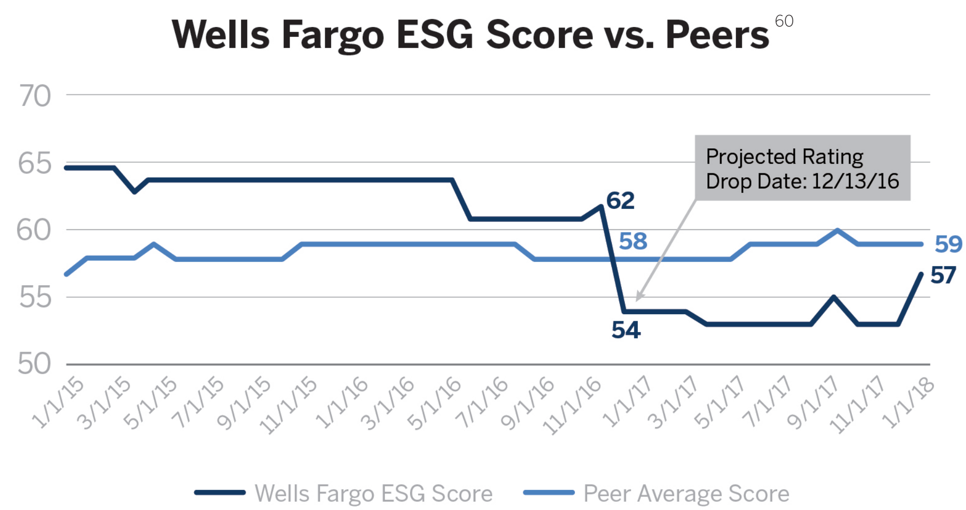
In addition to inconsistencies in how various issues are interpreted by ratings agencies, differing methodologies only compound the lack of clarity for investors. Without standardized grading methodologies, these scores may lead investors in different directions and certainly cause confusion if compared. In addition, companies do not have the consistent benchmarks necessary to drive improvement.

56 Data sourced from subset of 150 RepRisk companies and of 4,150 Sustainalytics companies.

FAILURE TO IDENTIFY RISK

Capturing ESG risk is admittedly difficult, but agencies market their rating systems as a way to understand and mitigate risks. For example, as one of their six 'key benefits,' Sustainalytics states that its ESG research and ratings allows investors to "understand which ESG factors affect a company and how prepared it is to manage risk."[57] And yet, as shown by this report, ESG ratings providers' methodologies are failing to accurately identify risk. Worse still, when corporate scandals have taken place, many of the affected companies had above average ratings at the same time as their stock price plummeted. By failing to identify risk ahead of severe stock price movements the rating agencies are not effectively assisting investors.

One example of failing to properly identify risk involves Wells Fargo. In September 2016, federal regulators announced that since 2011, unbeknownst to customers, Wells Fargo employees had secretly opened 1.5 million bank accounts and applied for roughly 565,000 credit cards in order to boost sales figures. In response, the bank fired roughly 5,300 employees associated with these actions and was assessed $185 million in fines.[58] Since then, the bank has had to address lawsuits from former employees, congressional investigations, and the resignation of some of its top executives.[59]



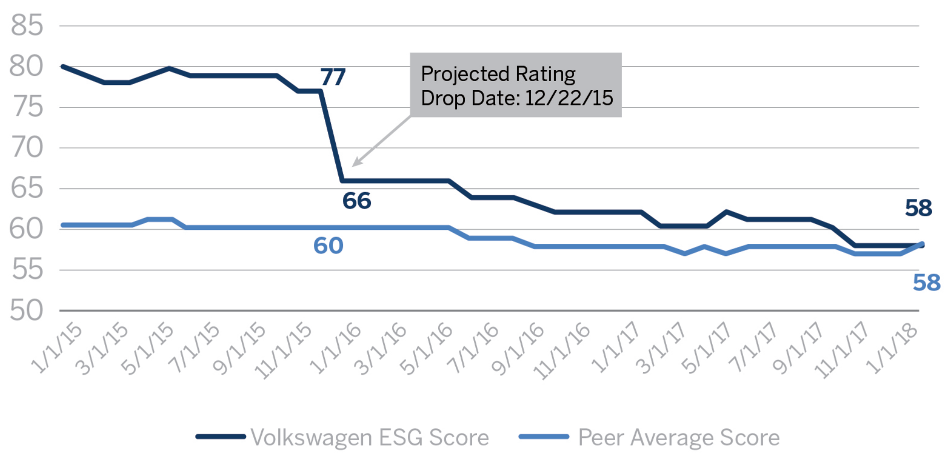
And yet, despite the internal failures to discover and rectify these actions by its employees over the course of five years, Wells Fargo had an ESG score that was as much as 10 points higher than its peers. Even after Wells Fargo had its rating revised downward following the scandal, its rating remained surprisingly high, just a few points of the peer average.

What are the economic repercussions? While banking peers JPMorgan Chase, Bank of America, and Citigroup have grown on average by 40% over the 12 months following the scandal, Wells Fargo's stock has remained flat. Had Wells Fargo's stock mirrored that of its competitors, the gain would have added nearly $100 billion in market value to the company.[61]

57 ESG Research & Ratings, Sustainalytics. https://www.sustainalytics.com/esg-research-ratings/
58 Michael Corkery, Wells Fargo Fined $185 Million for Fraudulently Opening Accounts, The New York Times. (September 8, 2016), https://www.nytimes.com/2016/09/09/business/dealbook/wells-fargo-fined-for-years-of-harm-to-customers.html
59 Paul Blake, Timeline of the Wells Fargo Accounts Scandal, ABC News. (November 3, 2016), https://abcnews.go.com/Business/timeline-wells-fargo-accounts-scandal/story?id=42231128
60 Wells Fargo, Yahoo! Finance. https://finance.yahoo.com/quote/WFC/sustainability?p=WFC
61 John Maxfield, Chart: The Cost of Wells Fargo's Sales Scandal, The Motley Fool. (September 6, 2017), https://www.fool.com/investing/2017/09/06/chart-the-cost-of-wells-fargos-sales-scandal.aspx

Another example of ESG ratings agencies failing to identify risk involved Volkswagen. In September 2015, the EPA issued a notice of violation of the Clean Air Act to auto manufacturer Volkswagen. This occurred after finding that the company intentionally programmed its turbocharged direct injection diesel engines to bypass emissions-testing software.[62] This deceptive practice affected roughly 11 million vehicles worldwide produced from 2009 to 2015. The company subsequently agreed to pay more than $25 billion in fines and penalties.[63]

Volkswagen ESG Score vs. Peers [64]



However, even after it was discovered that Volkswagen committed one of the most serious clean air violations, it continued to enjoy an ESG rating higher than its peer average. The ratings dropped from well above average at 77 to still 6 points above average at 66 following the scandal becoming public. Even in first quarter 2018, its ESG ratings place the company on par with the rest of the industry.

This example is concerning because it shows a complete failure by the ratings agencies to accurately capture ESG risk, even after a blatant attempt at bypassing environmental regulations. This was both an environmental and corporate governance failure.

Following the scandal, it wasn't only Volkswagen's reputation that suffered. Overnight, the company's stock dropped 30% and ultimately fell 50% from prior months' highs.[65] This massive value loss of roughly $50 billion exemplifies the importance of accurate risk assessment.

Taken together, these two ratings failure examples depict how the subjectivity and biases inherent to ESG ratings ensure that ratings agencies are either unable or unwilling to both identify risk and properly protect investors from mismanagement.

62 Bill Chappell, Volkswagen 'Dieselgate' Fallout: Germany Tests Cars; Report Sends BMW Shares Down, NPR. (September 24, 2015), https://www.npr.org/sections/thetwo-way/2015/09/24/443078669/volkswagen-dieselgate-fallout-germany-tests-cars-new-report-sends-bmw-shares-dow

63 Roger Parloff, How VW Paid $25 Billion for 'Dieselgate'-and Got Off Easy, Fortune. (February 6, 2018), http://fortune.com/2018/02/06/volkswagen-vw-emissions-scandal-penalties/

64 Volkswagen, Yahoo! Finance. https://finance.yahoo.com/quote/VOW3.DE/sustainability?p=VOW3.DE

65 Paul R. La Monica, Volkswagen has plunged 50%. Will it ever recover?, CNN Money. (September 25, 2015), http://money.cnn.com/2015/09/24/investing/volkswagen-vw-emtissions-scandal-stock/index.html

ACTIONABLE RECOMMENDATIONS

As we discuss in this paper, ESG ratings are currently disconnected from real company risks. The current ratings are a reflection of how much a company discloses, rather than the risks that are being disclosed. Inconsistency and a lack of transparency render many ESG ratings meaningless, as we've seen with dramatically different ratings for the same company across multiple rating agencies. These issues raise considerable questions about the utility of the current ESG ratings process in terms of assessing company risks or sustainability.

As such, we recommend the following for consideration:

1. **ESG information already disclosed in regulatory filings should be standardized to incorporate risk.**
   To keep ESG analysis "apples-to-apples" it is critical to adopt universal disclosure techniques (i.e. standard metrics included or defined calculation methods). Reforms from the Sustainability Accounting Standards Board ("SASB"),[66] while genuine, do not appear to be feasible for universal compliance due to their sizeable complexity. Further, the SASB framework contradicts principal driven approaches like the Global Reporting Initiative ("GRI") [67, 68] Measures should be taken to reform the current non-financial reporting structure so that ESG rating consistency can improve.

2. **ESG ratings need to adjust for company size, geographic reporting, and industry sector differences.**
   Providing non-financial ESG-related information is valuable for all investors in forming an investment perspective of related risks and opportunities for an individual company. That said, rating agencies treat the absence of information critically and need to adjust their rating methodologies to address different quantities of information from a geographic and industry specific level. This adjustment should also include how these companies compare to state owned and privately held companies. Investors need to know how companies fare in the global market in making their investment decisions.

3. **ESG rating agencies need to be transparent on how E, S, and G factors impact scores and prioritize those that are material.**
   To apply ratings to companies empirically, one must thoroughly understand the underlying assumptions, which, as this paper outlines, are biased, subjective, and limited by non-uniform disclosure. With fiduciary duties on the line and the goal of generating standardized returns and long-term performance, a more careful approach is advised.

4. **ESG rating agencies should be carefully compared and should fully disclose their success rate in protecting investors from large underlying risks.**
   Admittedly, ESG ratings won't get it right 100% of the time. That said, it is important to measure and report how well ESG ratings help investors to mitigate financial risk or identify opportunities. Allowing ESG rating agencies to run unchecked in determining significant investment direction is irresponsible and negligent to managers' fiduciary duty.

As there continues to be a growing interest in ESG investing, it is paramount that investors and money managers have the necessary information to make sound investment decisions. Given that investments are increasingly based on a company's ESG rating, the rating agencies that assign these ratings have a vital impact on investment strategies. Currently there appears to be no uniform criteria used by the largest and most influential rating agencies.

We believe that the recommendations given in this report will improve the process of standardizing ESG ratings. While this is still a relatively new factor for investors to consider, improved transparency and uniformity will bring much needed clarity to the process.

In the end, all investors need consistent, transparent, and easily understandable ratings on which to base their investment decisions.

66 SASB is dedicated to enhancing the efficiency of the capital markets by fostering high-quality disclosure of material sustainability information that meets investor needs. (Source: https://www.sasb.org/overview/)

67 GRI is an independent international organization that has pioneered sustainability reporting since 1997. (Source: https://www.globalreporting.org/Information/about-gri/Pages/default.aspx)

68 Jeff Leinaweaver, Is Corporate Sustainability Reporting a Great Waste of Time?, The Guardian. (January 6, 2015), https://www.theguardian.com/sustainable-business/2015/jan/06/corporate-sustainability-reporting-waste-time