GIBSON DUNN

Susy Bullock is a partner and Jonathan Cockfield is an associate attorney at Gibson Dunn. Ms Bullock can be contacted on +44 (0)20 7071 4283 or by email: sbullock@gibsondunn.com. Mr Cockfield can be contacted on +44 (0)20 7071 4021 or by email: jcockfield@gibsondunn.com.

Published by Financier Worldwide Ltd
©2022 Financier Worldwide Ltd. All rights reserved.

Permission to use this reprint has been granted by the publisher.

SPOTLIGHT ARTICLE October 2022

ESG ratings: key considerations for stakeholders

BY SUSY BULLOCK AND JONATHAN COCKFIELD

In March 2022, the Financial Times reported a "boom" in environmental, social and governance (ESG) ratings, with a "race to carve out market share in the very lucrative business of providing advice to investors on environmental, social and governance issues". These ratings typically assess the impact of ESG factors on a company or product and (in some cases) a company's impact on the outside world.

It is estimated that there are some 140 different ESG data providers in the market currently, including ESG branches of well-known agencies such as Refinitiv, Moody's, S&P and Morgan Stanley Capital International (MSCI). This growth is unsurprising given the intensifying focus of institutional investors on ESG matters and the proliferation of 'ESG funds'.

To put that into context: membership of the Principles for Responsible Investment (PRI) – an investor initiative by asset owners, investment managers and service providers, focused on the incorporation of ESG factors into investment decisions and active ownership – has quadrupled in the past decade, with less than 1000 members of the PRI in 2011 (approximately US$20 trillion assets under management (AUM)), growing to more than 3500 members (and AUM in the region of US$120 trillion) in 2021.

And the interest does not sit with investors alone. Many companies are themselves commissioning ESG reports and rating reviews to help establish their ESG credentials and enhance their own ESG frameworks and reporting. Equally, financial services firms increasingly turn to ratings when assessing creditworthiness and commercial terms, or to determine inclusion in ESG funds or indices.

However, while the universe of ESG data expands, there remains a crucial lack of understanding, transparency and cohesion of ESG rating methodology and output. With this in mind, we explore five key considerations for those relying on, or responding to, ESG ratings.

ESG rating methodology varies significantly

Remit. Each rating agency develops its own methodology and criteria for assessment, and these vary significantly. Even the expressed 'purpose' of an ESG rating is not consistent across the board. Many ratings are purely inward looking. For example, MSCI ESG ratings aim "to measure a

company's management of financially relevant ESG risks and opportunities", while Sustainalytics measures "the degree to which a company's economic value is at risk driven by ESG factors".

Others, such as Refinitiv, take a broader stance with industry-based relative performance, describing their ESG scores as "designed to transparently and objectively measure a company's relative ESG performance, commitment and effectiveness across ten main themes (emissions, environmental product innovation, human rights, shareholders etc) based on publicly-reported data". Some are single-issue focused, such as Equileap, which addresses and assesses companies on their progress toward gender equality in the workplace.

Output. Similarly, there is no uniformity in output. Some agencies award numerical values to company performance with ratings out of 100 (100 being the "best" score), while others apply a letter grade (AAA being optimal) or qualitative description.

Information sources. Certain agencies, such as Refinitiv, confine their analysis to publicly available information obtained from companies' filings and disclosures, whereas others take a more proactive and interventionist approach. Institutional Shareholder Services ESG, for example, uses (among other sources) information derived directly from the companies themselves, including from interviews with stakeholders and company policies and practices, informed by company and stakeholder dialogue. There are also variations in the weight attached to information categories. For example, some ratings focus solely on current policies, whereas others take into account forward-looking metrics and transition frameworks aligned metrics.

In any event, it is widely accepted that there are inherent challenges to data quantity, quality and consistency when it comes to ESG, since there is not yet one globally accepted standard which informs company measurements, definitions and disclosure.

Rating agencies may reach different conclusions regarding the same entity or product

In the absence of any regulation, there can be significant differences in how any one company is treated by the primary rating agencies. Indeed, a recent MIT Sloan School of Management study found that the correlation between six prominent ratings agencies on ESG ratings was on average 0.61, whereas the correlation for credit ratings issued by Moody's and S&P was 0.99. According to that same study, this means that "the information the decision-makers receive from ESG ratings agencies is relatively noisy".

This variance in methodology and outcomes when compared with other market ratings has led to mistrust, with some investors preferring to generate their own internal ESG ratings calculations as they "cannot rely on external ESG sources", as many ESG rating agencies "use 'black-box' algorithms… and do not provide access to the backing data" (Financial Times, quoting the chief executive of Marsham Investment Management).

Engagement by companies with rating agencies carries risks and rewards

Opportunities for dialogue vary significantly between agencies. Some may engage the company from an early stage or share a draft report for company review. Others operate entirely behind closed doors. By way of example, MSCI is explicit in stating that its engagement with companies will not extend to providing draft data or reports prior to publication.

It does, however, have a portal which companies are able to access at any time, and through which they can upload additional information or generally provide feedback and comments. By contrast, Sustainalytics sends its draft report to the relevant company prior to it being made available to clients – with the stated goal being to "gather feedback on the accuracy of the information captured in the draft report".

Furthermore, some agencies state publicly that they will penalise a company in its ESG scoring if they cannot obtain the information they ask for, nor find the relevant information through a third party.

The PRI has identified "managerial fatigue", as companies often have to navigate multiple, simultaneous lines of enquiry and questionnaire and information requests from multiple ESG rating agencies.

To the extent that companies do engage, caution is advisable when they consider how to fill any perceived policy gaps in short order. The production of ESG-relevant policies is, of course, commendable, but kneejerk policy production may be unwise if prepared in a vacuum, rather than as part of a holistic ESG framework and strategy with the appropriate implementation.

There are currently few clear avenues for legal challenge

On the international stage, there have been few reported ESG rating agency court challenges. Most notable is the case of *ISRA Vision v ISS ESG Az.* (2020) in the Regional Court of Munich. There, the court held that a poor ESG rating of Isra Vision prepared by ISS ESG was based upon fundamental misunderstandings regarding the nature of ISRA Vision's business, and enjoined ISS ESG from publishing the rating (notably, ISRA had not responded to ISS's request as to whether ISRA wanted to contribute to the sustainability review).

While the Federal Court of Australia has recognised a duty to exercise reasonable care and skill by a credit agency toward investors in a rated financial product (*ABN Amro Bank NV v Bathurst Regional Council* (2014)), this was in circumstances where S&P was aware of the size of the issuance of the products and the minimum subscription size for the products, and the products were so complex that reliance on the rating was reasonable.

However, this has not translated into litigation against agencies in Australia, and English courts have yet to adopt a similar construct. Indeed, to date there have been no reported cases concerning rating agencies (ESG or otherwise) in English courts, with claimants perhaps deterred by the perceived challenges of a claim in tort and requirement to prove reliance and attributable loss.

Expect significant change in the coming years

The unsatisfactory nature of the current ESG rating ecosystem has prompted loud calls for regulation and greater transparency. For example, the European Securities and Markets Authority has been consulting on this topic since spring 2020, and in July 2022 the Financial Markets Standards Board published a spotlight report on ESG ratings, exploring opportunities for greater transparency and comparability.

The European Union has responded accordingly – conducting a consultation earlier this year to "help the Commission gain a better insight on the functioning of the market for ESG ratings, as well as better understand how credit rating agencies (CRAs) incorporate ESG risks in their creditworthiness assessment".

While regulation would be a welcome relief to many market participants (with 84 percent of respondents to the consultation believing that the market is not functioning well today), agencies themselves, perhaps unsurprisingly, responded to the consultation with concern. It was reported in August 2022 (by Responsible Investor) that a number of ratings agencies, including MSCI, S&P, Moody's, Fitch and the London Stock Exchange Group, posited that any intervention should be non-regulatory in nature. A range of reasons were cited, including that such regulation would be "unnecessary", could lead to a "significant cost burden" and that any such regulation would risk being "counterproductive".

In the UK, the Financial Conduct Authority has recently acknowledged the significant impacts of poor ESG ratings on companies and the lack of consistency between ratings agencies methodologies and scores, announcing in May 2022 that regulation of the ESG ratings industry "is coming, and coming quite quickly". Meanwhile, in Japan, the Financial Services Agency released a draft 'Code of Conduct for ESG Evaluations and Providers' in July 2022, for public consultation.

In any event, the quality and quantity of ESG data looks likely to improve as disclosure standards evolve at a global level. In November 2021, trustees of the International Financial Reporting Standards Foundation announced the creation of the International Sustainability Standards Board (ISSB), with the stated aim of delivering a "comprehensive global baseline of sustainability-related disclosure standards", enabling stakeholders better to understand reporting and its impacts.

The free rein currently enjoyed by ESG rating agencies looks set to change significantly in the coming months and years, as supervisory authorities take hold of the market. As standards evolve and companies benefit from greater transparency over methodologies and assessments, we may well see companies emboldened to challenge their ratings through litigation. This dynamic area is certainly one to watch for ESG professionals and general counsel. ■

This article first appeared in the October 2022 issue of Financier Worldwide magazine. Permission to use this reprint has been granted by the publisher. © 2022 Financier Worldwide Limited.

FINANCIER WORLDWIDE corporatefinanceintelligence