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Environmental Social Governance: Uncovering Strengths, Weaknesses, and Misconceptions in ESG Disclosure and Rating

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by
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Abstract

ESG is a metric designed to assess the extent to which a company has mitigated its risks with regard to environmental, social, and governance factors. In the past two decades, ESG investing and adoption has risen significantly, and ESG evaluation and practices are increasingly being introduced to governments and the private sector. However, today, ESG disclosure is not mandated in the United States, leading to asymmetries in disclosure quality and divergence in ESG scores issued by ratings providers. These massive discrepancies have consequences for companies (e.g. cost of capital), investors (e.g. investment hesitance, lost potential returns), and the ESG metric itself (i.e. damage to ESG's reputation and reliability), making it imperative that disclosure is made mandatory and that a generally-accepted disclosure framework is developed. In recent years, several proposals for ESG disclosure regulation have been put forth to achieve this, and as such, this paper assesses the viability of these proposals. To this end, this paper aims to clarify some of the confusion surrounding ESG and its meaning, as well as offer recommendations for future ESG regulation.

Acronym Key

AUM - Assets Under Management

CDSB - Climate Disclosure Standards Board

CSR - Corporate Social Responsibility

EPA - Environmental Protection Agency

ESG - Environmental Social Governance

ETF - Exchange-Traded Fund

FASB - Financial Accounting Standards Board

FSOC - Financial Stability Oversight Council

GRI - Global Reporting Initiative

MSCI - Morgan Stanley Capital International

OECD - Organisation for Economic Cooperation and Development

SASB - Sustainability Accounting Standards Board

SEC - Securities and Exchange Commission

SFDR - Sustainable Finance Disclosure Regulation

SRG - Sustainability Reporting Guidelines

SRI - Socially-Responsible Investment

TCFD - Task Force on Climate-Related Financial Disclosures

UN PRI - UN Principles for Responsible Investing

VRF - Value Reporting Foundation

GAAP - Generally-Accepted Accounting Principles

Introduction

Since its nascence in 2004 (International Finance Corporation, 2004), ESG investing has surged to the point where, today, ESG funds account for 10% of global fund assets (Reuters, 2021) and ESG investor preferences and company considerations are only forecast to keep growing (Bloomberg, 2021). In fact, managed ESG assets are believed to grow to represent over one third of total global assets (projected to hit $140 trillion) by 2025 (Bloomberg, 2021). Moreover, gradually, governments are including ESG considerations in their decision-making and nations are beginning to instate regulation regarding ESG, such as the EU's recent Sustainable Finance Disclosure Regulation (SFDR) which was designed to direct investment towards sustainable assets (J.P. Morgan, 2021).

The term ESG is an acronym denoting a metric used to evaluate the extent to which a company or government has mitigated its risk (and identified potential opportunities) with respect to the following factors: Environmental, Social, Governance. It is important to note that, to date, there is no single, internationally defined set of criteria used to evaluate ESG practices, however, there are numerous ESG goals that companies and investors alike strive to address. Some common environmental objectives include reducing carbon emissions and pollution, increasing energy efficiency, and ensuring animal welfare. Social criteria are more focused on how a company treats people, encompassing issues such as human rights, gender and diversity, data protection, labour standards, and customer satisfaction. Finally, governance refers to how a company is run, for example, is the company susceptible to corruption? Are executives compensated reasonably? How is the board composed? Are any conflicts of interest present? While ESG *can* cover certain socially- or environmentally-conscious issues, it is ultimately concerned with "the ability to create and sustain long-term value in a rapidly changing world, and managing the risks and opportunities associated with these changes", rather than ESG ethics and values in and of themselves (Corporate Finance Institute, n.d.). Simply put, a company with a high ESG score is not necessarily concerned with "doing good", but rather is mitigating its exposure to risk associated with not "doing good". Indeed, the issues that pertain to ESG (as well as which category in which a given issue belongs) are not universally-defined and can vary according to industry, business models, and general company attributes (Corporate Finance Institute, n.d.).

The existing literature on ESG is cluttered, contradictory, and confusing; getting a grasp on what ESG means, let alone how it functions, can be tedious at best - as such, this paper aims to dissect the available (mis)information regarding ESG. More importantly, this paper attempts to assess the current and potential future state of ESG in the United States, particularly with regards to disclosure and ratings regulations. The first section will provide an overview of the history of ESG and identify some of the major organisations and stakeholders involved in the discourse surrounding this topic. The next section aims to outline and critically evaluate the predominant perspectives opposing ESG, namely that of Milton Friedman and the anti-ESG movement. Following this, issues of ESG disclosure such as current and future regulation, as well as prior research on disclosure practices will be discussed, after which the ESG ratings system and divergence within it will be covered. Finally, a summary of this paper's findings and suggestions for the future will be presented.

The Evolution of ESG

ESG is a form of socially-responsible investment (SRI), a phenomenon with roots dating back to as early as 1500 BC in the Pentateuch, which first introduced the concept of Tzedek (Martini, 2020) - essentially, this idea refers to the responsibilities one acquires when assuming ownership of an asset, including the prevention of harm and generally doing what is 'right' (Rabbi Troster, 2014). Over time, this and similar ideas have appeared in several other religions and communities from Ancient Roman Law to Islam, to the Religious Society of Friends (also known as the Quakers), however, it was really only in the mid-twentieth century that our modern understanding of SRI came to fruition (Martini, 2020).

By the 1970's, smoking, gambling, and alcohol consumption were generally considered "sinful: activities (Hong & Kacperczyk, 2009); concurrently, activism against U.S. involvement in the Vietnam War intensified to the point where many began to avoid financially supporting the war effort (Levy, 2018). Eventually, listings of companies in or supporting the industries of alcohol, tobacco, gambling, and war came to be known as "sin stocks", of which many investors chose to steer clear in an effort to avoid contributing to activities that would seem to have a negative impact on society. While these were the primary industries under which sin stocks were listed, at this time, the demand for environmental accountability in the business world was also beginning to develop. Specifically, it was in 1969 when an oil rig off the coast of Santa Barbara, California experienced a disastrous spill resulting in major protests across the country, eventually leading to the creation of Earth Day in 1970 (Mai-Duc, 2015). These two occurrences were really the first of their kind - in scale - to direct focus on the environment, inspiring new legislation such as the 1969 National Environmental Policy Act, which contributed to the inception of the Environmental Protection Agency (EPA), among the many other agencies and initiatives that would eventually have an impact on business responsibilities (Agudelo, Johannsdottir, & Davidsdottir, 2019).

With a growing societal interest in "doing good" through investment practices, new forms of SRI such as Corporate Social Responsibility (CSR) - the moral obligation employers have to operate in such a way that is in line with society's values and desires (Stobierski, 2021) - entered mainstream dialogue and were being adopted as a crucial strategy by many major corporations by the early 2000s (Thomasnet, 2019). In practice, CSR can take many forms, though it generally refers to the adoption of a business model that implements and embraces a company's positive initiatives regarding society and the environment. While CSR is not currently federally-mandated in the United States, it is considered to be a "soft law", meaning a CSR model is paradoxically neither strictly binding nor legally inconsequential for corporations (U.S. Legal, n.d.). This being said, legal efforts are being made internationally to enforce CSR activity and reporting, such as in Denmark where the 2001 (revised in 2009) Danish Financial Statements Act mandates that firms disclose their use of environmental resources if it is "material to providing a true and fair view of the company's financial position" (Initiative for Responsible Investment, n.d.). In the 2009 revision, this has also come to include CSR practices, and companies are urged to abide by the Sustainability Reporting Guidelines (SRG) designed by the Global Reporting Initiative (GRI). Nevertheless, it is clear that we still have a long way to go when it comes to proper CSR implementation on a global scale, and major CSR compliance issues (e.g. greenwashing) continue to require careful attention.

It was only in 2004 that ESG was officially coined in the United Nations Global Compact report, *Who Cares Wins - Connecting Financial Markets to a Changing World* (International

Finance Corporation, 2004), which recommended that analysts, financial institutions, companies, and investors[1] take environmental, social, and governance factors into account in their respective work. By 2006, the UN Principles for Responsible Investing (UN PRI) was formed and, today, manages assets worth over $3 trillion and has over 3,000 signatories (Johnson, 2021). At this point, it is important to note that, while they do bear similarities and have a shared interest, CSR and ESG are *not* equivalent: CSR refers to a type of business model that honours a company's responsibilities to surrounding communities and the environment, wheres as ESG is a series of factors used to evaluate a company's risk exposure and tends to be used as a metric for investors.

Similar to credit ratings, today, publicly-listed companies receive ESG ratings by third-party agencies (e.g. Sustainalytics, MSCI, Bloomberg) that collect company, industry, and market data to compile into a single score that investors can use to inform their portfolios and investment strategy. Second in the ESG financial intermediary chain are firms which develop ESG indices (oftentimes this is also done by these ratings agencies), then come asset managers who build ESG funds and market them to the public, and finally, institutional investors who are responsible for managing ESG assets (Boffo & Patalano, 2020). Various other bodies have been founded to develop and/or regulate facets of ESG investing (e.g. ESG disclosure, materiality and rating), and international bodies have also arisen to suggest standards for ethically responsible conduct on a more global scale. For example, seven years after the aforementioned Global Compact report was released, initiatives such as the Sustainability Accounting Standards Board (SASB)[2] was founded to "guide the disclosure of financially material sustainability information by companies to their investors" (SASB, n.d.), designed to act as the ESG counterpart to the Financial Accounting Standards Board (FASB). The SASB does not currently require that US

[1] Among other financial and ESG stakeholders.
[2] Now known as the Value Reporting Foundation (VRF).

companies fully disclose their ESG practices and evaluations in their financial reports, however, it does provide a standard or reference point for companies that wish to do so. This said, the U.S. Securities and Exchange Commission (SEC) *does* require that publicly-listed companies disclose any and all information that is deemed relevant for investors, which may or may not include certain ESG considerations. Given, however, that ESG inherently addresses risk, and by extension, potential earnings - logically rendering ESG information necessary for investors to know - it would seem that ESG reporting *would* be mandatory, though this view is not explicitly enforced by the SEC. This type of contradictory grey area highlights how important it is to develop official reporting frameworks, audits, and ratings, especially considering the ever-growing public interest in this investment habitat.

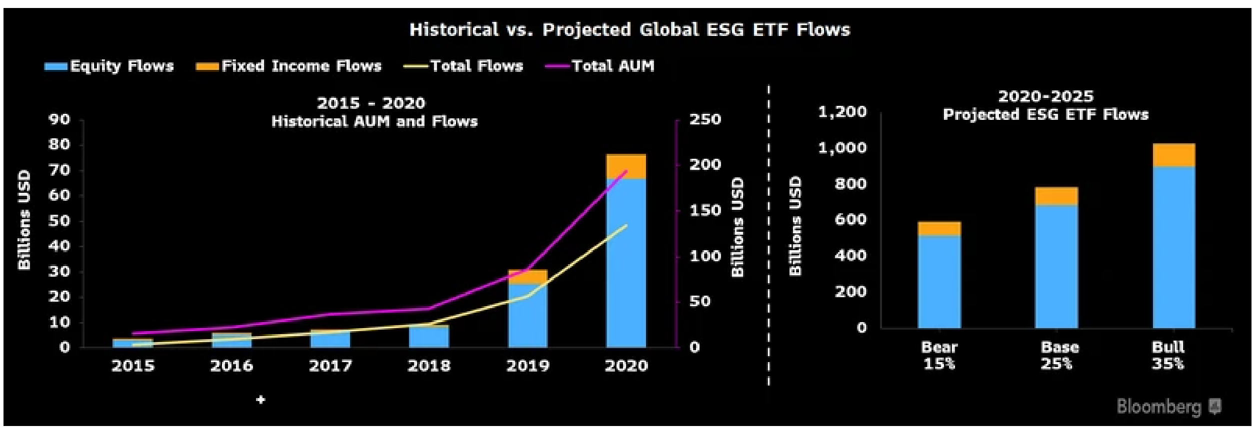


Fig. 1 Historical vs. Projected Global ESG ETF Flows (Bloomberg, 2021).

At the same time, ESG investing has become so popular that in 2020 alone, over $51.1 billion of net new capital was invested in ESG-aligned funds - the fifth consecutive year that this investment record was broken (Hale, 2021). In the same year, approximately $80 billion flowed through exchange-traded funds (ETFs), a number which is projected to rise ten-fold, on average, within the following 5 years (Fig. 1). Similarly, more and more companies are voluntarily disclosing their ESG practices in an effort to attract capital, boost share prices, and enhance their reputation. So what exactly is causing this huge influx of interest in ESG investing? To begin with, ESG pertains to minimising the risk a company faces, whether it be financial or reputational, and thus, ESG practices would seemingly incur a negative cost that would be appealing to investors. Specifically, long-term investors often take a shine to ESG-focused investing strategies, as ESG stocks today are cheap (given discounted present value) relative to what they would be later on in, say, a 10 or 20 year horizon (RBC Wealth Management, n.d.). While there is controversy surrounding the profitability of companies, funds, or portfolios with high ESG ratings, some studies have found that ESG-positioned portfolios do tend to outperform comparable, non-ESG portfolios, thus further contributing to the surge in ESG investment (Hale, 2021; Morgan Stanley, 2021).

Among returns-related factors contributing to the ESG boom lie the risk benefits of ESG, which became even more attenuated when a significant shock, the COVID-19 pandemic, hit the global economy. Despite a major stock market crash in early 2020 and its subsequent recession, global ESG funds prevailed with $542 billion in investment, almost twice as much as in the previous year (Kerber & Jessop, 2021). Given the nature of ESG - i.e. being designed to avoid or mitigate risk and to identify opportunity - it is not surprising that a systematic risk as massive as the coronavirus pandemic would attract investor interest in assets evaluated as having mitigated potential future risk, i.e. ESG assets. However, it was not only the pandemic that contributed to 2020's massive inflows into ESG.

On a political level, much of the discourse in the beginning of 2020 was dedicated to environmental strategy, such as the launch of the Green Deal in Europe, which generally drew more attention to sustainable investing and ESG (Wu & Juvyns, 2020). This, combined with a heightened awareness of social justice issues in the United States (voting rights, police brutality, the rise of the Black Lives Matter movement, and inequalities in healthcare, gun violence, etc.), further underscored the importance of socially responsible investment and ESG considerations on a corporate, financial, and political level (Kerber & Jessop, 2021). This perfect storm contributed to millennials and, more recently, Gen Zs - two generations shown to have more concern for environmental and social matters (Forbes, 2021) - to push the importance of ESG considerations, where millennials contributed over $50 billion to sustainably-focused funds in 2020 alone (NASDAQ, 2021). According to a study conducted by Natixis, 61% of fund selectors who responded to their survey said they were adding ESG to their strategy due to investor demand; 75% of these fund selectors believed this demand was due to “growing social awareness among investors”, half of whom maintained that ESG’s more prominent position in the mainstream has driven up this demand (Goodsell, 2021). However, investors are not the only ones supporting ESG: in a survey targeting financial professionals, 77% of fund selectors claimed that ESG analysis is “integral to sound investing” (Goodsell, 2021).

With this relatively sudden rush of ESG-related discourse and investment, critics of this trend would be inevitable and controversies would be bound to arise.

Friedman and Foes - Critical Reception of ESG

The Friedman Doctrine and Shareholder Theory

Despite its rapid rise in popularity, ESG and other forms of SRI have not always been well-received. In 1970, during the escalation of socially-responsible investing, Milton Friedman published his controversial essay, *A Friedman Doctrine - The Social Responsibility Of Business* *is to Increase Its Profits* in the New York Times, where he outlines the reasons for why a firm's responsibilities stop at its duty to shareholders: maximising its profits. In the essay, Friedman begins by philosophically questioning the nature of a company and whether it is capable of having responsibility in the first place, let alone social responsibility, emphasising that there are many individual interests and responsibilities across stakeholders and employees that are not necessarily congruous or related to company operations (Friedman, 1970). He continues to write that a corporate executive may have private social responsibilities, but that these should be acted on by the executive as a "principal" (i.e. in their private life using their own time and money), not as an "agent" (i.e. on behalf of the business, using the resources of business stakeholders), such that any actions by an executive must fulfil the responsibilities and goals of a corporation's owners or shareholders (a concept also known as shareholder theory or shareholder primacy). In this point lies a second message implying that individual members of a company acting according to their personal social responsibilities could introduce significant biases, as well as conflicts with the responsibilities of other members of the same business. This perspective foreshadowed some of the issues we face with ESG today, namely the urgent need to universally determine what is considered to be "good" and measure "goodness" accordingly. In other words, today in the United States, companies and ratings agencies alike are acting as principals of what they believe to be "good" or socially-responsible behaviour, and have failed to develop a common goal or definition of what constitutes "good" that they could pursue as agents, thus rendering their current efforts inconsistent and potentially contradictory.

Beyond semantics and definitions, however, Friedman raises an interesting question on a company's suitability to act on its social responsibilities, when he writes:

> On the grounds of consequences, can the corporate executive in fact discharge his alleged "social responsibilities"? On the one hand, suppose he could get away with spending the

> stockholders' or customers' or employees' money. How is he to know how to spend it? He is told that he must contribute to fighting inflation. How is he to know what action of his will contribute to that end? He is presumably an expert in running his company—in producing a product or selling it or financing it. But nothing about his selection makes him an expert on inflation. (Friedman, 1970)

The argument he is making here suggests that a business is solely suited to conduct its operations and perform its fiduciary duties, and any social externalities (or otherwise) it might induce ought to be confronted by an "expert". One could interpret this as a rejection of seemingly extraneous company efforts, in that companies should focus on direct and related consequences and not concern themselves with non-business-related activities such as, for example, the malaria initiative led by ExxonMobil, an American oil and gas company whose business does not impact and is not impacted by the disease the initiative is trying to eradicate (ExxonMobil, n.d.). However, it seems that Friedman is taking a more extreme stance, and is suggesting that any activity (directly related to company decisions) that does not impact the bottom line should not be realised. Using the example of ExxonMobil, the Friedman Doctrine would then suggest that the environmental impact of their products - gas and oil - should not be considered if taking responsibility for these environmental externalities would reduce its profits. On the other hand, who, then, would be better suited for this responsibility? If a company's activities have a direct consequence on a given "social" issue, are they not responsible for mitigating the negative impacts of their actions with regards to that issue? Admittedly, this is perhaps a discussion better suited for a financial ethics paper, however, the success of sustainable and socially-conscious companies and funds today proves to support the notion that social responsibility *does* have a place in corporate consideration.

Shareholder theory has shaped how corporations operate and make decisions since the theory's nascence in 1970 well into the 1990's, resulting in an accountability vacuum and shareholder-centric corporate responsibility (Bower & Paine, 2017). What this means in practice is that companies have operated with respect to their financial obligations to shareholders and haven't taken into account the role the *company* itself has in society (again, unless this role impacts earnings). In terms of ESG issues and social responsibility, this can be boiled down to a situation where companies are cleaning up their "messes" (e.g. corruption, poor data security, misrepresentation of environmental impact etc.) after they are discovered, rather than preventing them from occurring, as would otherwise be done under the ESG model. Not only does this short-run outlook hurt society, it also damages a firm's earnings in the long-run. By way of explanation, in presuming that the scope of a company's responsibilities stops at profits, Friedman expects firms to minimise costs and operate efficiently, however, many ESG-related initiatives require financial support, such as, for example, investing in research and development to create more energy- or water-efficient practices. In Friedman's world, the company has no incentive or business to invest in R&D of this kind unless it bolsters the bottom line, and should only consider doing so if not doing so will hurt its financial statement. The problem is, oftentimes, the circumstances where avoiding action hinders a company's performance generally occur in reaction to misconduct, such as social violations, negative environmental shocks, or poor organisational conduct. As such, shareholder theory does not account for future implications - i.e. potential financial losses - of solely catering to shareholders today. This is where good ESG practices may be a viable compromise, in that future losses with regards to ESG risks are minimised and potential opportunities are identified, while duties to maximise profits are maintained.

In fact, recent findings have suggested that the positive relationship between high ESG scores and profits are not limited to future potential earnings, but also short-run profits and valuation (Henisz, Koller, & Nuttall, 2019; MSCI, n.d.). Given the investor climate today which, admittedly, has different characteristics than that of the 1970's, companies with higher ESG scores not only experience higher top-line growth and certain lower costs, but also have a greater chance of raising capital (Henisz, Koller, & Nuttall, 2019). As is the case for credit-ratings, positive ESG ratings indicate to investors a low risk of a company suffering from losses associated with poor ESG practices, and thus, attracts capital, especially from investors with long investment horizons. Is minimising future costs and attracting capital not in line with Friedman's corporate ideals? The only difference is that ESG has the added benefit of serving the social and environmental good.

In his essay, Friedman goes as far as to say that decisions that could reduce or fail to maximise profits, whether they be for the social good or not, are effectively a tax on shareholders. This is where an important distinction needs to be made. Certainly, if, like much of mainstream discussion, one erroneously conflates ESG and CSR, and misdefines ESG[3], it is plausible that Milton Friedman would take issue with the ESG trend we are experiencing and would regard the loss of potential profit associated with these activities as a violation of a company's duties to shareholders. However, had Friedman been asked to give his take on the true purpose of ESG - i.e. a set of criteria evaluating the mitigation of risk in ESG areas to avoid future costs and identify potential opportunities - he, like many investors today, may very well have been on board too. Ultimately, this doctrine refers to socially responsible investing and corporate social responsibility, and does not speak to the financial, risk-assessing nature of ESG. If anything, ESG is an evolution of how companies were traditionally valued using fundamentals, only this form of evaluation renders risks previously regarded as intangible and/or

[3] i.e. defines ESG as a company's efforts to improve their activities with regards to environmental, social, and governance considerations in order to contribute to the greater societal good.

negligible as real, relevant to potential future earnings, and sizable enough to now be categorised and accounted for. This, along with the findings that high ESG ratings are associated with high performance (MSCI, n.d.), suggests that ESG may very well be the compromise that satisfies both shareholder primacy believers and those concerned with companies' impact on the world.

The Anti-ESG Movement

Of course, Milton Friedman wasn't the only critic of socially responsible investing. In 2018, the Main Street Investors Coalition formed to increase the minimum capital injection needed for a stockholder to propose a resolution to shareholders (Hale, 2020) and shift the focus of proxy meetings away from ESG issues back to business performance (Whieldon, 2018), rendering them the largest organised group within the anti-ESG movement. While the general anti-ESG movement relates to financial issues, its political underpinnings and roster of supporters are pronounced, such as former President Donald Trump's Labour Secretary nominee, Andy Puzder, and Kevin Hassett, former Chairman of the Council of Economic Advisers and Senior Advisor to the Trump administration. According to an article written for PR Newswire, their goals can be grouped into 4 topics:

- Calling for fund managers to maximise performance, rather than "playing politics with other people's money"
- Establishing that retail investors that possess passive funds in 401(k)s have a voice in deciding how their shares are used in voting
- Insisting that third-party, "black-box" proxy-advisory firms are more transparent with regards to potential conflicts of interest
- Ensuring that public pension funds follow the same basic regulatory and reporting standards as private pension funds.

  (Main Street Investors Coalition, 2018)

Concentrating on their first goal, the coalition speaks directly to Friedman's ideas of a firm's collective responsibility to maximise profits, however, their point about "playing politics with other people's money" should probably be taken with a grain of salt, considering the largely politically conservative composition of the group. On this issue, the movement has criticised firms such as BlackRock and Vanguard for their evolving approach to investing that has increasingly promoted highly contentious (in the United States) ESG-related causes such as climate change and gun control, an approach that Blackrock argues is necessary to ensure the long-term success of a business (Sorkin, 2018). Ironically, many exchange-traded funds under the anti-ESG movement are designed to account for social issues such as abortion-related or gun-related funds, despite the attitude expressed in the coalition's first goal.

The Main Street Investors Coalition's sentiment is echoed by some of the funds that have developed in recent years, such as the exchange-traded fund run by 2ndVote Advisers that targets "unwoke" investors (Sullivan, 2021). In fact, Andy Puzder, a member of 2ndVote Advisers' advisory board was quoted saying "we believe that companies that focus on profit make more than companies that don't" (McCormick, 2021) - sound familiar? While Friedman's stance leaned more towards the issue of corporate responsibility than "wokeness", Friedman and Puzder's end goals remain the same: maximising profits. This being said, ETFs geared towards companies which manufacture and sell guns, for example, are not focused on maximising returns if their portfolio is at odds with the sociopolitical climate that reflects the beliefs of a large segment of the investor population. In other words, while it often does correspond to a more liberal agenda, good ESG practices do not *necessarily* fall in line with progressive ideals, but rather indicate how prepared a company is to face future social and environmental standards and demands. Considering the sociopolitical climate we currently live in and are projected to face, i.e. exhibiting generally left-leaning social preferences (Gerber, 2022), anti-ESG ETFs are actually *not* reaching the full potential of their profits, as they are missing out on potential returns resulting from the ESG wave. To top it off, it would seem that the anti-ESG movement operates similarly to that of ESG in that, at least in the case of 2ndVote Advisers, companies are given a “Basic Freedoms” score that communicates the extent to which a company’s social activism is conservative (garnering a higher “Basic Freedoms” score) or liberal (associated with a lower score) (SEC, 2021). So in both scenarios, companies are given scores that reflect their involvement in ESG issues, the only difference is whether each side of the ESG spectrum considers a given practice as “good” or “bad”. Unfortunately, as Friedman and the anti-ESG movement have demonstrated, much of the opposition to ESG is predicated on a poor understanding of its definition - this is not to say that ESG is without flaws (to the contrary!), however, these will be discussed subsequently.

ESG Materiality and Disclosure

As was mentioned earlier, in the United States today, the SEC does not require that publicly-listed companies disclose information regarding their ESG practices if it is not financially material to stakeholders, making most of ESG disclosure voluntary. This said, over 90% of the firms listed in the S&P 500 chose to publish sustainability reports in 2020 (Governance & Accountability Institute, 2021). Begging the question that, if companies are not required to disclose their ESG practices, what then prompts them to spend money and other resources on publishing ESG reports?

The possible motivations behind this choice are numerous, the first being a firm’s relationship with stakeholders and potential investors. It is usually within a company’s best interest to indicate how it is tackling and preparing for potential future ESG opportunities and threats, as this shows its progress and dedication to positioning itself in a way that maximises returns in the long run and doesn't expose capital to unnecessary risks or shocks, thus demonstrating respect for the needs of investors with a longer-run investment outlook. Considering the increased general desire to make a positive social impact with one's investments (Goodsell, 2021), as well as the massive ESG wave we are experiencing (Bloomberg, 2021), it is not surprising that investors are beginning to seriously consider a firm's ESG report and scores when exploring options to add to their portfolio. As such, disclosing this information could give one firm an advantage with these investors over other companies which choose not to disclose. As stated by John Coates, director for the Division of Corporation Finance in the SEC, ESG information is needed for more and more investors in order for them to confidently commit their capital, however, these disclosures do come at a cost to companies, especially in the confusing disclosure climate of today[4] (Tyson, 2021). According to Coates, if firms don't invest in ESG disclosure, they risk facing higher costs of capital, as an increasing number of investments are being withheld in the absence of ESG information. This perspective has also been supported by research conducted by Raimo et al. (2021), who found that greater ESG disclosure (i.e. more transparency) was associated with lower costs of financing. ESG reporting also builds trust, as it signals not only an inherent consciousness of a firm's non-financial activities and larger impact, as well as transparency with regards to current ESG shortcomings that need to be addressed (OneTrust, 2022). Finally, while this may not be the primary motivation of a firm, disclosing ESG practices and plans also reduces information asymmetry between management and the

[4] Coates suggests that firms are faced with additional costs associated with "answering conflicting and redundant requests for ESG information from investors." (Tyson, 2021)

market when it comes to industry knowledge, earnings and prospects, as well as best practices (DeLisle, Grant, & Mao, 2021).

Materiality

Materiality, arguably the most important element of ESG disclosure, refers to how financially or sustainably significant certain information is to a company. According to the SASB, materiality is defined as information that is “reasonably likely to be important to investors in making investment decisions” (SASB, 2021). More specifically, something is considered to be financially material if its exclusion in reporting would have an impact on a company’s economic strategy, where information deemed to have other significant consequences is classified as sustainable materiality (NYU, 2019). This being said, there is a lot of debate as to what constitutes material information, and multiple efforts are being made to narrow in on what this actually means, such as double materiality and the ESG materiality score developed by Russell Investments.

Double materiality accounts for both information relating to the ESG-related financial risks imposed on a company from external sources (financial risk), as well as information regarding the ESG impact a company’s operations has on the rest of the world (non-financial risk) (Täger, 2021). This idea is elaborated by LSE’s Matthias Täger (2021), where he evaluates two perspectives on why ESG risks could be considered material in the first place: a) because these risks could have associated financial costs such as damage to a company’s reputation, and b) because a “reasonable person” could deem these risks as having repercussions that are not necessarily financial. Täger assigns the latter reason as a stronger conception of ESG, as this more broadly reflects the consequences of a company’s operations, both for the company and for external stakeholders, i.e. double materiality. Nonetheless, yet again, this perspective ignores the fundamental definition of ESG that is only concerned with how a company both manages its potential risks (again, within the realm of ESG-related practices) and takes advantage of opportunities associated with ESG-related changes in the world, such that long-term value is maximised. Certainly, the impact of a company's activities on the world is incredibly important and should be assessed, monitored, and rated accordingly, however, this should not fall under the purview of ESG. In fact, proposals such as double materiality may even contribute to the misconceptions about ESG and its relationship with corporate social responsibility and conscious, sustainable company practices.

Rather than lumping the issue of risk together with ethical company practices under the umbrella term of "ESG", a more productive alternative could be an update to the existing idea of "corporate social responsibility". At present, CSR primarily covers social issues such as philanthropy and social ethics, but what is stopping the expansion of CSR to C**ESG**R? Could companies not also have a CESGR score? If anything, this proposed score would not only address the confusion surrounding the scope of ESG issues, but would also clarify what information would be deemed as material - here, ESG would only refer to potential *financial risk imposed on a company* - and thus, clarify what is informing a given ESG score. In fact, isolating the non-financial impact of a firm's practices would provide investors with the option to further fine tune their portfolio to reflect both their financial habitat (covered by credit ratings, ESG ratings, stock prices, fundamentals, etc.), but also their ethical preferences (addressed by a CESGR rating). This idea is not new, and similar score structures have already been developed, such as that created by Russell Investments, who revealed their Material ESG Score in 2018 (Adams, Smalling, & Dichter, 2022). This score was designed to tackle the notion that ESG scores tend to be composed of a “large number” of issues that aren’t financially material, such that 66% of the securities in the Russell Global Large Cap Index had over 75% of data items that were not considered financially material (ibid.). This metric was designed to insulate solely financially-material ESG information into one score, and while this confronts the blurred line between the two types of materialities, it leaves a score (and disclosure) vacuum for non-financial ESG information. As such, should this strategy be implemented in the future, it may behove regulators, disclosure framework developers, and ratings agencies to come up with a 2-pronged solution that both isolates and covers both types of ESG materiality.

ESG Disclosure Regulation

Given its current voluntary nature, there is little-to-no regulation when it comes to how a corporation even evaluates its ESG activity, let alone how it should interpret or disclose its findings. To be clear, ESG disclosure standards do exist, however, many differ in approach and rigour, making it difficult for ratings companies to condense this information into a single score, let alone compare companies on ESG practices. Then again, according to the Chair of the SASB, Jeff Hales, SASB standards are complementary with other ESG reporting standards and the SASB will continue to “place greater emphasis on how it complements other approaches, including the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), the framework of the Climate Disclosure Standards Board (CDSB), and the Global Reporting Initiative (GRI)” (Hales, 2021). While these standards may be thorough enough to suffice when used in conjunction with one another, this assumes companies a) are aware of the complementary nature of these standards and b) will invest in using both. Eric Hespenheide, the Chairman of GRI, applauds the compatibility of these frameworks and claims that “by sharing practical experiences, we are enabling companies to determine the sustainability reporting path that is right for them, based on the needs of their stakeholders" (GRI, 2021). It is understandable that the GRI Chair is promoting his product's applicability, however, his statement actually proves to be counterproductive to the ESG disclosure problem when he suggests that companies can finetune what they include in their ESG disclosure according to the "needs of their stakeholders" for two reasons. The first is the issue of comparability - if companies can pick and choose which standards they use, and thus what information they disclose, ratings agencies are forced to compare apples and oranges, leading to ratings discrepancies and investor confusion. Secondly, while tailoring disclosure processes to the needs of stakeholders is resource-efficient and considerate, it does leave room for firms to choose a reporting standard that portrays them in the most desirable light and potentially avoids unfavourable or damaging information. It is only to be expected that these reporting associations are working towards *alignment* and not *simplification,* as this preserves their relevance and maximises their client base. Be that as it may, without regulatory enforcement or a defined generally-accepted framework, reports using these standards are impossible to compare with one another, thus rendering ESG ratings based on these frameworks moot.

With this said, more and more bills pertaining to ESG disclosure have been brought before Congress, suggesting an increase in regulatory interest in ESG (Silk & Lu, 2022). The Biden administration has also expressed support for ESG disclosure in its May 2021 executive order calling on the federal government to, among other environmental and social initiatives, develop a strategy pertaining to the federal government's Climate-Related Financial Risk Strategy, as well as the Assessment of Climate-Related Financial Risk by Financial Regulators (Sec. 2 & Sec. 3, respectively). While this executive order focuses more on climate-related risk, it reflects the White House's recognition of how important assessment, disclosure, and rating of these issues is (including the *S* and the *G* in ESG), as well as the urgent need to reexamine how we think about finance.

The first part of the government's 2-part approach to addressing climate-related financial risk concentrates on the ESG (particularly the E in ESG) practices of the federal government itself and, more specifically, "the measurement, assessment, mitigation, and disclosure of climate-related financial risk to Federal Government programs, assets, and liabilities in order to increase the long-term stability of Federal operations." (Biden, 2021). The Director of the National Economic Council, the National Climate Advisor, the Secretary of the Treasury, and the Director of the Office of Management and Budget were given 120 days to develop a plan to execute this order and develop a framework to tackle these issues, however, today, almost a year later, the outcome of this order is unclear and no plans have been released. This being said, the Office of Management and Budget did note in their Budgetary Impact Analysis for this order that implementing this strategy would have "no impact on costs and revenues to the Federal Government" (Young, 2021), a point that disputes the notion that ESG practices and disclosure hinder returns, signalling to other organisations that ESG is worth the resource investment.

The federal government's second ESG-related initiative pertains to the assessment of climate-related financial risk by financial regulators, such as the SEC and the Financial Stability Oversight Council (FSOC). This initiative is outlined in 6 points, the first being the assessment of the climate-related financial risk by the FSOC (in coordination with the Secretary of the Treasury), specifically risk to the U.S. financial system and the federal Government. Again, given the lack of universal or mandated ESG evaluation and disclosure frameworks, it is unclear whether the FSOC will use standards established by the SASB, the Task Force on

Climate-Related Financial Disclosures (TCFD), the Climate Disclosure Standards Board (CDSB), or establish an entirely new set of standards. However, while this initiative is important to promoting the adoption of ESG on a wider and more official scale, it remains open-ended and does not address the confusion as to which disclosure framework should be generally used. Perhaps this is not within the scope of expertise of authority of the President's Office but, hopefully, this will prove to be an opportunity for the FSOC to work with existing ESG standards boards, as well as the SEC, to define a single framework for assessing and disclosing an organisation's exposure to ESG risk and opportunities. Having said this, the executive order does call for recommendations to enhance climate-related disclosure regulations later on, which will be discussed shortly.

Indeed, the need to not only accurately assess ESG practices, but also to ensure this information is disclosed effectively is reflected in the President's executive order where he asks the Secretary of the Treasury and the FSOC to facilitate the "sharing of climate-related financial risk data and information among FSOC member agencies and other executive departments and agencies (agencies) as appropriate". This also speaks to the issue of information asymmetry in that it underlines the significance of sharing information across agencies to ensure they are making decisions under the same assumptions. Most importantly, this order calls upon the FSOC to issue a report on efforts by FSOC member agencies to integrate the analysis of climate-related financial risk in their operations, including a review of:

> (A) the necessity of any actions to enhance climate-related disclosures by regulated entities to mitigate climate-related financial risk to the financial system or assets and a recommended implementation plan for taking those actions;
> (B) any current approaches to incorporating the consideration of climate-related financial risk into their respective regulatory and supervisory activities and any impediments they faced in adopting those approaches;
> (C) recommended processes to identify climate-related financial risk to the financial stability of the United States; and

> (D) any other recommendations on how identified climate-related financial risk can be mitigated, including through new or revised regulatory standards as appropriate (Biden, 2021)

The first point up for review is that of climate-related disclosures and how they can be enhanced by regulated entities - certainly, there is no question that ESG disclosure frameworks and regulation require an overhaul, however, it is unclear as to which "regulated entities" would be responsible for these changes. While the executive order was addressed to the FSOC, keep in mind that the FSOC is composed of 15 member agencies, including the SEC and excluding any of the existing ESG disclosure framework providers (U.S. Department of the Treasury, 2022). Given the current lack of ESG regulation on the part of the SEC and the voluntary status of ESG disclosure, would this give the SEC motive to move towards mandatory ESG disclosure? The SEC does not offer disclosure standards, meaning that any actions to enhance climate-related risk disclosures would require consultation with disclosure standards suppliers to improve the quality of information companies are required to disclose. Additionally, the FSOC is tasked with developing a plan to implement these changes, meaning the commission will need to outline how these issues should be disclosed which would, again, likely shift the reporting regulations closer to a mandatory framework. The point that follows pertains to the current state of ESG integration in the activities of the FSOC and, importantly, requests information about impediments faced by the FSOC in executing this integration. Considering the incredibly fractured state of ESG, the mention of challenges faced in integrating ESG considerations is incredibly relevant, as it encourages communication of best practices and contributes to the streamlining of the ESG regulatory overhaul needed moving forward.

The need to ensure that these practices are effective is reiterated in the following two points, in which the Biden Administration asks for recommendations for processes to identify climate-related risks with which the financial stability of the United States may be faced, as well revisions of existing regulations or proposals for new regulations that would mitigate this risk. This point is especially intriguing, as it puts ESG in the context of the U.S. economy, as opposed to a single entity such as a company or government. Could a framework be used to assess the ESG-related risks of an entire economy? Could this be the future of ESG? Keeping in mind the already complex and undefined disposition of ESG, this would likely not be the case. At present, varying considerations are being taken for different industries such that, for example, a firm in the energy sector will be assessed on their ESG practices differently to one in the consumer goods segment. Given the complexities of an economy composed of many sectors, firm sizes, and importantly, values that could shape what makes a "good" or "poor" ESG practice, it would be a monumental task to develop an accurate measure to establish materiality or assess ESG-related risk. For that matter, should disclosure and ratings frameworks for an economy be developed, their inability to accurately account for all variables (including potential future events) and their relationships to one another would undermine any insights they may provide. Granted, this order simply broaches the issue of *climate*-related risk, however, for the reasons outlined above, an assessment of the entire United States' exposure to climate-related financial risk would be unbelievably difficult to conduct and should be taken with a substantial grain of salt.

There is no doubt, however, that the Executive Order on Climate-Related Financial Risk has potential to encourage meaningful change in the extent to which we assess at least the environment-related portion of ESG risks, however, the real responsibility falls on the shoulders of the FSOC and related organisations to develop effective frameworks and implementation processes, as well as to distil accurate conceptions of what ESG means. If nothing else, Biden's call for increased recognition of climate-related financial risk in both the private and public sectors sets a valuable example for ESG-disclosing companies, financial regulators, and disclosure framework developers alike. For that matter, prior to and since Biden's executive order, many FSOC member agencies have established both Climate Units and more broadly, ESG task forces (Jones Day, 2021), and ESG discourse in both regulatory and commercial channels continues to rise. However, the outcomes of many of the order's requests remain either hidden from the public or unaddressed, with the notable exception of the ESG Disclosure Simplification Act. In June 2021, the House of Representatives passed the ESG Disclosure Simplification Act of 2021 which, among other things, would require publicly-listed companies to disclose ESG metrics along with their financial statements, necessarily requiring a pre-determined definition of "ESG metrics" from the SEC, the body charged with overseeing publicly-listed companies (ESG Disclosure Simplification Act, 2021). Almost a year later, the ESG Disclosure Simplification Act has yet to be brought before the Senate, and it is unclear as to why this has been stalled. Taking a step back, this does raise an interesting question, should ESG disclosure be mandatory?

A study conducted by Krueger et al. (2021) would suggest so. Mandatory ESG disclosure has already been adopted by several countries, including the U.K., Australia, and China (Nelson, 2021), however, mandatory disclosure does not necessarily presume an improvement in ESG practices or information distribution due to potentially "low standards and loose guidelines" (Krueger et al., 2021). This is what prompted Krueger et al.'s exploration of the real outcomes associated with mandatory ESG disclosure (2021), where they found that not only does mandatory disclosure improve the financial information habitat of a company, but also improves a company's financial performance. More specifically, this analysis revealed that suitable mandatory disclosure improves the accuracy of earnings forecasts and lowers the dispersion of the forecasts, while reducing the chance of adverse ESG incidents. In fact, these economists also found that mandatory ESG disclosure improves the *quality* of ESG reports, especially for firms whose investors demand the most ESG information (ibid.).

This last implication of mandatory ESG disclosure is distinctly crucial, as it addresses one of the major disclosure issues identified by Christensen, Serafeim & Sikochi (2019), who found that greater ESG disclosure leads to greater disagreement in ESG ratings by ratings agencies. The authors suggest that this relationship reflects a simple dynamic - more data means more information to be interpreted differently - as opposed to any inherent issues with ESG disclosure in and of itself. The scope of this study spans across 69 countries, some of which have implemented mandatory disclosure and many of which differ in available ESG disclosure frameworks, making it difficult to interpret these results with any conclusive policy suggestions. In terms of the United States, where ESG disclosure is not mandatory, it is conceivable that companies who do choose to disclose their ESG performance will provide differing amounts of information, and thus, will have more ratings disagreements than in a country where disclosure is mandatory. To that end, the authors of this study note:

> ... over time as analysts develop a consensus both on the metrics to use to assess a firm's performance on a specific ESG issue and how to interpret the information reflected in each metric, the relation between disclosure and disagreement might diminish or even become negative. In other words, our study is likely to be reflective of the early stages of institutional innovation around ESG disclosures. (p. 35, Christensen et al., 2019)

In other words, it is implied that a general disclosure framework and a defined interpretation process would likely ameliorate or even dissipate the relationship between ESG disclosure and ESG ratings discrepancies. How else does one control the amount and quality of ESG information being disclosed if not with mandatory disclosure and a comprehensive disclosure framework?

Despite these findings, some individuals and organisations are still against the idea of mandatory ESG disclosure, including Hester M. Peirce, a commissioner at the SEC, who issued a statement entitled "We Are Not the Securities and Environment Commission - At Least Not Yet" in response to the SEC's proposed rules requiring companies to disclose climate-related financial risks (Peirce, 2022). In this statement, Peirce raises both valid and questionable points that speak to voluntary disclosure and illustrate some improvements that should be made to these disclosure rules. For starters, she argues that mandatory climate disclosure shifts the narrative being told by managers, in that, managers are now being asked to run their companies according to the agenda of regulators and identify real and theoretical risks that they "should" be considering where, previously, managers were responsible for communicating the performance of a given company both in the present and in the future. In other words, Peirce argues that these rules force investors to assess a given company through the perspectives of a "vocal set of stakeholders". However, these rules only ask firms to assess how climate events and trends impact their bottom line, both present and future, using climate data. Nowhere in this proposed set of rules does the SEC mandate that companies operate in a manner in line with a given agenda, political or otherwise, and any company efforts to shift operations to be more climate-friendly would be done on account of climate-related risks identified through this disclosure and/or general company goals.

It should be mentioned that the SEC's new disclosure rules would *require* firms to disclose information pertaining to the following:

1. The registrant's governance of climate-related risks and relevant risk management processes;

2. how any climate-related risks identified by the registrant have had or are likely to have a material impact on its business and consolidated financial statements, which may manifest over the short-, medium-, or long-term;
3. how any identified climate-related risks have affected or are likely to affect the registrant's strategy, business model, and outlook; and
4. the impact of climate-related events (severe weather events and other natural conditions) and transition activities on the line items of a registrant's consolidated financial statements, as well as on the financial estimates and assumptions used in the financial statements. (SEC, 2022)

Peirce claims these proposed rules "will undermine the existing regulatory framework that for many decades has undergirded consistent, comparable, and reliable company disclosures", which assumes that previous climate-related financial disclosure has, in fact, been consistent, comparable, and reliable. However, considering the voluntary state of climate-related disclosures and the notion that voluntary disclosure is associated with information asymmetry and ratings variability (Krueger et al., 2021; Christensen et al., 2019), this is likely not the case. If anything, the SEC's proposal to make disclosure mandatory would make climate-related information even more reliable and comparable, as companies would now be asked to conduct the same assessments (as mandated by the SEC) and provide the same type and amount of information across the board (at least within their industry). With this said, Peirce does elaborate and note that companies would now be asked to speculate about issues not necessarily within their area of expertise, such as climate policies and "changing weather patterns" (Peirce, 2022), rendering their data and findings unreliable. However, it could be argued that most companies are not in the financial sector, for example, yet many hire financial advisors and teams to review and prepare their annual reports - are these, too, unreliable? In other words, the proposed rules do not suggest that companies conduct these evaluations themselves, and mandating them to compile information that requires hiring certified experts (such as the Certified Public

Accountants hired to compile audited financial statements) would again, if anything, ensure this information and the sourcing of this information is up to a generally-accepted standard.

One of the more compelling arguments in Commissioner Peirce's presentation focuses on the matter of materiality. For comparison, Peirce provides what the SEC previously used as a definition for materiality: "an item is material if there is a substantial likelihood that a reasonable investor would consider the information important in deciding how to vote or make an investment decision", where a "reasonable investor" is someone whose interests lie in their financial return from a given company. The Commissioner emphasises that the financial component of materiality needs to be maintained and, thus, takes issue with the idea of mandatory climate disclosure, as some data disclosed (e.g. information about a company's water management) may not be relevant to their industry or finances.

To assess this argument, it should be mentioned that ESG consciousness manifests in various forms, such as ESG integration investors, who value ESG information that has financial implications (i.e. material information), or impact investors who only invest in companies that deliver positive social/environmental impacts in addition to satisfactory financial performance (Neufeld, 2021). Peirce's concern about non-financially-relevant information disclosure is thus disputable, as it overlooks potential stakeholders such as the impact investor who may withhold their investment due to insufficient climate information, thus making this disclosure financially material to their investment decisions. Additionally, seemingly immaterial information may have hidden financial implications, as well as the potential to contribute to longitudinal analyses that could, indeed, have significant ramifications. While this might not make the top of the SEC's or a firm's priority list, in disclosing immaterial information, firms are contributing to common knowledge and may provide valuable learnings for companies who may find this information has financial relevance. What Peirce's point of critique does illustrate, however, is the fine line between risk-assessment (ESG) and social/environmental impact (CSR) that the SEC needs to tread moving forward.

Further on, the Commissioner questions who would evaluate the materiality of the effects of climate change and jokingly quotes "but have no fear, 'climate consulting firms are available to assist registrants in making this determination'". Perhaps Peirce is alluding to the offloading of responsibility to the private sector, however, it is unclear how else this information should be evaluated if not by climate consulting firms. If anything, consulting firms are more suitable to assess this than anyone, as conducting this type of evaluation does not fall under the expertise of most companies who would be making ESG disclosure, and consulting firms can pull from their ESG knowledge acquired from ESG assessments across different companies. Considering that these rules are climate-centred and there is currently no one single ESG disclosure framework, the mention of climate-specific consulting firms is understandable, though ideally, these consulting firms should be experienced in evaluating all three pillars of ESG, so as to avoid further methodological and information fragmentation.

Among these topics, Peirce also mentions that the SEC was granted regulatory authority with statutory limits that cover "protecting investors, facilitating capital formation, and fostering fair, orderly, and efficient markets" (Peirce, 2022), and asserts that the SEC's proposed rules includes objectives that are not theirs to pursue. While the SEC's constitutional jurisdiction is not within the scope of this paper, the previously mentioned suggestion to distinctly separate ESG, financially-relevant, risk-oriented disclosure from more idealistic issues that fall under CSR could bypass this problem. Not only does it maintain the SEC's responsibility to ensure investors are provided with an accurate image of a company's performance (present and future) from the manager's perspective, but it also leaves moral judgement associated with CSR evaluation at the discretion of individual firms.

There is no doubt that ESG disclosure regulation is a complex affair, which is why so much care needs to be taken in order to not just change how ESG functions in the financial system, but improve it. Clearly, coordinated efforts will be necessary for this to occur, as well as the sorely-needed simplification of both the processes of ESG disclosure and the structure of parties involved (i.e. regulators, consulting firms, etc.). Furthermore, considering the vital role ESG reporting plays in ESG score provision for companies, it is imperative that disclosure processes are streamlined as soon as possible, as this will minimise inaccuracies that can contribute to market imbalances.

Rating ESG

Given the fact that a company's ESG report can be difficult to access, lengthy, incomplete, or even absent, it is to be expected that ratings agencies would take it upon themselves to condense this information into a simple rating that is backed by data analysis and an expert eye. How exactly do they do this? While the details may differ between ratings institutions, the general approach to ESG rating tends to hold true for the majority, however, given its reputation and detailed methodological publications, Morgan Stanley Capital International (MSCI, 2022) will be used as a reference for methodology.

To begin with, MSCI gathers historical, current, and projection data pertaining to 35 key predefined ESG issues[5] for each industry, such as the sources of a company's raw materials or potential opportunities in renewable energies (MSCI, 2022). These datasets come from government and NGO publications, as well as media sources, and of course, a company's

[5] Issues are reselected annually.

disclosure, all of which are analysed to develop two types of metrics, 1) exposure metrics which assess how exposed a company is to industry issues that are material, and 2) management metrics which evaluate how well a company is addressing each predefined issue. These metrics are then evaluated in terms of industry and weighted according to MSCI's framework, resulting in the appraised company being given a score for each of the 35 key issues. Based on these metrics and scores, said company will receive a score between AAA and CCC, as well as individual E, S, and G scores.

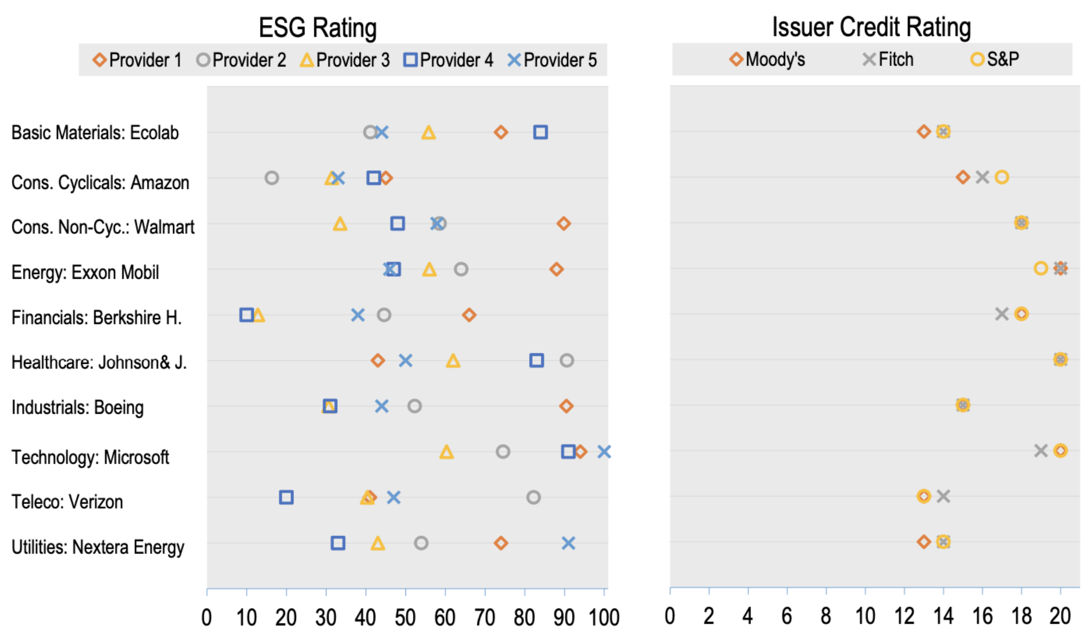
One of the major benefits of ESG ratings is independence from the entities being rated. Traditionally, credit rating agencies are paid by companies to give them a score indicating their likelihood of default which is then used as an indicator for investors - unfortunately, this dynamic leaves room for corruption, such as famously in the crash of 2008, when Moody's, having been "influenced" by investment banks, overrated risky mortgage-backed securities. Conversely, ESG ratings are typically sponsored by investors, thus better ensuring ratings are unbiased. Furthermore, 90% of the value of S&P 500 listed companies can be attributed to intangible assets (Ali, 2020), which are often driven by ESG practices, making it as important as ever that ratings agencies are objective and put similar weight on the various metrics. This, however, does not currently seem to be the case.

Ratings Disparities

With over 100 institutions delivering ESG data and ratings to date (Bergman et al., 2021), there is often disagreement and divergence on the ESG quality of a company or fund. In fact, Berg, Kölbel, and Rigobon (2022) conducted a study to test the extent to which these ratings do diverge across 6 of the most reputable ratings agencies, and identified three points of divergence

- scope divergence, measurement divergence, and weights divergence. In this context, scope divergence refers to when ESG ratings are founded on different characteristics (e.g. one agency may include customer satisfaction while another would omit this). Conversely, measurement divergence involves agencies assessing the *same* characteristics, but using different indicators. Finally, weights divergence is defined as the case when agencies have different stances on the weight or relative importance of the characteristics of a given company (e.g. one agency may weigh labour standards more than community relations, where another may not). These economists found not only correlations between ratings that ranged from 0.38 to 0.71 - a massive divergence compared to the 0.99 credit ratings correlation between Moody's and Standard & Poor's - but also that the largest source of divergence was measurement divergence, accounting for 56% of ratings differences, followed by scope divergence (38%) and weight divergence (6%). They also found that, while the structures of ESG ratings are often incongruous, it is not impossible to configure them into a standardised framework that explains ratings differences. Additionally, this study revealed that measurement divergence was partially due to a 'rater effect', meaning that a company is more likely to receive a high score on all categories if they have received a high score on another category from the same rater - this accounts for 15% of score variation.

The OECD conducted a similar analysis, comparing the ratings of public companies in the United States, representing different industries (companies were selected based on their market capitalization), issued by 5 major ratings providers (Boffo & Patalano, 2020). For comparison, a figure depicting the credit ratings of these same companies conducted by Moody's, Fitch, and S&P was included. Chiefly, this visual highlights how far ESG ratings have to go to become remotely informative or reliable. Data points for ESG ratings appear almost random, and no identifiable pattern is present, unlike the relatively consistent credit ratings shown on the right. Nevertheless, disclosure framework development could benefit from the review of these ESG ratings providers' methodology and the identification of any significant methodological differences (such as weighting or categorization) to better understand the source of this divergence and hopefully develop framework points that address or reduce some of these issues.



Note: Sample of public companies selected by largest market capitalisation as to represent different industries in the United States. The issuer credit ratings are transformed using a projection to the scale from 0 to 20, where 0 represents the lowest rating (C/D) and 20 the highest rating (Aaa/AAA).
Source: Refinitiv, Bloomberg, MSCI, Yahoo finance, Moody's, Fitch, S&P; OECD calculations

Figure 2. ESG Rating Consistency Compared to Credit Ratings (Boffo & Patalano, 2020)

Another study conducted by Li and Polychronopoulos (2020) analysed the ratings of two companies - Wells Fargo and Facebook - by two leading ESG ratings providers. As part of their rationale for conducting this study, these authors report that the quality of ESG ratings data "can be deficient due to a lack of coverage and a dependence on self-reporting", citing a finding from a BNP Paribas survey (2017) that found this deficiency to be the largest deterrent for investors who would otherwise like to take part in the ESG wave. Not only does this support the need for mandatory, regulated disclosure, but it also points to the need for a disclosure framework that can standardise ESG data collection and analysis to promote accurate comparison with data from previous years and other companies in a given industry. They found that one provider ranked Facebook in the top 10% when it came to their environmental data, while the second provider placed Facebook in the bottom third of this ranking. Similarly, this study revealed that Wells Fargo was ranked for their governance in the top third within their universe by one provider, where the other placed the company in the bottom 5% for the same category. What were the grounds for this inconsistency? The authors' analysis detected major differences in how each provider weighed each issue (e.g. "Protection of Biodiversity" or "Tax Disclosure"), and found inconsistencies as to under which category certain data were placed, which ultimately comes back to the weighting problem, since different categories are given different weights, both within a provider's rating framework and across providers. Included in this particular study is an enlightening statement, "Investors should…select the provider whose ratings align more closely with the investor's own views on ESG." However, who is advising investors to do so? And how many investors would go to these lengths to discern which ratings agency is compatible with their views and values? Where would they get enough information to do so? Yet again, the onus is assumed to be on the investor, which not only deters investors, as was previously mentioned, but also contributes to the negative perception some might have of the validity of ESG as an investment metric.

Referring back to the study conducted by Christensen et al. (2019), the divergence in ESG scores could, at least partially, originate from the imbalance in information provided by companies. This study also found that ratings agencies differed more on outcome metrics (i.e.

performance outcomes of a company's efforts, such as carbon emissions) than input metrics (i.e. what the company is doing to achieve a specific outcome such as data protection policies), which would suggest that outcomes are more sensitive to bias and the principles of individual ratings providers (Christensen et al., 2019). Importantly, this study identified a key issue with ESG disagreement - the more agencies disagreed, the greater the stock return volatility of a firm, and the greater its absolute price movements. This finding has consequences for both firms and investors, in that considerable disagreement over a firm's ESG status develops uncertainty in the market and impedes a company's ability to raise external funds (Raimo et al., 2021).

It is difficult, however, to evaluate how ESG is measured and scored when so much of rating discrepancies are rooted in poor disclosure practices and regulation. Surely, more flaws will arise or become more clear once the negative data noise associated with voluntary disclosure is eliminated, and these should be tackled as they come to light.

Discussion and Recommendations

ESG today finds itself at a critical moment that could either make or break its credibility. Will it become a metric as indispensable as credit ratings or P/E ratios? It will depend on how regulators choose to tackle materiality and disclosure, as well as how effectively a coherent and consistent definition of ESG is disseminated. Ultimately, ESG is a win-win, as it both reflects the demands of the modern investor who takes into account long-term risk exposure in our rapidly changing world, and has sizable corporate benefits if the proper measures are taken to achieve these three items. Recent research suggests that mandatory disclosure would be an effective mechanism to both improve the quality of ESG disclosure, as well as the comparability of data with other firms or industries (Christensen et al., 2019; Krueger et al., 2021). It has also been posited that an improvement in the quality of ESG disclosure can have positive effects on a company's performance and ability to raise capital (Tyson, 2021; Raimo et al., 2021). However, in order for mandatory disclosure to reach its full potential, it must be done with sufficient and appropriate structures put in place, such as a clear set of disclosure standards and the establishment of SEC-approved ESG accounting and consulting firms.

There are several viable strategies the SEC can take in order to do this, the first and most likely being to clearly separate the definition of ESG and CSR practices. More specifically, the mandatory ESG reporting framework must be concerned solely with the assessment and communication of ESG-related *risk*, and must avoid conflating this risk with company practices that make a positive impact on society and the environment, as this would need to be disclosed in a separate document using different procedures. This approach has the benefit of isolating ESG as a financial metric, which avoids ESG being undermined by the misconception that it includes non-financial, "nice to have" information that would otherwise add noise to the data and make ESG scores more unreliable. To be clear, the intention behind this approach is to ensure that ESG reporting is mandatory, however, more research would need to be conducted to assess the viability of mandatory CSR disclosure (or CESGR, if you will). Additionally, mandating CSR is not within the SEC's jurisdiction, and as such, until these issues are evaluated, this recommendation entails voluntary CSR disclosure for the purposes of this paper. Distinguishing ESG from CSR will also encourage more accurate uses of the term ESG, which will hopefully provide more clarity for investors who erroneously believe an ESG score reflects a company's social and environmental consciousness. This definitional correction can also be maximised if the Biden administration, the SEC, and other financial regulators hold news outlets and financial institutions accountable for circulating accurate information, though this point is secondary to this recommendation.

By splitting these two bodies of information - CSR and ESG - the problem of materiality and what should be included in ESG disclosure is also reduced, such that information that *could* have a financial impact is compiled in one single report (ESG), detached from information that could not (CSR). On this note, for this approach to work, it is essential that the SEC redefines materiality to cover information that has *potential* to be financially-important to investors when making investment decisions, however the extent of this potential would need to be assessed by experts in the field and specific industries (i.e. ESG accounting and consulting firms, to be discussed further), as this would be dictated by the industry in which a company is situated, as well as general events in the economy. This plan of action segmenting ESG and CSR, should it be implemented, also aligns with the notion of double materiality, in that it both accounts for the impact of external factors on a company, as well as the externalities a company's operations may have on the rest of the world.

The SEC could also pursue a different avenue, where ESG risk becomes integrated with generally-accepted accounting principles (GAAP), so that annual financial reports include ESG (again, risk-related and potentially financially-relevant) information. This would, naturally, also require the merging of the Financial Accounting Standards Board (FASB) with the Sustainability Accounting Standards Board (SASB), which would further streamline the disclosure process and has potential to boost the board's efficiency and lower their costs. On a definitional level, this strategy is also viable, as annual reports require that all relevant financial information is disclosed, where material ESG information is that which is relevant to discerning the financial risks associated with external ESG changes in the world. This approach, however, would still necessitate a separate measure that covers pro-social and pro-environmental initiatives, such as a CSR or CESGR score, in order to account for these efforts and to prevent the conflation of these issues with ESG. However, considering the permanent nature of the FASB and GAAP, perhaps this approach is less likely to gain traction.

Ultimately, these recommendations can be boiled down to structural simplification, conceptual clarification, and transparency. Certainly, there are intricacies and hidden stakeholders that complicate this matter further, however, given the huge potential ESG has to improve financial information asymmetries and expand investor considerations, one can hope that financial regulators are taking these factors into account and are proceeding with logic and due process. Only time will tell!

Conclusion

This paper explored the benefits and issues associated with ESG, and has attempted to interpret and respond to various criticisms of the metric, namely by Milton Friedman and the anti-ESG movement, while developing potential solutions to their valid concerns. Following this, a review of existing literature on data materiality and disclosure was conducted, which assessed future plans for ESG integration by various regulators, including the Biden administration and the SEC, while developing suggestions and alternative mechanisms to ensure this integration is completed to its utmost efficacy. An inspection of research pertaining to ESG ratings was also completed, which revealed support for the notion that disclosure is the most crucial facet of the ESG system to be revamped, and a summary of suggestions for the future was offered. At the very least, this paper offers a clarification for how to think about ESG and strives to contribute to the accurate dissemination of ESG's scope and intentions.

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