[Hastings Environmental Law Journal](https://repository.uchastings.edu/hastings_environmental_law_journal)

Volume 28
Number 2 *Summer 2022*

Article 2

Summer 2022

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Ebbe Rogge

Lara Ohnesorge

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ABSTRACT

The European Union ("EU") set out an ambitious policy agenda to reduce its impact on climate change. Although the popular image is that economic growth and sustainability are practically incompatible, this policy agenda includes measures enabling reallocation of investment towards sustainable projects and companies. This paper posits that, by adopting measures requiring the disclosure of non-financial and in particular Environmental, Social, and Governance ("ESG") information, EU policy relies on market efficiency to ensure the desired reallocation of investment.

In order for this market efficiency approach to work properly, non-financial information must be accessible, comparable, and verified. This creates a new role for (non-financial) information verifiers, such as ESG Rating Agencies. Their role, as observed with Credit Rating Agencies, thus becomes twofold: reducing the non-financial information asymmetry and performing an almost regulatory function on sustainability. This paper examines the impact of ESG Rating Agencies, suggesting that methodologies differ widely although industry consolidation has improved uniformity. Furthermore, the combined measurement of 'E', 'S', and 'G' could lead to decent overall ratings but with poor scores for 'E'.

This paper concludes that increased oversight and regulation of ESG Rating Agencies may be required to ensure they fulfill their role in enabling this market-based approach towards tackling climate change.

[*] Ebbe Rogge is an Assistant Professor, Hazelhoff Centre for Financial Law, Lei-den University, The Netherlands, and Senior Policy Advisor, Dutch Authority for Financial Markets. E-mail: e.rogge@law.leidenuniv.nl. The opinions ex-pressed herein are solely those of the authors and in no way represent those of the Dutch Authority for Financial Markets. The authors would like to thank Ilya Ko-korin and Marloes van Rijsbergen for comments on an earlier version. Lara Ohnesorge is a Ph.D.-Fellow, Hazelhoff Centre for Financial Law, Leiden University, The Netherlands. E-mail: l.g.l.ohnesorge@law.leidenuniv.nl.

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INTRODUCTION

Over the last two decades, public attention has increased towards one of the greatest human-induced environmental challenges of our time, climate change.[1] This threat has triggered an internationally coordinated response, beginning with the establishment of the Intergovernmental Panel on Climate Change ("IPCC") in 1988.[2] Its objective is to analyze published literature on (human-induced) climate change and produce review reports. These reports contribute to the establishment of international treaties such as the United Nations Framework Convention on Climate Change ("UNFCCC").[3] Despite the global nature of the problem, responses by various nations and regions have differed.[4] In 2015, the UNFCCC was updated and agreed upon at a conference in Paris, commonly known as the Paris Agreement.[5] The Paris Agreement includes a commitment to a long-term goal pursuing efforts to limit the increase of the global temperature to a maximum of 1.5 degrees Celsius, in line with the analysis done by the IPCC.[6] The agreement appears to be based on a "bottom-up" approach: it provides parties (States) with the discretion to establish their mitigation

1. *See generally* WashPostPR, *The Washington Post Wins the 2020 Pulitzer Prize for Explanatory Reporting for Groundbreaking Climate Change Coverage*, WASH. POST (May 4, 2020), https://perma.cc/A4YB-MMKD; Henry Fountain, *Climate Change Is Accelerating, Bringing World "Dangerously Close" to Irreversible Change*, N.Y. TIMES (Dec. 4, 2019), https://perma.cc/K6MA-EMWJ; Alice Bell, *Sixty Years of Climate Change Warnings: The Signs that Were Missed (and Ignored)*, GUARDIAN (July 5, 2021), https://perma.cc/96ZF-8RAQ; Levi Pulkkinen, *"We Thought It Wouldn't Affect Us": Heatwave Forces Climate Reckoning in Pacific North-West*, GUARDIAN (July 3, 2021), https://perma.cc/BC4H-2YZ2; Daniel Judt et al., *To Save the EU, Its Leaders Must Focus on Saving the Plane*t, GUARDIAN (July 27, 2020), https://perma.cc/VP7X-XSKP.

2. *History of the IPCC*, IPCC, https://perma.cc/5645-3S2M.

3. *See generally The Fifth Assessment Report of the IPCC*, U.N. CLIMATE CHANGE, https://perma.cc/AB3U-WPUG (the fifth assessment report was published in 2014); *About the Secretariat*, U.N. CLIMATE CHANGE, https://perma.cc/AB3J-FWNG.

4. *Compare* Jennifer Huang, *Exploring Climate Framework Laws and The Future of Climate Action*, 38 PACE ENV'T L. REV. 285, 291–302 (2021) (discussing recent trends in the adoption of climate framework laws in the U.K., Mexico, New Zealand, and Denmark), *with* Cinnamon Carlarne, *Climate Change Policies an Ocean Apart: EU & US Climate Change Policies Compared*, 14 PENN. ST. ENV'T L. REV. 435, 437–39 (2006) (comparing the U.S. and EU climate change policies), *and* Jutta Brunnee, *Europe, the United States, and the Global Climate Regime: All Together Now*, 24 J. LAND USE & ENV'T L. 1, 9–20 (2008) (analyzing the motivating factors that shape the U.S. and EU climate policies). *See also* P.T. MUCHLINSKI, *Environmental Issues*, *in* MULTINATIONAL ENTERPRISE AND THE LAW 606 (2021) (providing an overview of corporate environmental regulation in).

5. The Paris Agreement to the United Nations Framework Convention on Climate Change, Dec. 12, 2015, T.I.A.S. NO. 16-1104; *e.g.*, *The Paris Agreement*, U.N. CLIMATE CHANGE, https://perma.cc/LFF5-D4AZ.

6. *Special Report on Global Warming of 1.5º C*, IPCC, https://perma.cc/6AUK-5P48.

targets.[7] As a result, it may place a heavy reliance on industry or non-governmental organization ("NGO") initiatives (private climate governance schemes) where parties (States) are less ambitious.[8] Private climate governance could, in practice, include voluntary disclosure of climate-related information, voluntary emission reductions, or carbon labeling.[9]

The European Union ("EU"), in light of its obligations under the Paris Agreement, has in recent years set out a comprehensive climate policy agenda. The EU's climate policy agenda contains several major initiatives. For example, the action plan on financing sustainable growth[10] and the European Green Deal,[11] which in turn includes the European Green Deal Investment Plan.[12] This "green policy agenda" sets out major regulatory proposals for corporations and financial market participants.[13] Although the EU has reframed certain objectives into market projects before, the current integration of sustainability into an economic agenda does demonstrate a remarkable shift in economic thinking. Economic growth has long and often been contrasted to environmental sustainability, the latter being characterized as a purely altruistic endeavor.[14] The notion that economic progress and sustainability are mutually exclusive or are part of some cost-benefit tradeoff is changing.[15] The EU's aim is to reorient capital toward a sustainable economy by making available information for investors to make more sustainable choices. Indeed, the approach relies to a large extent on the willingness of investors to take responsibility and invest in sustainable growth.

7. Maria L. Banda, *The Bottom-Up Alternative: the Mitigation Potential of Private Climate Governance after the Paris Agreement*, 42 HARV. ENV'T REV. 325, 327 (2018).

8. Banda, *supra* note 7, at 340–41.

9. *Id.* at 355–57; *see also* Michael P. Vandenbergh et al., *The Gap-Filling Role of Private Environmental Governance*, 38 VA. ENV'T L.J. 1, 32, 38, 45 (2020).

10. *Renewed Sustainable Finance Strategy and Implementation of the Action Plan on Financing Sustainable Growth*, EUR. COMM'N (Mar. 8, 2018), https://perma.cc/3SFV-UK8R; *Action Plan: Financing Sustainable Growth*, Communication from European Commission, COM(2018) 97 final (Mar. 8, 2018).

11. *A European Green Deal*, EUR. COMM'N, https://perma.cc/GT9H-QPYA.

12. *Financing the Green Transition: The European Green Deal Investment Plan and Just Transition Mechanism*, EUR. COMM'N (Jan. 14, 2020), https://perma.cc/684A-6CBV.

13. *See* Lara Ohnesorge & Ebbe Rogge, *Europe's Green Policy: Towards a Climate Neutral Economy by Way of Investors' Choice*, 18 EUR. CO. L. 34, 34–39 (2021).

14. *See generally* Joan Martinez Alier, *Socially Sustainable Economic De-Growth*, 40 DEV. CHANGE 1099, 1099 (2009) (asserting that economic growth and sustainability are incompatible).

15. *See generally* Michael A. Livermore et al., *Symposium Panel: Economics & Environmental Policy*, 28 N.Y.U. ENV'T L.J. 49, 54–56 (2020) (describing a beneficial relationship between economics and environmental decision making).

There is a noticeable discrepancy between the attention for sustainable management and what is actually happening to our planet.[16] Although there is an increasing interest in climate change over the last decade or two, the climate crisis is worsening rapidly, which implies the EU's approach simply has to work. To make the EU's approach of relocating capital a reality, non-financial information and its verification are essential for investors to make informed investment choices. Hence, the EU has prepared ample legislation to expand, morph, and use this non-financial information for measuring the impact of corporations on climate change. This approach is not unlike the previously developed concept of Corporate Social Responsibility ("CSR"), which pertains to measuring the broader impact of corporations on society and the environment.

The EU's approach forces market participants to publish climate information, thereby facilitating "private climate governance," relying on investors and market forces to reallocate their capital.[17] This paper focusses on the sector that verifies and simplifies this non-financial climate information. Special attention is paid to the emergence and role of ESG Rating Agencies. The ESG Rating Agencies have received substantial criticism.[18] However, like Credit Rating Agencies ("CRAs") with respect to credit worthiness, these ESG Rating Agencies play a crucial role in financial markets, particularly concerning "green credentials," or sustainability of firms. This role will provide them with a potentially significant impact on the success of the EU's climate policy. This paper, therefore, examines ESG Rating Agencies' role and influence. The paper concludes with policy recommendations on how to manage any potential risks.

This paper proceeds as follows: first, it sets out the relevant details of the EU's policy agenda on enhancing private investments in sustainable activities through market efficiency and increased disclosure of non-financial information. Second, the most important legislative initiatives for non-financial information disclosure are briefly examined. Third, the verifiers of non-financial information, particularly the (relatively) new and increasingly important ESG Rating Agencies, are studied. Fourth, we look

16. Thomas Dyllick & Katrin Muff, *Clarifying the Meaning of Sustainable Business: Introducing a Typology from Business-as-Usual to True Business Sustainability*, 29 ORG. & ENV'T 156, 157–159 (2016) (noting that the increased acceptance and integration of sustainability by big companies has not translated into a realized change in the state of the planet).

17. Banda, *supra* note 7, at 389.

18. *See* Chris Flood, *SEC Chair Warns of Risks Tied to ESG Ratings*, FIN. TIMES (May 27, 2020), https://www.ft.com/content/2c662135-4fd3-4c1b-9597-2c6f8f17faed; Timothy M. Doyle, *Ratings That Don't Rate: The Subjective World of ESG Rating Agencies*, AM. COUNCIL FOR CAP. FORMATION (July 2018), https://perma.cc/P4NW-2Q74; Cam Simpson et al., *The ESG Mirage*, BLOOMBERG BUS. WK. (Dec. 10, 2021), https://perma.cc/E6QZ-7ECY.

at their methodology and impact in the financial markets. Finally, policy implications for the regulation of ESG information verifiers and the EU's Green Policy are discussed. The main focus of this paper is on the EU's climate policy; however, it is fair to say that the U.S. has recently taken steps in the same direction.[19] Since his inauguration, U.S. President Joe Biden has (re-)committed the U.S. to tackling the climate crisis.[20] Moreover, the Biden-Harris Administration has set out to improve the disclosure of financial information relating to climate risk.[21] This paper will venture into the situation in the U.S. when appropriate.

I. ENABLING A MARKET FOR SUSTAINABLE INVESTMENTS

A. USING MARKET EFFICIENCY AS PART OF THE EU GREEN POLICY

The European Green Deal can be described as a macro-economic growth plan that sets out pathways of transformation, founded on a deal between the EU, the Member States, and their citizens.[22] It is not a coincidence that this document has received the title "Green Deal," a name which strongly resembles the U.S. "New Deal" of the 1930's, in the sense that both signify progress and change in economic policy.[23] In essence, the Green Deal spells out a number of reallocation mechanisms within the European economy which should bring about the shift to a climate-neutral Europe.[24] In the past, climate action has often been characterized as antithetical to economic growth[25], but the European Green Deal frames the

19. *See generally* Tom Daschle, *Changing the Political Climate on Climate Change*, 9 GEO. J. INT'L AFFS. 93 (2008) (providing an overview of US interests and a call to action for the U.S. to address climate change).

20. Exec. Order No. 14008, 86 Fed. Reg. 7619 (Jan. 27, 2021); *See generally, e.g.*, Cass R. Sunstein, *Changing Climate Change*, 2008–2016, 42 HARV. ENV'T L. REV. 231 (2018) (detailing the previous efforts, in particular by the executive branch, under the Obama-administration); Shany Winder, *Extraordinary Policymaking Powers of the Executive Branch: A New Approach*, 37 VA. ENV'T L.J. 208 (2019).

21. Exec. Order No. 14040, 86 Fed. Reg. 27867 (May 20, 2021); *See generally* Colin Myers, *Financing Our Future's Health: Why the United States Must Establish Mandatory Climate-Related Financial Disclosure Requirements Aligned with the TCFD Recommendations*, 37 PACE ENV'T L. REV. 415, 433–439 (2020) (considering the US adoption of a regime for climate related financial disclosures).

22. Eigil Hodne, *The European Green Deal—A Norwegian Perspective*, 9 EEJ 18, 19 (2020).

23. Ludwig Krämer, *Planning for Climate and the Environment: the EU Green Deal*, 17 (3) J. FOR EUR. ENV'T & PLAN. L. 267, 269 (2020).

24. *See generally* Grégory Claeys et al., *How To Make the European Green Deal work*, 13 BRUEGEL POL'Y CONTRIBUTION, 1, 2 (2019).

25. Mark Landler & Somini Sengupta, *Trump and the Teenager: A Climate Showdown at Davos,* N.Y. TIMES (Jan. 21, 2020), https://perma.cc/HW4G-7E2F (reporting

transition as an opportunity for socio-economic progress.[26] Reframing an ambition which *prima facie* has little to do with economic growth into a market stimulus, a strategy commonly employed by the EU.[27] The most well-known example is the early predecessor of the EU, the European Coal and Steel Community, which successfully transformed the agenda of preventing wars by controlling commodities into a welfare project which proved essential for rebuilding the European economy.[28]

The financing element of the Green Deal is set out in the Sustainable Europe Investment Plan.[29] The idea is to stimulate the allocation of funds, including private sector funds[30], to those firms and projects that are facilitating the transition towards a climate-neutral Europe. Specific policy actions are set out in the Action Plan on financing sustainable growth, which sets out ten initiatives that should contribute to closing the current annual investment gap of EUR 350 billion in sustainable financing.[31] The mechanics applied in the EU's Green Policy to achieve this (re)allocation appear simple and are derived from other related fields of finance and financial markets.

Based on the notions of transparency and disclosure driving a form of market discipline and accountability, the mechanics introduced by the Action Plan aim to increase the transparency and disclosure regarding the sustainability risks and impacts of investments. According to the efficient-market hypothesis ("EMH"), the price of a product reflects all information

on critics from the corporate world stating they have been unable to combine economic growth, based on gross domestic product, with keeping carbon emissions in check).

26. The European Green Deal, Dec. 11, 2019, COM(2019) 640 final, 7; *see Ten Facts About the Economics of Climate Change and Climate Policy*, HAMILTON PROJECT & STANFORD INST. FOR ECON. POL'Y RES. (Oct. 2019), https://perma.cc/L56P-JYL6 (it appears however more widely recognized that climate change in itself will have a negative economic impact).

27. Joaquín Roy, *All Roads Lead to Rome: Background, Context and Legacy of the Treaty on the European Community*, JEAN MONNET/ROBERT SCHUMAN PAPER SERIES (SPECIAL ISSUE) 3 (Aug. 2012); Bela Balassa, *The Theory of Economic Integration: An Introduction*, *in* THE EUROPEAN UNION—READING ON THE THEORY AND PRACTICE OF EUROPEAN INTEGRATION, 125–37 (Brent F. Nelsen & Alexander C-G. Stubb eds., 1994).

28. *Id*.

29. European Green Deal Investment Plan, Jan. 1, 2020, COM(2020) 21 final, §§ 2–4.

30. *Id*. at §§ 1, 4.

31. *Renewed Sustainable Finance Strategy and Implementation of the Action Plan on Financing Sustainable Growth*, EUR. COMM'N (Mar. 8, 2018), https://perma.cc/89RD-KHY9; Action Plan: Financing Sustainable Growth, Mar. 8, 2018, annex 3, COM(2018) 97 final (Workplan of the initiatives set out by this Action Plan); *Financing the Green Transition: The European Green Deal Investment Plan and Just Transition Mechanism*, EUR. COMM'N (Jan 14, 2020), https://perma.cc/8CQ4-8ASL; *Strategy for Financing the Transition to a Sustainable Economy*, EUR. COMM'N (July 6, 2021).

available on that product.[32] A market is said to be efficient if prices reflect all the information available. Without access to all information, potential investors suffer from the adverse selection problem, also known as the "lemon problem."[33] This problem arises when not all information is available to the buyer, who would then be unwilling to pay more than the average price for a certain product. This would be a disadvantage for some selling a premium (and more expensive) product, but a benefit to those selling "lemons." In other words, if buyers lack reliable information, they cannot properly assess the value of the product, which frustrates efficient price formation.[34] In the situation where prices do not reflect the value of the product, this is mostly to the detriment of those offering higher quality (value) products: quality issuers and securities are driven away from the market.[35] In the context of the aim to increase sustainable investments, sustainable issuers are at risk of being driven out of the market because their products are indistinguishable from non-sustainable products due to a lack of information for the investor. One solution is to create regulation that forces the disclosure of certain information, thereby removing (or at least reducing) the information asymmetry. By forcing market participants to create and make public information on their sustainability risks and impacts, the EU aims to negate the current information asymmetries.[36] The idea seems to be that with information on sustainability available to the market proper price formation can take place, leading to the allocation of capital to more sustainable projects.[37]

32. Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970) ("A market in which prices always 'fully reflect' available information is called 'efficient.'"); *See generally* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (further discussing the Efficient Market Theory); *See also* Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 718 (2003); *but see, e.g.*, Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17(1) J. ECON. PERSPECTIVES 59, 80 (2003) (criticizing the Efficient Market Theory); Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AMER. ECON. REV. 393, 403–05 (1980).

33. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 488–92 (1970) (using the automobile market to analogize the negative effect of market uncertainty).

34. *Id*. at 489–90 (explaining that good cars and bad cars must be trading at the same price as the buyer, who has less information than the seller, cannot tell the difference).

35. *Id*. at 489–90 (explaining that most cars traded will be 'lemons' driving out the good, because they would trade at the same price); Dan S. Dhaliwal et al., *Voluntary Nonfinancial Disclosure and the Cost of Equity Capital: The Initiation of Corporate Social Responsibility Reporting*, 86 ACCOUNTING REV. 59 (2011) (finding that initiating corporate social responsibility information disclosure reduces the cost of capital compared with previous years of non-disclosure).

36. *E.g.*, Sanjay Ramchande et al., *The Informational Relevance of Corporate Social Responsibility: Evidence from DS400 Index Reconstitutions*, 33 STRATEGIC MGMT. J. 303 (2012) **Error! Hyperlink reference not valid.**(finding that information published on corporate social responsibility influences price formation as the information has a positive or negative effect on the share price).

37. Jin Boon Wong & Qin Zhang, *Stock Market Reactions To Adverse ESG Disclosure Via Media Channels*, 54 BRITISH ACCOUNTING REV. 1, 4 (2022) (explaining the

In the present context, one should consider whether the price is also a reflection of all non-financial sustainable information available, as this presumption appears to be a prerequisite for the EU's policy to work. Various research indicates that a combination of financial and non-financial information, particularly ESG information, contributes to the price formation process.[38] In U.S. markets, it has been shown that ESG disclosure in general for U.S. S&P 500-listed companies between 2009 and 2018 positively affected those firms' performance measures, such as return-on-equity.[39] The same research also shows, however, that looking at the different ESG components provides a more subtle picture: CSR and environmental disclosure has a negative relation to Return on Assets, whilst corporate governance disclosure has a positive relation. Research from Chinese capital markets shows that, for listed companies, disclosure of environmental information can significantly improve the value of the company through significant positive correlation with investor confidence.[40] Research for German listed companies between 2010 and 2014 shows that ESG has a positive impact on Return on Assets, and that governance has a stronger impact than environmental and social factors.[41] Other research does not focus on specific jurisdictions but on industry sectors. For the food and beverage industry, it has been shown that access to financial resources, such as equity, improves with ESG disclosure.[42] Likewise, ESG disclosure has an impact on performance of European banks with individual elements of this disclosure having slightly different forms of influence.[43]

link between signaling theory and corporate reputation emerging from corporate social responsibility, and the importance of corporate social responsibility information in reducing information asymmetry and price formation).

38. Eli Amir & Baruch Lev, *Value-Relevance of Nonfinancial Information: The Wireless Communications Industry*, 22 J. ACCT. ECON. 3, 4 (1996).

39. *E.g.*, Bahaaeddin Ahmed Alareeni & Allam Hamdan, *ESG Impact on Performance of US S&P 500-Listed Firms*, 20 CORP. GOV. 1409, 1422 (2020); Yannik Bofinger et al., *Corporate Social Responsibility & Market Efficiency: Evidence from ESG and Misvaluation Measures*, 134 J. BANKING & FIN. 1, 17 (2022) (suggesting that a firm's ESG profile reduces undervaluation but may expand overvaluation).

40. T.M. Yuang, *Does Environmental Information Disclosure Increase the Firm Value and Investors' Confidence?, in* SUSTAINABLE DEVELOPMENT 614 (L. Zhu & A. Ouadha eds., 2016).

41. P. Velte, *Does ESG Performance Have an Impact on Financial Performance? Evidence from Germany*, 8 J. GLOB. RESP. 169, 176 (2017).

42. N. Raimo et al., *Non-Financial Information and Cost of Equity Capital: An Empirical Analysis in the Food and Beverage Industry*, 123 BRIT. FOOD J. 49, 58 (2020).

43. A. Buallay, *Is Sustainability Reporting (ESG) Associated with Performance? Evidence from the European Banking Sector*, 30 MGMT. OF ENV'T QUALITY 98, 111 (2019) (finding that, individually, the environmental disclosure positively affected ROA and TQ, whereas the corporate social responsibility disclosure negatively affected ROA, ROE, and TQ).

This overview demonstrates the impact of non-financial, and in particularly ESG, information on the price formation process. Policy to provide market participants with comparable, non-financial information should therefore enable a market-based solution by way of market efficiency. If this policy indeed leads to a reallocation of capital toward sustainable projects, it could ultimately allow the EU to reach the agreed climate targets under the Paris Agreement. The next section discusses why the integrity, availability, and comparability of this non-financial information are essential.[44]

B. THE IMPORTANCE OF INFORMATION AND ITS INTEGRITY, AVAILABILITY, AND COMPARABILITY

The existence and availability of information is necessary for an efficient market, but unfortunately is not a given in the current financial markets. The first point to make is that non-disclosure of relevant information will lead to information asymmetries between the issuers of securities and potential buyers. The issuer, or seller, holds more non-financial information than the buyer, which, as discussed previously, leads to the "lemon problem," which in turn drives high quality issuers and securities away.[45] There are ways of overcoming difficulties caused by asymmetries, for example, by the knowledgeable party "signaling" its credentials.[46] In financial markets, issuers (or owners) can signal their credentials by retaining a significant percentage during an initial public offering, which would be too costly if they were a poorly performing company.[47] Another solution is to create regulation which forces the disclosure of certain information, thereby removing (or at least reducing) the information asymmetry. This is the approach taken in Europe's Green Policy.

Before setting out the key legislative elements of the Green Policy, one must consider another issue: the integrity and fairness of the price formation process. Such integrity and fairness in markets are core objectives of securities regulation, yet they are not necessarily trivial to define, and may depend on whether one refers to assumptions in the EMH or to the International Organization of Securities Commissions' ("IOSCO") regulatory principles.[48] Some of the common requirements for integrity and fairness are likely to include: absence of market abuse; non-discriminatory

44. *See generally* Becky L. Jacobs & Brad Finney, *Defining Sustainable Business—Beyond Greenwashing*, 37 VA. ENV'T L.J. 90 (2019).

45. Akerlof, *supra* note 33, at 488.

46. *See generally* Michael Spence, *Job Market Signaling*, 87 Q. J. ECON. 355 (1973).

47. *See* Hayne E. Leland & David H. Pyle, *Informational Asymmetries, Financial Structure, and Financial Intermediation*, 32 J. FIN. 371, 371–72 (1977).

48. Int'l Org. of Sec. Comm'n, *Objectives and Principles of Securities Regulation,* Res. 2/2017 (May 2017).

access to the market for participants; transparent and accurate information about the prices of securities available to all participants at the same time; and accurate information about the issuers of securities available to all participants at the same time.[49] The first three requirements are rather general, but the last one is particularly relevant in the present context: all market participants need to have the same timely access to accurate information with a material impact on the price of a security. Having previously discussed the material impact of ESG disclosure on price, the remaining key element here is having the same, timely, and accurate information available.

Finally, one needs to contemplate the issue of comparability. Generally speaking, the price for a particular financial instrument depends on the expected future return on the investment. In the present context, the "sustainability" associated with this instrument also becomes a key component. For market participants to make an investment choice, this non-financial information must not only be available in a timely and accurate manner, but it must be available in an intelligible and standardized form, allowing for the easy comparison between these investment choices.[50] Put simply, if it is too difficult for market participants to assess and compare potential investment opportunities based on the disclosed non-financial information, then publishing the information in the first place was to no avail.

C. CRITICISM AND HURDLES

It should be noted that despite the arguments presented above, a market-based approach is not without its critics. Even generally speaking, the debate regarding which policy instruments are most suited to tackling climate change is ongoing.[51] A fundamental question raised by some is whether the market-based idea that disclosure leads to solving the ESG problems is actually going to work.[52] Is the basic assumption that in an efficient market investors will invest more sustainably, correct? Some authors appear to argue in favour, explaining that creating these "green light" signals will help investors reallocate their funds to sustainable companies, rather than the usual "red light" signals which merely flag

49. Janet Austin, *What Exactly Is Market Integrity? An Analysis of One of the Core Objectives of Securities Regulation*, 8 WM. & MARY BUS. L. REV. 215, 240 (2017).

50. JOHN ARMOUR ET AL., PRINCIPLES OF FINANCIAL REGULATION 102 (2016).

51. *See* William Boyd, *The Poverty of Theory: Public Problems, Instrument Choice, and the Climate Emergency*, 46 COLUM. J. ENV'T L. 399, 400–01 (2021); *See generally* Eric L. Lane, *Greenwashing 2.0*, 38 COLUM. J. ENV'T L. 279 (2013).

52. *See* B. Christophers, *Climate Change and Financial Instability: Risk Disclosure and the Problematics of Neoliberal Governance*, 107 ANNALS AM. ASS'N GEOGRAPHERS, 1108, 1118–24 (2017).

which companies not to invest in.[53] Other research suggests that "enabling" ESG regulation may not be sufficient to create, let alone force, the radical change of investment behaviour which is envisaged.[54] Chiu suggests instead that a wider set of reforms, like those following the Great Financial Crisis, is warranted.[55] It has further been suggested that a paradigm shift in shareholder thinking is required, with shareholder activists stimulating the entire market to consider long-term value creation.[56]

Besides this fundamental criticism, there are other hurdles such as greenwashing. Greenwashing is the practice of misleading investors or consumers with regards to the sustainable or green credentials of the entire firm or some of its products.[57] As per the previous section, the integrity of non-financial information is paramount to the functioning of an efficient market. Thus, the notion of greenwashing has the potential to seriously undermine the foundations on which the EU's Green Policy framework is built. That raises the question: why is greenwashing taking place? Delmas and Burbano set out a useful framework, in *The Drivers of Greenwashing*, to examine a variety of factors which may lead to a firm greenwashing.[58] The framework consists of four elements: (1) market external drivers such as consumers, investors, or competition, where a brown firm may want to present itself as more green to meet consumer demands or follow its competitors in positive green messaging; (2) non-market external drivers such as NGOs, activists, the media, or a lax regulatory environment, where official regulation and oversight is limited and reliant mostly on activist or NGO-led campaigns; (3) organizational internal drivers, such as its industry sector, the cost-benefit within the firm, or the incentive structure and ethical climate; and (4) finally, individual drivers, such as the personal ideas and tone from senior management.

Perhaps not surprisingly, Delmas and Burbano recommend decreasing the risk of greenwashing by, amongst others, increasing transparency of environmental performance. This would include extended mandated disclosure as well as independent verification (e.g., by the policymakers possibly in collaboration with NGOs). Other research shows

53. Daniel C. Esty & Quentin Karpilow, *Harnessing Investor Interest in Sustainability: The Next Frontier in Environmental Information Regulation*, 36 YALE J. REG. 625, 628–29 (2019).

54. Iris Y. Chiu, *Regulating Sustainable Finance in Capital Markets: A Perspective from Socially Embedded Decentered Regulation*, 84 L. CONTEMP. PROBS. 75, 78–79 (2021).

55. *Id*. at 78–79.

56. Alexander T. Kraik, *Environmental, Social, and Governance Issues: An Altered Shareholder Activist Paradigm*, 44 VT. L. REV. 493, 545–46 (2020).

57. William S. Laufer, *Social Accountability and Corporate Greenwashing*, 43 J. BUS. ETHICS 253, 253 (2003).

58. Magali A. Delmas & Vanessa Cuerel Burbano, *The Drivers of Greenwashing*, 54 CAL. MGMT. REV. 64, 65 (2011).

that sustainability ratings could deter greenwashing.[59] These observations support the line of thinking put forward in this paper: the EU Green Policy mandates a substantial increase in the disclosure of non-financial information, which would be independently verified by ESG Rating Agencies. Following the Delmas and Burbano framework would likely reduce the risk of greenwashing. This, in turn, would improve the integrity of the non-financial information and enable the market efficiency approach.

II. THE DISCLOSURE OF NON-FINANCIAL INFORMATION

To create an efficient market where investors invest more sustainably, the EU is expanding the obligation to disclose non-financial information. There are three main pillars enhancing the general availability of sustainability information:[60] the Non-Financial Reporting Directive ("NFRD")[61] together with the proposed Corporate Sustainability Reporting Directive ("Proposed CSRD")[62], the Taxonomy Regulation[63], and the Sustainable Finance Disclosure Regulation ("SFDR").[64] These form an overarching, cross-sectoral framework that focusses on ESG-related measures. In addition, the EU is designing specific, sectoral information with a more limited focus, such as the proposed European Green Bond

59. Beatrice Parguel et al., *How Sustainability Ratings Might Deter "Greenwashing": A Closer Look at Ethical Corporate Communication*, 102 J. BUS. ETHICS 15, 23–24 (2011).

60. *See* Ohnesorge & Rogge, *supra* note 13, at 36–37; *see generally* Javier El-Hage, *Fixing ESG: Are Mandatory ESG Disclosures the Solution to Misleading ESG Ratings?*, 26 FORDHAM J. CORP. & FIN. L. 359 (2021) (discussing ESG disclosures in the U.S.).

61. Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014: Amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups, OFFICIAL J. OF THE E.U. 330/1 (Nov. 15, 2014), https://perma.cc/6DAX-XAJ2 [hereinafter NFRD].

62. European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting, COM(2021) 189 final, https://perma.cc/JR25-VCTC [hereinafter Proposed CSRD].

63. Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, OFF. J. E.U. 198/13 (June 22, 2020) https://perma.cc/PU4U-G3LU [hereinafter Taxonomy Regulation].

64. Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 Nov 2019 on sustainability-related disclosures in the financial services sector, OFF. J. E.U. 317/1 (Dec. 9, 2019), https://perma.cc/4CWE-GTT2 [hereinafter SFDR].

Standard.[65] Put simply, the NFRD (and Proposed CSRD) will require companies to make their ESG information public. The SFDR subsequently requires financial market participants and financial advisers to provide information on the integration of the sustainable and environmental impact of their investments in the aforementioned companies, which is facilitated by the information made available under the NFRD. The Taxonomy Regulation contains a classification system for sustainable information, allowing the aforementioned disclosed data to be analyzed and compared. In other words, by creating a "common language," the Taxonomy Regulation enables the effective use of the information made available under the NFRD and Proposed CSRD by owners, financial market participants, and advisors who have to disclose information under the SFDR. This overarching framework of transparency requirements should contribute to the production and accessibility of sustainable information that is necessary for a functioning market in sustainable finance to emerge.

A. CORPORATE SUSTAINABILITY REPORTING DIRECTIVE

In 2014, the first pillar of enhancing the general availability of sustainability information, the NFRD was adopted.[66] The NFRD amends the Accounting Directive by *inter alia* introducing Article 19a, which requires "large undertakings that are public interest entities with more than 500 employees" to disclose information about "environmental, social and employee matters, respect for human rights, [and] anti-corruption and bribery matters".[67] Taking into account how it was transposed into national law, the NFRD applies to approximately 11,700 companies.[68]

More information provided by companies about their sustainability impacts is necessary to enable the transparency and disclosure required for an efficient market for sustainable finance to function. The NFRD, however, does not provide a framework that sufficiently generates such information.[69] Many companies fall outside its scope, and information is not sufficiently reliable and comparable, possibly resulting in

65. Proposal for a Regulation of the European Parliament and of the Council on the Establishment of an EU Green Bond Standard, Document Ares(2020)3052805, https://perma.cc/D3DJ-6S54.

66. NFRD, *supra* note 61.

67. *Id.*, inserting Article 19a(1) into Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, OFF. J. E.U. 182/19 (June 29, 2013), https://perma.cc/D998-YE67.

68. European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting, COM(2021) 189 final, https://perma.cc/J7YP-UG92.

69. NFRD, *supra* note 61.

greenwashing.[70] In order to reduce the lack of precision in the current environmental reporting requirement, non-binding guidelines were drawn up in 2017 and 2019, providing more details on drawing up non-financial statements than the NFRD.[71] The 2019 guidelines specifically address climate-related information, integrating the recommendations made by the Financial Stability Board's Task Force on Climate-Related Financial Disclosures.[72] It appears that these guidelines, possibly due to their voluntary nature, did not have a significant effect on the quality of non-financial reporting.[73]

In light of the shortcomings of the NFRD, the European Commission has adopted a proposal for a Corporate Sustainability Reporting Directive, the Proposed CSRD, which would amend the current reporting framework.[74] It would extend the scope of companies that have to report, whilst differentiating between the size of companies in order to keep reporting requirements proportional. For example, even small and medium-sized companies will have to include information about their impact on sustainability in their management reports.[75] Moreover, the Proposed CSRD would contain more detailed requirements on the information that needs to be reported, including the requirement to report in line with EU sustainability reporting standards. Moreover, information would have to be published as part of management reports and disclosed in a digital, machine-readable format, increasing the accessibility.[76]

B. TAXONOMY REGULATION

The notion of common standards also leads to the second pillar of enhancing the general availability of sustainability information, the Taxonomy Regulation.[77] The Taxonomy Regulation defines a wide range of ESG related matters: Article 3 of the Taxonomy Regulation defines what economic activity will be considered as environmentally sustainable, namely when it actively contributes to one or more of the environmental

70. *See, e.g.*, Deirdre Ahern, *Turning Up the Heat? EU Sustainability Goals and the Role of Reporting under the Non-Financial Reporting Directive*, 13 EUR. CO. & FIN. L. REV. 599 (2016); M.A. DELMAS & D COLGAN, THE GREEN BUNDLE: PARING THE MARKET WITH THE PLANET 170–194 (2018).

71. Communication from the Commission: Guidelines on non-financial reporting (methodology for reporting non-financial information), (2017/C 215/01) OFF. J. E.U. (July 5, 2017), https://perma.cc/Z7JP-DW98.

72. Communication from the Commission: Guidelines on non-financial reporting: supplement on reporting climate-related information (2019/C 209/01) OFFICIAL J. OF THE E.U. (June 20, 2019), https://perma.cc/PVD3-JUWJ [hereinafter Guidelines on non-financial reporting].

73. Proposed CSRD, *supra* note 62, at Recital 32.

74. Proposed CSRD, *supra* note 62.

75. Guidelines on non-financial reporting, *supra* note 72.

76. Proposed CSRD, *supra* note 62, at Recital 48–49.

77. Taxonomy Regulation, *supra* note 63.

objectives.[78] The environmental objectives are set out in Article 9 of the Taxonomy Regulation and include climate change mitigation and adaptation, and the protection of ecosystems.[79] Article 10 of the Taxonomy Regulation also specifies what is meant by contributing substantially to climate change mitigation, thus providing a "common language" on an ESG matter.[80] This enhances the comparability, reliability, and consistency of sustainability related information in financial markets, especially, because the obligations under the Taxonomy Regulation are explicitly linked to the NFRD[81] and the SFDR.[82] In particular, Article 5 of the Taxonomy Regulation[83] prescribes that, if information on financial products is disclosed based on Article 6 of the SFDR[84], then the disclosure must include information on the environmental objective(s) set out in Article 9 of the Taxonomy Regulation.[85] By explicitly expanding the obligations of the NFRD and SFDR, the Taxonomy Regulation creates a cohesive framework integrating all three pieces of legislation. It is expected that the European Supervisory Authorities ("ESA") will publish a consultation on taxonomy-related product disclosures under the Taxonomy Regulation which would increase the interaction between the instruments even more, by amending the empowerments provided for under Articles 8(4), 9(6) and 11(5) of the SFDR.[86] Because the Taxonomy Regulation is an EU Regulation rather than an EU Directive, it is aimed at creating uniformity amongst EU Member States by removing the need for transposition in national law, allowing all market participants in the EU to determine uniformly what is sustainable.[87] This in turn reduces risks of greenwashing and other similar activities which would undermine confidence in non-financial information.

The Taxonomy Regulation applies to both financial market participants that make available financial products, linking it to the SFDR,

78. *Id.* at Article 3.
79. *Id.* at Article 9.
80. *Id.* at Article 10.
81. NFRD, *supra* note 61.
82. SFDR, *supra* note 64.
83. Taxonomy Regulation, *supra* note 63, at Article 5.
84. SFDR, *supra* note 64, at Article 6.
85. Taxonomy Regulation, *supra* note 63, at Article 9.
86. *The Three European Supervisory Authorities publish Final Report and Draft RTS on Disclosures Under SFDR*, EUR. SECS. & MKTS. AUTH. (Feb. 4, 2021), https://perma.cc/K7M4-YMHG.
87. Russell Sparkes, *Ethical Investment: Whose Ethics, Which Investment?*, 10 BUS. ETHICS, ENV'T & RESP. 199–200 (2008); Georg Inderst et al., *Defining and Measuring Green Investments*, OECD WORKING PAPERS ON FINANCE INSURANCE AND PRIVATE PENSIONS NO 24, 13–14 (2012), https://perma.cc/532W-WBWD; Anastasia O'Rourke, *The Message and Methods of Ethical Investment*, 11(6) J. CLEANER PROD. 683, 684–685 (2003).

and to undertakings that are subject to Article 19(a) of the NFRD.[88] The Taxonomy Regulation thus provides the necessary definitions and categorizations in which information can be made available under both statutes, increasing the comparability of financial products with a sustainability aspect. Generally speaking, the price for a particular financial product depends on the expected future return on the investment. In the present context, the "sustainability" associated with the product also becomes a key component. For market participants to make an investment choice, non-financial information must not only be available in a timely and accurate manner, but it must be available in an intelligible and standardized form, allowing for the easy comparison between investment choices.[89] The Taxonomy Regulation intends to ensure reliability, consistency, and comparability of sustainability-related disclosures in the financial services sector.[90]

C. SUSTAINABLE FINANCE DISCLOSURE REGULATION

The third and final pillar of enhancing the general availability of sustainability information is the SFDR, most of which came into force on March 10, 2021.[91] Essentially, the SFDR obligates those who fall under its reach to disclose information on the integration of sustainability risks and impacts in their investment decisions and advice, and sustainability-related information with respect to financial products.[92] The SFDR applies to financial market participants and financial advisers, defined broadly in Article 2 of the SFDR.[93] Disclosure obligations include publishing information about the integration of sustainability risks in the decision-making processes on a company's website under Article 3 of the SFDR[94] and the pre-contractual disclosure obligation to describe how sustainability risks are integrated into investment decisions as per Article 6 of the SFDR.[95] The latter obligation in Article 6 of the SFDR is refined and expanded upon in subsequent articles, notably in Article 7 of the SFDR, relating to the transparency of sustainability impacts on a financial product level.[96] It is important to note that the SFDR, though applicable across the financial sector, has an element of voluntariness. Firstly, numerous

88. Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088, OFF. J. E.U. 198/13, Art. 1 (June 22, 2020), https://perma.cc/5BQL-D754.

89. Armour et al., *supra* note 50, at 102.

90. Taxonomy Regulation, *supra* note 63, at Preamble 20.

91. SFDR, *supra* note 64.

92. *Id.* at Preamble 10, Article 1.

93. *Id.* at Article 2.

94. *Id.* at Article 3.

95. *Id.* at Article 6.

96. *Id.* at Article 6–7.

obligations are of a "comply or explain" nature: for example, Article 4 contains the obligation to publish adverse sustainability impacts on websites at entity level, but also contains the option to comply by stating on the website clear reasons for why the company does not take such impacts into account.[97] Secondly, some obligations only apply in case the financial product promotes environmental or other sustainability-related characteristics (notably, Articles 8, 9, 10, and 11 of the SFDR).[98] This means that for products which are not clearcut climate friendly, there are less obligations to be transparent about adverse impacts. One question this raises is whether the increased regulatory burden regarding "green" products could have the counter-effect of discouraging companies to go green.

As already mentioned, the transparency requirements of the SFDR are intimately linked to the reporting standards set out in the Taxonomy Regulation, which refers to and amends the SFDR. The Taxonomy Regulation contains the format for the reporting requirements laid down in the SFDR. The SFDR leaves quite some operational details to be elaborated and specified in future Regulatory Technical Standards.[99]

III. VERIFICATION OF NEW NON-FINANCIAL INFORMATION

A. Credit Rating Agencies

The previous sections set out the mechanisms behind the EU's Green Policy: how disclosure of the relevant non-financial, sustainability-related information would, by way of market efficiency, lead to the allocation of capital towards sustainable projects and companies. Thus, the key is the disclosure of the necessary information, for which various legislative initiatives are taken. What remains is the verification of (this) information, so that market participants can trust the information and rely upon it in their decision making. This section examines some of the traditional verifiers of information in financial markets, as well as new entrants to the market. In discussing these verifiers, in particular the traditional ones with a long history, it is necessary to reflect on some of the issues and challenges they faced over the last few decades. That is not to say that they are necessarily unreliable or inadequate; the point is that past failures should not be repeated in this new context.

One of the traditional verifiers of information are the numerous Credit Rating Agencies ("CRAs"). These companies examine financial

97. *Id.* at Article 4.

98. *Id.* at Articles 8–11.

99. Joint Committee of the European Supervisory Authorities, *Joint Consultation Paper—ESG Disclosures*, EUR. SECS. & MKTS. AUTH. (Apr. 23, 2020), https://perma.cc/5WYS-9CN2.

information of other companies in order to assess their ability to repay debt in a timely manner. In accordance with their assessment, CRAs assign a particular credit rating to such a company, signifying its credit worthiness. For example, a company that is highly likely to make its debt payments in a timely fashion might receive an "AA"-rating, whilst one that is less credit worthy may receive a "BB"-rating. There are two functions traditionally associated with CRAs: (1) correcting the issue of information asymmetry between debt issuers and buyers; and (2) a regulatory role with regard to the rated investments.[100] In the first function, CRAs play the role of information intermediary, reducing or negating the information asymmetry by assigning ratings to issuers and issuances.[101] This is not without its critics; the assignment of a rating, as sometimes argued, may not involve much more than analyzing publicly available information.[102] If that were indeed the case, then such ratings would do little to reduce the asymmetry of information. One could also question why such ratings are issued for bonds (i.e., debt instruments), but not for other financial instruments such as shares.

In the second function, it is argued that CRAs fulfill a certain regulatory role by assigning a rating. The sell-side, for example in the form of brokers, signals the creditworthiness of the issuer and the particular issuance to the buy-side, such as investment managers or banks.[103] The regulatory role becomes explicit when this creditworthiness is subsequently used in the calculation of the capital requirements for the buyer. This reliance creates a number of concerns:[104] the reputation and authority of major CRAs become a guarantor for the accurate measurement of risk and amount of capital required to hold; and this authority may create, amongst other things, a significant reliability on such agencies, as well as potential conflicts of interests between issuers, or the sell-side, and the agencies.

The question arises whether one should be comfortable with these roles, particularly the second function: are CRAs sufficiently equipped to perform these important roles? For example, the role of CRAs in the Global Financial Crisis of 2008 has been well documented.[105] The focus on their

100. Robert J Rhee, *Why Credit Rating Agencies Exist*, 44 ECON. NOTES 161, 163–66 (2015).

101. A.W.A. Boot, T.T. Milbourn & A. Schmeits, *Credit Ratings as Coordinated Mechanisms*, 19 REV. FIN. STUD. 81, 84–85 (2006).

102. Rhee, *supra* note 100, at 163.

103. *See* Gilson & Kraakman, *Mechanisms of Market Efficiency* (1984) *supra* note 32, at 604–605 (regarding the role of CRAs in signaling).

104. Mia Mahmudur Rahim, *Credit Rating Agencies' Roles Have To Be Reassessed*, 4 L. & FIN. MKT. REV. 433, 434 (2010).

105. *See generally* US FINANCIAL CRISIS COMMISSION, The Financial Crisis Inquiry Report (Jan. 2011), https://perma.cc/7KUC-Z58L; *see also* Frank Partnoy, *Overdependence on Credit Ratings Was a Primary Cause of the Crisis*, U. SAN DIEGO 1, 8–9 n.9–15 (2009);

role is typically on their high ratings assigned at the time to complex financial instruments, in particular, to collateralised debt instruments. There are three broad lines of criticism: the "issuer-pays" model generates a conflict of interest; the lack of accountability towards the assignment of ratings; and the agencies' importance and power in light of their roles.[106] The "issuer-pays" model implies that the issuer, who requires a rating for its product or financial instruments, will pay the CRAs for obtaining a rating – with the risk that clients may offer higher fees in order to obtain a better rating. The second point, regarding accountability, refers to the fact that so far it has been difficult to hold CRAs accountable for, with hindsight, too favourable ratings. The third point comes back to the important role played by CRAs regarding regulation. The market at the time was dominated worldwide by a limited number of players. There were in effect only three CRAs that mattered: Standard & Poor's, Moody's, and Fitch.

Since the Global Financial Crisis of 2008, various regulatory initiatives have sought to address the above concerns, thereby allowing CRAs to continue to improve their roles.[107] It should be noted that there was already some framework in place, following the collapse of Enron and WorldCom.[108] The main thrust of criticism was that credit ratings of these firms remained very high until, in practice, everyone already knew they were about to enter into default. In the U.S., the Credit Rating Agency Reform Act of 2006 ("CRARA") was implemented.[109] It determines that Nationally Recognized Statistical Rating Organizations ("NRSROs") must register with the Securities and Exchange Commission ("SEC"), providing full disclosure on their organization, methods, conflicts of interests, etc. Whilst the SEC obtained the power to censure an NRSRO, it did not obtain

Martin Mayer, *Credit Rating Agencies in the Crosshairs*, BROOKINGS (Aug 31, 2010), https://perma.cc/45FA-N62F.

106. Ryan Voorhees, *Rating the Raters: Restoring Confidence and Accountability in Credit Rating Agencies*, 44 CASE W. RES. J. INT'L L. 875, 878 (2012); *See generally* Lynn Bai, *On Regulating Conflicts of Interest in the Credit Rating Industry*, 13 N.Y.U. J. LEGIS. & PUB. POL'Y 253, 254–70 (2010) (discussing the conflicts of interest that arise in the credit rating industry).

107. *See also* A. Kruck, *Asymmetry in Empowering and Disempowering Private Intermediaries: The Case of Credit Rating Agencies*, 670 ANNALS AM. ACAD. POL. & SOC. SCI. 133 (2017).

108. Claire A. Hill, *Why Did Anyone Listen to the Rating Agencies After Enron?*, 4 J. BUS. & TECH. L. 283, 285 (2009) ("since (and as a result of) Enron, the regulatory regime and the overall climate had changed to make such massive fraud less likely to occur, or at least less likely to continue to go unnoticed."); Claire A. Hill, *Regulating the Rating Agencies*, 82 WASH. U. L. Q. 43, 57–59 (2004); Kathleen F. Brickey, *From Enron to Worldcom and Beyond: Life and Crime After Sarbanes-Oxley*, 81 WASH. U. L. Q. 357, 359 (2003) (citing the enactment of the Sarbanes-Oxley Act).

109. *See generally* Erin M. Wessendorf, *Regulating the Credit Rating Agencies*, 3 ENTREPRENEURIAL BUS. L.J. 155 (2008).

any power to regulate the substance of the ratings nor the procedures to obtain a rating.[110] However, as the Great Financial Crisis demonstrated, the measures taken post-Enron were not sufficient and IOSCO updated its code for CRAs[111], whilst both the U.S. and the EU adopted additional legislation.[112] In the U.S., the Dodd-Frank Act created far greater regulatory oversight by the SEC, as well as more possibilities for investors to sue CRAs in case of clearly incorrect ratings.[113] In the EU, the Credit Rating Agency Regulation (2013) preamble (9) clearly states the aim to reduce overreliance of financial market participants on CRAs and their ratings, seeking to ensure these participants put in place their own procedures to make credit risk assessments, including regulatory purposes such as risk weighting for assets.[114] The Credit Rating Agency Regulation (2013) also establishes rules to reduce conflicts of interests, to ensure high quality and transparency, to ensure rotation, and to establish direct regulatory oversight by the European Securities and Markets Authority ("ESMA"). That said, whilst the above regulations will no doubt address shortcomings highlighted, it can still be argued that they may not necessarily prevent any incidents or crisis from happening in the future.[115]

B. ACCOUNTANCY FIRMS AND OTHER GATEKEEPERS

Whilst the focus of this paper is on the role of ESG rating providers, there is another traditional group of verifiers of information, the accountancy firms. Accountancy firms' main role is auditing financial information disclosed by companies. The framework in which this work is carried out has been strengthened over the last decades, at least partly as a

110. *Id*. at 169.

111. IOSCO, CODE OF CONDUCT FUNDAMENTALS FOR CREDIT RATING AGENCIES: FINAL REPORT (2015), https://perma.cc/22FT-E5AV.

112. Voorhees, *supra* note 106, at 878; Nina Dietz Legind & Camilla Horby Jensen, *The European Regulation of Credit Rating Agencies*, 30 L. CONTEXT: A SOCIO-LEGAL J. 114, 118–122 (2014).

113. Aline Darbellay & Frank Partnoy, *Credit Rating Agencies and Regulatory Reform*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW (2013) and SAN DIEGO LEGAL STUDIES PAPER No. 12-082 (2013).

114. Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (1), amended by Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013, https://perma.cc/DLR4-5829.

115. Voorhees, *supra* note 106, at 889 ("The international financial system survived the recent financial crisis, but it may not be able to survive another."); Legind & Jensen, *supra* note 112, at 145 (suggesting that, if the CRA Regulation were enacted before the financial crisis, it would not have prevented it because the causes were multifactorial. The author further alleges that the CRA Regulation alone probably will not prevent a future financial crisis either.); *see generally* Iris H-Y Chiu, *Regulatory Governance of Credit Rating Agencies in the EU: The Perils of Pursuing the Holy Grail of Rating Accuracy*, 4 EUR. J. RISK REG. 209 (2013) (critiquing the EU Regulation of credit rating agencies. In doing so, the author highlights the difficulty of getting the regulation just right.).

consequence of various accounting scandals. For example, in the U.S., Enron and WorldCom have led to the Sarbanes-Oxley Act of 2002.[116] Around the same time in Europe, in Italy, the Parmalat scandal unfolded – this concerned a dairy food company that stood at the center of a large financial fraud.[117] A few years later, around 2011, Olympus stood accused of hiding large losses for many years, one of the largest corporate scandals in Japan.[118] Even more recently, Germany experienced a series of accounting scandals related to Wirecard, a financial services provider.[119] The point of this list, which is of course far from complete, is to demonstrate clearly the importance of accountancy firms in their role as gatekeepers.

However, these examples must be seen in light of the question as to what extent, if any, Credit (and ESG) Rating Agencies are like other gatekeepers, such as the aforementioned accountancy firms.[120] Firstly, not all gatekeepers are the same, and some authors have argued they all bear rather different characteristics.[121] Some of these gatekeepers, such as auditors and analysists, could be described as independent and acting for an unknown audience. Whereas others, including lawyers and underwriters, could be considered dependent, i.e., acting on behalf of and providing advice to a known audience – the client. It is suggested that dependent gatekeepers are more easily influenced or biased, reaching a less robust recommendation than independent gatekeepers.[122] Secondly, various authors have not merely argued that there are differences amongst gatekeepers, but that Rating Agencies in particular are unlike any of the other gatekeepers.[123] In short, CRAs "are more profitable than other gatekeepers, they face different and potentially more serious conflicts of

116. *See generally* John C. Coffee Jr., *Understanding Enron: "It's About Gatekeepers, Stupid"*, 57 BUS. LAW. 1403 (2002); Peter T. Muchlinski, *Enron and Beyond: Multinational Corporate Groups and the Internationalization of Governance and Disclosure Regimes* 37 CONN. L. REV. 725, 742 (2005).

117. Guido Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, ECGI LAW WORKING PAPER NO 40/2005 (2005).

118. Bruce E. Aronson, *The Olympus Scandal and Corporate Governance Reform: Can Japan Find a Middle Ground between the Board Monitoring Model and Management Model?*, 30 UCLA PAC. BASIN L.J. 93, 106–114 (2012).

119. *ESMA Identifies Deficiencies in German Supervision of Wirecard's Financial Reporting*, EUR. SECS. & MKTS. AUTH. (Nov. 3, 2020), https://perma.cc/EJ2H-EFW9.

120. Frank Partnoy, *How and Why Credit Rating Agencies Are Not Like Other Gatekeepers*, San Diego Legal Studies Paper No. 07-46, BROOKINGS INSTITUTION PRESS AND THE NOMURA INSTITUTE OF CAPITAL MARKETS RESEARCH (Yasuyuki Fuchita &Robert E. Litan eds. 2006).

121. *See generally* Arthur B. Laby, *Differentiating Gatekeepers*, 1 BROOK. J. CORP. FIN. & COM. L. 119 (2006).

122. *Id.* at 120.

123. Partnoy, *supra* note 120; Steven L Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1 (2002), and Duke Law School, Public Law Working Paper No. 18 (2001).

interest, and they are uniquely active in structured finance."[124] This final point might also be made with regard to ESG Rating Agencies and the issues observed in the Green Bond industry, which will be discussed later on. But even if one does not want to go along all the way with these criticisms of CRAs, it nevertheless must be recognized that, due to the similarities between the ESG rating industry and the credit rating industry, ESG Rating Agencies stand out as gatekeepers with specific characteristics and potential issues. Whilst acknowledging the existence and role of other gatekeepers in relation to the newly available non-financial information, in particular, recognizing the role of accountancy firms, it is posited that ESG Rating Agencies probably play the most important role in potentially reducing information asymmetry and enabling market efficiency as far as climate-related information is concerned.

C. THE ESG DATA PROVIDERS INDUSTRY

The aforementioned legislative measures in the EU Green Policy will create a tremendous amount of new additional non-financial information. Even if reporting by each individual company is certified by accountancy firms (the relevant gatekeepers for this purpose as outlined above) there remains a lot of additional material for investors to gather and digest as part of their investment process. It has created an industry for data and information providers. The amount of available information is huge, and the first issue becomes gathering all the required and necessary information. Once that is done, it needs to be presented in a comparable way often accompanied by some form of scoring, scaling, or ranking methodology. In this section, the ESG services industry is thus pulled apart in more separate categories, going beyond the mere provision of ratings.

Amongst the ESG services industry are numerous ESG Data Providers.[125] For example, Bloomberg is a traditional provider of information in financial markets, and, in 2009, it has set up the Bloomberg ESG Data Service through the acquisition of New Energy Finance.[126] They currently offer ESG data on more than 11,500 companies globally, standardizing the reported ESG information into consistent and comparable fields of information.[127] Likewise, in 2009 Reuters bought Asset4, one of the first companies providing raw ESG data to investors.[128] This data was

124. Partnoy, *supra* note 120, at 62.

125. *See* Betty Moy Huber & Michael Comstock, *ESG Reports and Ratings: What They Are, Why They Matter*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 27, 2017), https://perma.cc/8SK9-FEYE.

126. Andrew Edgecliffe-Johnson, *Bloomberg Buys UK Energy Data Group*, FIN. TIMES (Dec. 10, 2009) (on file with Hastings Environmental Law Journal).

127. Bloomberg Professional Services, *Global Environmental, Social & Governance – ESG Data: Content and Data*, https://perma.cc/92HP-USGL.

128. Sophia Grene, *Thomson Reuters Buys Governance Data Firm*, FIN. TIMES (Nov. 29, 2009) (on file with Hastings Environmental Law Journal).

made available by way of their Eikon platform, which was transferred to Refinitiv, currently providing ESG data as a subsidiary of the London Stock Exchange Group. Like Bloomberg, it claims to provide ESG data for over 10,000 companies across more than seventy-five countries.[129] In short, ESG data is a major industry. In several instances, data providers will combine offering ESG data with a provision of other services discussed in this paper: S&P Dow Jones provide ESG indices as well as ESG data,[130] whilst Morgan Stanley Capital International ("MSCI") provides ESG ratings based on their ESG data.[131]

D. THE ESG RATING INDUSTRY

The new legislative measures, along with voluntary disclosure, will result in a substantial increase in the disclosure of non-financial information. This large amount of available ESG data raises various issues, amongst them investor accessibility.132 In the EU, one of the solutions towards improving the accessibility of ESG data is the creation of a European Single Access Point ("ESAP").133 The ESAP is intended to become a comprehensive data base for both financial and non-financial company information. One central access point clearly benefits investors, with the aim of substantially simplifying their investment decision process. The ESAP facilitates the centralization and accessibility of this data. However, it is still a complex task to compare and contrast the many different firms and their reports This can be overcome by relying on ESG Rating Agencies, which will process the vast amounts of information provided to the market into an easily digestible and more user-friendly format.

The problem at hand is a familiar one, a substantial amount of information about a company (or a set of companies or capital market instruments) must be transformed into a signal rating or ranking system to inform potential investors. CRAs have much experience in this field. As described previously, their business model is based on combining financial information about a company or product and reducing that to a credit rating within their credit ranking system. From 2005 onwards, a large amount of ESG Rating Agencies have appeared and there has been a large amount of

129. *Environmental, Social and Corporate Governance—ESG*, REFINITIV, https://perma.cc/Y5BB-EBRQ.

130. S&P DOW JONES, INVESTMENT THEME—S&P DJI ESG SCORES, https://perma.cc/ZHZ5-R3E2.**Error! Hyperlink reference not valid.**

131. *ESG Ratings*, MSCI, https://perma.cc/VP48-HKSW.

132. *See generally* Sakis Kotsantonis & George Serafeim, *Four Things No One Will Tell You About ESG Data*, 31 J. APPLIED CORP. FINANCE 50 (2019).

133. European Commission, *Targeted Consultation on the Establishment of a European Single Access Point (ESAP) for Financial and Non-Financial Information Publicly Disclosed by Companies*, EUR. COMM'N, https://perma.cc/XQ7D-PHGJ.

consolidation in the sector ever since.134 One of the main reasons for the increase of ESG Rating Agencies is that ESG Rating Agencies require a huge scale to have a commercial business model, with consolidation allowing the larger firms to become market leaders and standard setters. These developments are set out in more detail in the following section.

IV. THE IMPACT OF ESG RATINGS

A. DIFFERENCES IN ESG RATING PERFORMANCE

The chair of the SEC stated ESG Ratings are "over-inclusive and imprecise," whilst researchers at MIT Sloan have described them as "aggregate confusion."[135] A wide variety and diversity of rating providers have, despite increased transparency, not provided much added value or comparability. ESG rating buyers may use it as empty talk or tokenism. Others point at the failures of ESG rating providers to spot governance issues at Wirecard[136] or to spot social issues and poor working practices at Boohoo;[137] the latter had stellar ratings in a notoriously difficult industry for sustainability. All of this relates to the underlying issue: what determines a firm's ESG rating performance, and how does one get a higher or lower score?

Many ESG rating agencies have consolidated, thereby gaining bargaining power. However, regarding their methodology, they appear not to include sustainability sufficiently, focussing instead on the other metrics.[138] At best, it appears that different ESG Rating Agencies regard different components as more or less relevant.[139] It does appear, however, that the focus is not on the economic aspects, and truly on the ESG factors.[140] Further, research shows that different ESG rating methodologies measure risk and performance differently, even within a single category,

134. Emma Avetisyan & Kay Hockerts, *The Consolidation of the ESG Rating Industry as an Enactment of Institutional Retrogression*, 26 BUS. STRATEGY & ENV'T 316 (2017).

135. Lucy Fitzgeorge-Parker, *What's Wrong with ESG Ratings?*, EUROMONEY (Sept. 1, 2020), https://perma.cc/N9J9-JEBZ.

136. ESMA, *supra* note 119; Robert Peres, *Wirecard Is a Scar on Germany's Corporate Landscape*, FIN. TIMES (Jan. 3, 2021), https://perma.cc/F9S2-BDCH; Dan McCrum, *Wirecard: the Timeline*, FIN. TIMES (June 25, 2020), https://perma.cc/PH8B-ZCPP.

137. Attracta Mooney & Patricia Nilsson, *Why Did So Many ESG Funds Back Boohoo?*, FIN. TIMES (July 27, 2020), https://www.ft.com/content/ead7daea-0457-4a0d-9175-93452f0878ec.

138. Elena Escrig-Olmedo et al., *Rating the Raters: Evaluating how ESG Rating Agencies Integrate Sustainability Principles*, 11 SUSTAINABILITY 915 (2019).

139. N. Attig et al., *Corporate Social Responsibility and Credit Ratings*, 117 J. BUS. ETHICS 679 (2013).

140. K. Saadaoui & T. Soobaroyen, *An Analysis of the Methodologies Adopted by CSR Rating Agencies*, 9 SUSTAIN. ACCT., MGMT. & POL'Y J. 43 (2018).

such as Environmental.[141] Part of the problem lies in the fact that it is not straightforward to set out ESG indicators that can be used to measure performance. Research shows it is a challenge to set out a balanced set of indicators covering all environmental, social and governance aspects.[142] This in turn makes it difficult for the outside world to understand how a firm is performing. It also makes it difficult for a firm itself to set out a holistic approach for possible improvements.

There might be biases in measuring ESG performance because of the differing methodologies. For example, studies show that the size of the firm has a positive effect on its ESG ratings because they are typically able to assign more resources to disclosing information.[143] It could well be that information being reported is less impactful to the ESG rating assigned than the absence of information: the latter appears to imply that absence is regarded as bad news. It raises the question whether the same standards could be set for smaller companies. In any event, ESG Ratings do not tell the whole story, as those who do not have sufficient resources to disclose may not necessarily be performing badly, although it is difficult to argue transparency cannot be improved. Another possible bias is towards the short(er) term performance of the firm. ESG Ratings appear to be driving more short-term changes, particularly in relation to the environmental factors, in order to achieve rating improvements.[144] However, the short-term changes lack the envisaged holistic and long-term approach which is preferable.

Besides methodology used, elements covered, and possible biases, the reliability of ESG Ratings is an important factor as well. The reliability of ESG assessments has been investigated using reported scandals as unexpected events, and by studying ESG ratings the year before, during, and after the event.[145] Utz shows that ESG ratings, which include retrospective information, will deteriorate significantly during such an event.[146] This research also shows that those firms which experience a

141. Natalia Semenova & Lars G. Hassel, *On the Validity of Environmental Performance Metrics*, 132 J. BUS. ETHICS 249 (2015).

142. Esmee Veenstra & Naomi Ellemers, *ESG Indicators as Organizational Performance Goals: Do Rating Agencies Encourage a Holistic Approach?*, 12 SUSTAINABILITY 10228 (2020).

143. Samuel Drempetic et al., *The Influence of Firm Size on the ESG Score: Corporate Sustainability Ratings Under Review*, 167 J. BUS. ETHICS 333 (2020).

144. María Jesús Muñoz-Torres et al., *Can Environmental, Social, and Governance Rating Agencies Favor Business Models that Promote a More Sustainable Development?* 26 CORP. SOC. RESP. & ENV'T MGMT. 439 (2019).

145. Sebastian Utz, *Corporate Scandals and the Reliability of ESG Assessments: Evidence from an International Sample*, 13 REV. MANAGERIAL SCI. 483 (2019).

146. *Id*. at 504.

scandal seek to improve their corporate social responsibility arrangements, which leads to a swift rebound in their ESG rating.[147]

B. DIFFERENCES IN ESG WORLDWIDE

As ESG performance measurements and ratings have existed for a while now, it is possible to examine these ratings historically and per region. A worldwide study shows that ESG scores improved from 2006 to 2017.[148] It shows that larger and more profitable firms have done well, especially in countries that show strong social and economic development. However, performance in the three ESG categories appears unrelated and different. And, in contrast with the general trend, U.S. financial services firms are actually showing a decline in ESG scores.

Apart from global studies, there are also country-specific studies. For example, in Poland, ESG reporting is still relatively low.[149] It was also found that publishing ESG information improves transparency, thereby reducing investment risk and information asymmetry, and improving share price stability. A study in Italy showed that responses to ESG ratings varied widely amongst different companies.[150] It concluded that a majority of the companies improved their rating by increasing transparency and disclosure, without significantly changing the underlying ESG aspects. If ratings and transparency do not lead to such improvements, this paper challenges the notion that disclosure of non-financial information is sufficient to bring about a change by way of market efficiency. Research in Australia shows a positive response to ESG ratings, and an improvement in performance.[151] Australia's improvement manifested itself mostly in the governance aspects, rather than social and environmental.

Finally, there is the remarkable case of JP Morgan financing the break-away European Super League. Some of Europe's top football clubs planned to leave their domestic league in favor of a newly created and far more profitable European Super League, despite furious responses from their fanbases.[152] As a result, Standard Ethics, an ESG Rating Agency, decided to downgrade JP Morgan's sustainability rating for financing the

147. *Id*.

148. Fabrizio Crespi & Milena Migliavacca, *The Determinants of ESG Rating in the Financial Industry: The Same Old Story or a Different Tale?*, 12 SUSTAINABILITY 6398 (2020).

149. Teresa Czerwinska & Piotr Kazmierkiewicz, *ESG Rating in Investment Risk Analysis of Companies Listed on the Public Market in Poland,* 44 ECON. NOTES 211 (2015).

150. Ester Clementino & Richard Perkins, *How Do Companies Respond to Environmental, Social and Governance (ESG) ratings? Evidence from Italy*, J. BUS. ETHICS (2020), https://perma.cc/SB8E-MCMU.

151. Jeremy Galbreath, *ESG in Focus: The Australian Evidence*, 118 J. BUS. ETHICS 529 (2013).

152. Jasper Jolly, *JP Morgan Given Lower Sustainability Rating After Funding Failed European Super League*, GUARDIAN (Apr. 21, 2021), https://perma.cc/AN5F-ZVAL.

new league. The reasoning behind lowering the rating was that the bank provided finance in spite of significant stakeholder opposition—in this case, the stakeholders being football fans. This example, as well as examples provided previously, clearly shows regional differences and national influences, as well as non-environmental factors, having a substantial influence on the ultimate ESG Rating. This is not always helpful for the purpose of sustainable investments and combating climate change. An investor would need to know how an ESG Rating is composed and to what extent individual elements have contributed, in particular the Environmental aspects. Put simply, an improved ESG rating due to improved Governance based on increased employee board representation is now arguably less significant than an improvement in Environmental aspects due to a reduction in carbon emissions.

C. ESG Ratings and Innovative "Sustainable securities"

The discussion above examined ESG rating for firms as a whole. As discussed, in this case, the ESG disclosure of a firm has a material impact on the price of its shares or bonds generally. But there are also initiatives for new types of securities. Besides measuring how climate neutral or sustainable a corporation is as a whole, these innovative securities look only at specific assets or financial products, such as, for example, Green Bonds, used for the financing of specific "green" projects.[153] In order to get some form of standardization in this market, the International Capital Market Association ("ICMA") has set out its Green Bond Principles.[154] These are international voluntary guidelines, and mostly set out requirements for the use and management of proceeds, as well as the reporting thereon. The EU's Technical Expert Group ("TEG") Proposals provide a European Green Bond Standard[155] which would create standards and labels for green financial products. Not surprisingly, the TEG's recommendations link the standards for how the proceeds of such Green Bonds are used pursuant to the already discussed Taxonomy Regulation. As before, this would allow for increased comparability by investors and provides yet another way for promoting sustainable investments. The role of ESG Rating Agencies in this process is similar to the role of CRAs in structured finance: rather than providing bonds and complex investment products with a credit rating, they can provide green bonds with an ESG rating.

Another innovation is the creation of ESG related benchmarks. S&P Dow Jones is an example of a major financial index provider who has

153. Nathan Bishop, *Green Bond Governance and the Paris Agreement*, 27 N.Y.U. ENV'T L.J. 377 (2019).

154. ICMA, GREEN BOND PRINCIPLES: VOLUNTARY PROCESS GUIDELINES FOR ISSUING GREEN BONDS (June 2021), https://perma.cc/U4PT-FHWW.

155. *Usability Guide EU Green Bond Standard*, EU Technical Expert Group on Sustainable Finance (Mar. 2020), https://perma.cc/K38L-A299.

created, amongst others, the Dow Jones Sustainability Indexes.[156] Like other equity indexes, these track the share price of a group of companies deemed to behave in a sustainable way. However, this is not always without criticism: in 2018, for example, Friends of the Earth accused S&P Dow Jones of continuing to include Golden-Agri Resources in their Asia-Pacific sustainability index.[157] This Singapore-based firm produces palm oil and is alleged to do this in a controversial and non-sustainable way in West Africa. Another example is MSCI, who, besides offering ESG rating services, also maintains MSCI ESG indexes.[158] In short, ESG index products are in heavy demand and this industry is expected to keep growing.[159] In light of these developments, two EU climate benchmark products have been introduced by way of amending the EU Benchmark Regulation ("BMR"): the EU Climate Transition Benchmark and the EU Paris Aligned Benchmark. This legislation, which will apply to the benchmark providers, lays out both the minimum requirements for such benchmarks as well as for the associated reporting requirements. As before, the aim is to increase comparability as well as prevent any potential greenwashing.

As a final example, consider the nascent market of ESG derivatives.[160] Some of these link sustainability targets to standard derivatives contracts. For example, an interest rate swap may see reduced payments by one of the counterparties if it attains certain predefined ESG targets. Others may trigger penalty payments, to the counterparty or even to a contractually defined charitable organization, if ESG targets are not met. Other innovations link credit derivatives, which pay out in case of a default event, with ESG ratings, arguing that a high ESG rating could be positively correlated with a lower default probability. As a final example, consider derivatives such as future contracts on the aforementioned ESG index products. With financial innovation taking place at such a rapid pace, it becomes clear that the reliance on ESG data and in particular on ESG ratings will only increase further.

V. A WAY FORWARD

156. S&P Dow Jones Indices, *Core ESG*, S&P DOW JONES INDICES, https://perma.cc/2UXU-K7VS.

157. Jennifer Thompson, *Friends of the Earth Accuses Ethical Index Provider of 'Greenwashing'*, FIN. TIMES (Oct. 14, 2018).

158. MSCI, *ESG Indexes*, MSCI, https://perma.cc/X32P-DBML.

159. Attracta Mooney, *ESG Benchmark Divergence No Barrier to Investor Demand*, FIN. TIMES (May 10, 2021), https://perma.cc/KG83-ABWT.

160. *Overview of ESG-related Derivatives Products and Transactions*, INTERNATIONAL SWAP AND DERIVATIVES ASSOCIATION (ISDA), (Jan. 2021), https://perma.cc/L779-DKBE; Richard Blackburn, *ESG Derivatives: A Look at Recent Developments*, 36 BUTTERWORTHS J. INT'L BANKING & FIN. L. 482 (2021).

A. Policy Considerations

The main point of this article has been that ESG Rating Agencies will inevitably play a crucial role in the EU's Green Deal. These agencies will reduce the non-financial information asymmetry and enable a more efficient market for sustainable investment, thereby transition to a more sustainable economy. This section sets out the views of various financial regulators on the role of these agencies. The chairperson of the SEC, Mr. Jay Clayton, has warned publicly about the risks of using simple ratings to measure complex issues, such as the ESG impacts, especially in some aggregated format.[161] Mr. Clayton has asserted, "I have not seen circumstances where combining an analysis of E, S and G together, across a broad range of companies, for example with a 'rating' or 'score', particularly a single rating or score, would facilitate meaningful investment analysis that was not significantly over-inclusive and imprecise."[162] A clear example of such potential confusion is the case of Tesla, an electric car maker, scores highly on "E," but poorly on "S," workers' rights.[163] With rapidly increasing investments finding their way into ESG focused funds, the main risk is disappointing investors, not due to less aggressive returns, but because of unsatisfactory ESG records.

The SEC has followed up by publishing a Risk Alert that reviews ESG investing.[164] This study looks at investment firms offering services such as portfolio management based on ESG investing approaches, related advertising and marketing, and their associated compliance and internal oversight frameworks. As the purpose of the study is to provide guidance to firms, it highlights both a wide range of risks and good practices. For example, investment firms would not necessarily hold assets in line with their own ESG policy when measured by sub-advisers' internal scoring.[165] Advice provided to clients is not always in line with the clients' preferences on ESG: in some cases certain industry sectors (e.g. tobacco or firearms) would be prohibited by the client but included in the advice.[166] Perhaps most worrisome, advisers were found to use potentially misleading claims in regards to ESG approaches, and on some occasions advisers were lacking the necessary internal controls to safeguard such marketing.[167] By highlighting a few good practices, the SEC emphasizes the accuracy and consistency for which investors must check when engaging with

161. Flood, *supra* note 18.
162. *Id*.
163. *Id*.
164. Securities and Exchange Commission, Risk Alert Division of Examinations, The Division of Examinations' Review of ESG Investing (Apr. 9, 2021), https://perma.cc/VCR9-DZW2.
165. *Id*. at 4.
166. *Id*.
167. *Id*. at 4–5.

investment managers.[168] At the same time, these firms are advised to get their own internal controls and compliance in order. The central theme here is to ensure the integrity of any information to the market.

In his speech celebrating the ten year anniversary of the European Securities and Markets Authority ("ESMA"), the chairperson at the time, Mr. Steven Maijoor, noted "ESG-washing" as one of the main challenges in financial markets.[169] Two months prior to this speech, ESMA had sent a letter to the European Commission, outlining its views on the key challenges for sustainable finance.[170] The main issue raised is the currently "unregulated and unsupervised nature for ESG ratings and ESG assessment tools" in light of the rapidly growing demand for these products.[171] In its letter, ESMA further highlights the importance of both their quality and reliability.[172] However, ESMA also noted the difficulties in designing any regulation for the ESG rating industry.[173] In particular, it is noted that the market in both products and rating providers is still developing, and that ESG rating assessments are complex.[174] Nonetheless, the ESMA letter contains several recommendations.[175] For example, any ESG ratings definition should be made in line with the Taxonomy Regulation.[176] Furthermore, any firm issuing ratings should be authorized and supervised by a public authority (regulator), setting out conflicts of interest-, organizational-, and transparency requirements.[177] Besides these requirements for the firms, there should be requirements for the products (e.g., ratings).[178] These could be less prescriptive as for credit ratings, but should guarantee these are up-to-date, robust, reliable, and so on.[179] Recognizing that this could pose barriers of entry for smaller newcomers, ESMA suggests these requirements are designed in a proportionate way.[180]

Other financial services regulators are catching up as well. The new Chief Executive Officer of the UK's Financial Conducts Authority

168. *Id*. at 5–7.

169. Steven Maijoor, *Back to the Future: A Look into ESMA's Next Decade,* EUR. SECS. & MKTS. AUTH. (Mar. 23, 2021), https://perma.cc/4UTX-LMTC.

170. Letter from European Securities and Markets Authority to Mairead McGuinness, Commissioner, Financial services, financial stability and Capital Markets Union, European Securities and Markets Authority (Jan. 28, 2021), https://perma.cc/TQD3-PG4B.

171. *Id*.

172. *Id*.

173. *Id*.

174. ESMA letter to McGuinness, *supra* note 170

175. *Id*.

176. *Id*.

177. *Id*.

178. *Id*.

179. *Id*.

180. *Id*.

(“FCA”) set out the requirements for premium listed companies to report their business’s effects from climate change.[181] Shortly after, the FCA’s Director of Strategy reiterated the UK’s commitment to “matching the ambition of objectives” of the EU’s green policies.[182] His main point was that consumers must be able to trust the information and sustainable investment products.[183] A key issue is that non-financial disclosures are often incomplete and difficult to compare. It is worth noting the UK government has mandated the FCA to include reaching a net-zero economy in their supervision of the financial system.[184] The French Autorité des Marchés Financiers (“AMF”) and the Dutch Autoriteit Financiële Markten (“AFM”), other European regulators, have published a joint position paper setting out their observations and priorities.[185] In short, they note the demand for ESG data and services is growing, and with it the necessity for increased reliability of this data and services. The chairperson of the AMF, Mr. Robert Ophèle, has highlighted that “regulators cannot accept that financial products are sold in their country which despite [being labelled as ESG] seem profoundly different [from other ESG funds].”[186] The proposed solution is to introduce a regulatory framework for such ESG service providers, including ESG Rating Agencies, which could also aid in increasing transparency and managing any conflicts of interests.[187]

B. Recommendations for the Supervision of ESG Rating Agencies

The issues raised by the various regulators as well as those in this paper are serious, especially in light of the role ESG Rating Agencies will likely play in reallocating investments as envisaged by a part of the EU’s climate policy. Based on the observations set out previously, one can

181. Nikhil Rathi, *Green Horizon Summit: Rising to the Climate Challenge*, FIN. CONDUCT AUTH. (Nov. 9, 2020), https://perma.cc/Y3JZ-3AD5.

182. Richard Monks, *Building Trust in Sustainable Investments*, FIN. CONDUCT AUTH. (Oct. 21, 2020), https://perma.cc/UM9U-4GN4.

183. *Id*.

184. Letter from HM Treasury to Nikhil Rathi, Chief Executive of Financial Conduct Authority, *Recommendations for the Financial Conduct Authority* (Mar. 23, 2021), https://perma.cc/Z7E4-ZL38.

185. Authority for the Financial Market, *French and Dutch financial market authorities call for a European regulation of ESG data, ratings, and related services*, AUTH. FOR FIN. MKT. https://perma.cc/G3ZU-8ZTH; AUTH. FOR THE FIN. MKT., POSITION PAPER: CALL FOR A EUROPEAN REGULATION FOR THE PROVISION OF ESG DATA, RATINGS, AND RELATED SERVICES (Dec. 15, 2020).

186. Siobhan Riding, *EU ‘Urgently’ Needs Common ESG Rules, Says French Watchdog*, FIN. TIMES (Nov. 25, 2019); Robert Ophèle, Speech at Les Entretiens de l’AMF 2019: Sustainable Finance, a fashion trend or a springboard for tomorrow’s economy (Nov. 14, 2019), https://perma.cc/2GBQ-4K8V.

187. AFM & AMF, *supra* note 185; Robert Ophèle, AMF Chairman, Speech at the FESE Convention 2021 (June 1, 2021), https://perma.cc/6D9P-9PM5.

foresee a few ways forward. With ongoing consolidation in the sector, competition reduces, solidifying the position of a few large players.[188] Regulators note that methodologies differ between rating agencies, include different factors, and generally lack transparency.[189] It would be wise to heed the lessons learned from recent history with CRAs, and some form of regulatory oversight appears necessary. The most likely candidate for acting as supervisory authority within the EU would be ESMA, the objective of which is inter alia to ensure the integrity, transparency, efficiency, functioning of financial markets, and enhancing investor protection.[190] Moreover, ESMA, as supervisor of European CRAs, already possesses experience and expertise in the supervision of rating agencies.[191]

There are a few areas which may serve as a starting point for such oversight. First, there is the potential for conflict of interests.[192] The ESG data and rating providers are often part of a larger company, which may provide other services to those obtaining, such as an ESG rating. Another issue also becomes apparent for CRAs, a conflict of interest. There is a clear conflict if there is a link between who is paying the rating agency, whether for this rating or other services, and those obtaining the rating for themselves or one of their products. Any such conflict should be noted, managed, and disclosed. Second, there is governance and internal control.[193] These aspects could include, for example, managing the methodology, reviewing its adequacy, updating how sufficient quality standards for input data are maintained, etc. It is also clear that the amount of ESG data available is increasing so rapidly that managing this raw data is critical. Furthermore, it is vital to set out how to deal with absences of data (e.g., by way of estimations). In the case of CRAs, it is clear from the examples of Enron and the Global Financial Crisis that ratings remained relatively high until it was already widely known that default was

188. Avetisyan & Hockerts, *supra* note 134.

189. Letter from ESMA to Commissioner Mairead McGuinness, *supra* note 170, at 2 "the lack of a legally binding definition and comparability among providers of ESG ratings or legal requirements to ensure transparency of underlying methodologies of such ratings"; AFM & AMF, *supra* note 185, at 2, "In particular, the lack of transparency concerning [Sustainability-related service providers'] methodologies as well as the role of estimates make it difficult to correctly appreciate what the ratings reflect.".

190. Article 1 (5) Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC, OFF. J. E.U. 331/84 (Dec. 15, 2010), https://perma.cc/XD8W-S3W6.

191. *Credit Rating Agencies*, EUR. SECS. & MKTS. AUTH., https://perma.cc/Y377-C232.

192. *See also* ESMA letter to McGuinness, *supra* note 170, at 3; AFM & AMF, *supra* note 185, at 5.

193. *See also* ESMA letter to McGuinness, *supra* note 170, at 3; AFM & AMF, *supra* note 185, at 9.

imminent. Such staleness must be prevented. Note that whilst this array for potential supervision addresses the governance and controls around rating methodology, it is not proposed to regulate the methodology in itself, which would be the expertise and value added provided by the individual rating agencies.

Whilst the methodology itself may not need to be the subject of prescriptive regulation, more transparency about the rating methodology is certainly needed.[194] It is clear from the example set out previously that different rating agencies may come to very different ESG ratings for the same firm. Reasons include a different weighting of the ESG factors, the approach taken on the non-disclosure of non-financial information, or the activities in certain countries or regions. Transparency around such methodology used would improve the comparability and usability of assigned ratings, as well as allowing the investors to make a better choice of which ESG rating to use as part of their investment decisions, without actually prescribing how the rating determination should be performed. In short, if an investor wants to make investment decisions based on the climate impact, his preference is likely to be for an ESG rating where the "E" component plays a far greater role than the "G" – this should be obvious from the transparency provided by the ESG Rating Agency with regards to the methodology used. An interesting proposal in this context is the introduction of specific "corporate climate ratings," rather than the broader ESG ratings, as these could isolate the firm's impact on climate change.[195]

VI. CONCLUSION

The concepts behind the European Green Policy appear straightforward: make sure that the market receives all the non-financial information necessary to make the right investment decisions in an accurate and comparable fashion, and, put simply, it will start allocating more resources towards sustainable companies and projects. Whilst this approach is not without its critics, this paper focusses on the contribution of information verifies in making the EUs plan work. Indeed, to make this Green Policy a reality, many steps are needed along the way. One of these steps identified in this paper is that all the newly disclosed non-financial information will be simplified and made more comparable by way of ESG ratings, in a way that is comparable to the well-known credit ratings in the structured finance industry. This paper sought to offer some insights into how ESG ratings and rating agencies work, and what potential trouble may

194. *See also* ESMA letter to McGuinness, *supra* note 170, at 3; AFM & AMF, *supra* note 185, at 4.

195. Felix Mormann & Milica Mormann, *The Case for Corporate Climate Ratings*, 53 ARIZ. ST. L.J. 1209 (2021).

be found on the path ahead. There are several question marks, some of which are fundamental to the ability with which ESG Rating Agencies may perform their role in reducing information asymmetry between issuers and investors. For example, questions around the different methodologies or factors included may reduce the accuracy, comparability, and even the credibility of such ratings.

Of course, there are alternatives when the non-financial information provided, or its derived ESG ratings, ultimately prove unsatisfactory. Further research may examine issues of liability for ESG rating agencies in case they get it completely wrong, although as with Credit Rating Agencies it appears this is still a difficult path to go down.[196] Another angle is to what extent investors may rely on forward-looking ESG statements made by investees and issuers, and to what extent such statements would be material disclosures for the reasonable investor – again, this road appears complex, as well.[197] The preferred approach must minimize the need for such private law action and litigation, even though an effective stick is a helpful backup plan.

Fortunately, there is an obvious candidate from which lessons can be drawn to improve the integrity, quality, and comparability of information available: the Credit Ratings Agencies. Not surprisingly, policy makers are seeking ways to manage similar issues, such as any conflicts of interest and maintaining adequate governance and controls around the rating methodology. This paper has sought to outline the essential role ESG Rating Agencies will likely play in enabling the shift in allocation of investments towards sustainable companies and projects as envisaged by the EU's climate policy. It is recommended that such lessons learned, both positive and negative, are applied and implemented to this rating industry to ensure it is up to this task.[198]

196. Frank Partnoy, *What's (Still) Wrong with Credit Ratings*, 92 WASH. L. REV. 1407 (2017), forthcoming, https://perma.cc/FA7K-KDNK (in particular the third issue discussed therein); Theresa Nagy, *Credit Rating Agencies and the First Amendment: Applying Constitutional Journalistic Protections to Subprime Mortgage Litigation*, 94 MINN. L. REV. 140 (2009); D.J. VERHEIJ, CREDIT RATING AGENCY LIABILITY IN EUROPE: RATING THE COMBINATION OF EU AND NATIONAL LAW IN RRGHTS OF REDRESS (2021) (Ph.D. thesis).

197. Robert K. Cowan, *Time for Plan(et) B? Why Securities Litigation is a Misguided Attempt at Regulating Climate Change*, 33 GEO. ENV'T L. REV. 1 (2021); Scott Novak, *The Role of Courts in Remedying Climate Chaos: Transcending Judicial Nihilism and Taking Survival Seriously*, 32 GEO. ENV'T L. REV. 743 (2020); Aisha Saad & Diane Strauss, *The New 'Reasonable Investor' and Changing Frontiers of Materiality: Increasing Investor Reliance on ESG Disclosures and Implications for Securities Litigation*, 17 BERKELEY BUS. L.J. 397 (2020); Connor Kuratek et al., *Legal Liability for ESG Disclosures*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 3, 2020), https://perma.cc/22WA-257G.

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