SQUIRE PATTON BOGGS

Lack of Uniformity in ESG Ratings System Poses Risks, Opportunities

Bloomberg Law

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There is a lack of uniformity in ESG ratings systems, which negatively impacts investors and consumers, according to Squire Patton Boggs attorneys and the general counsel for Fermata Energy. They explore the different standards in ESG ratings, pros and cons of each, the movement toward uniformity, and offer recommendations for how public and private companies can approach reporting obligations.

If the hypothesis of institutional investors such as BlackRock, State Street, Vanguard and others are correct in predicting that capital increasingly will be deployed to the most sustainable companies committed to environmental, social, and governance (ESG) principles, then the question for CEOs and corporate boards is how should they disclose their performance on these issues given the lack of uniformity across ratings systems?

The need for both public and private companies to have access to reliable and auditable ESG data has never been greater. Growing evidence reaffirms that companies with higher ESG ratings outperform their competitors, obtain better credit ratings, and present a lower risk profile.

One of the biggest challenges at the moment, however, has been the lack of uniformity across the different ratings systems, which leaves investors and consumers alike to grapple with the reliability of the ratings systems. The ratings environment is by and large unregulated—there are tens, if not hundreds, of different frameworks from a myriad of providers.

The leading US credit ratings companies have invested billions in ESG capabilities, and the Securities and Exchange Commission and the European Securities and Markets Authority (ESMA) have recently highlighted the conflicts of interest risks arising from ESG-related services and credit ratings. The lack of regulation increases the risk of such conflicts, including the failure to "make adequate disclosure regarding the use of ESG factors applied in rating actions, or maintain effective internal controls involving the use in ratings of ESG-related data from affiliates or unaffiliated third parties."

The problem is further exacerbated by the lack of transparency and the scarcity of quality verification underlying ESG data.

Balancing the Uncertainty With Compliance

As ESG issues continue to rise as an agenda priority for key stakeholders, including investors, customers, and regulators, companies that desire to remain competitive have no choice but to balance the uncertainty with compliance. This uncertainty creates opportunities for differentiation and competition, but companies must also exercise caution to avoid costly mistakes, shareholder litigation, and regulatory enforcement proceedings.

At a minimum, a company's ESG measurement protocol must confirm, verify, and disclose the requested data based on the reporting guidelines of the framework it chooses. And once a company discloses ESG data, it must be prepared to substantiate it, as it would any financial disclosure.

Instituting the same internal processes for reporting ESG disclosures, such as independent auditing, is a helpful mitigation step to ensure consistency and identify potential gaps that might create liability.

Choosing a Framework

Companies are encouraged to identify clear and quantifiable metrics that enhance executive accountability and investor confidence. As a result, ESG priorities must be thoughtfully integrated within the culture and aligned with the company's corporate mission.

This means companies must map their risk profile, identify specific areas of focus, and consider operational impacts.

A number of organizations identify and rank corporate ESG programs, including but not limited to the following:

- Global Reporting Initiative (GRI);
- Sustainability Accounting Standards Board (SASB);
- Global Initiative for Sustainability Rankings (GISR);
- Morningstar Sustainalytics; and
- MSCI

The relevant criteria for benchmarking in these frameworks and others generally include labor practices, climate change impact, natural resource scarcity, supply chain management, political contributions, board composition, and DEI.

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Moving Toward Alignment

One of the most important outcomes at the recent annual UN climate change conference, COP26, was the introduction of an international ESG standard-setting body—the International Sustainability Standards Board (ISSB)—which represents an important step toward ESG ratings alignment.

The ISSB's role is to establish a global baseline for ESG disclosures, and to thus aid in establishing uniformity across the key ratings providers so that stakeholders may be better able to evaluate and compare companies to their peers. This move toward consolidation is further supported by the recent alignment between the GRI and the International Financial Reporting Standards (IFRS), creators of the ISSB.

These efforts, coupled with the recent creation of the ISSB's cross-jurisdictional working group, are welcomed attempts at harmonizing the patchwork of standards into a globally-accepted ESG reporting framework.

Enhancing the Reliability of ESG Data

The cornerstone of ESG reporting is that the data must be reliable and verifiable. The reporting of false or misleading data could lead to litigation, regulatory sanctions, and reputational damage.

In practice this means that the level of scrutiny of ESG data is virtually analogous to that which is applied to financial disclosures. This is especially the case in an environment in which positive ESG credentials are increasingly associated with a premium in value and reputation.

The EU Taxonomy Regulation, which is already in force, provides a good illustration of the level of detail and verification that is required to comply with such reporting obligations. It is reasonable to expect that the SEC requirements will follow a similar approach.

Disclosing accurate and measurable ESG disclosures should always link to value and impact, and companies should find the right metrics to tell the story. When investors do not receive ESG data directly from a company, they will look to third-party sources for context of what the company should report, but has not disclosed.

It is therefore in the company's best interest to set the tone and provide verifiable disclosures that communicate the company's ESG agenda. This will enable a company to control the narrative of its disclosures, which is key in defining ESG value.

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Author Information

Petrina Hall McDaniel is litigation partner and co-chair of the Class Action Practice at Squire Patton Boggs, litigating bet-the-company cases and class actions. She defends clients in high-stakes controversies involving consumer class actions, unfair business practices, fraud cases, and regulatory investigations.

Pamela Rosen is general counsel of Fermata Energy and a lecturer at the University of Virginia Law School. She previously served as GC at Formation Capital.

Jonathan Chibafa is a director at Squire Patton Boggs, specializing in investigations, financial crime, ESG compliance and supply chain risk management. Jonathan has extensive industry experience, including senior compliance roles at Tesco Plc and GlaxoSmithKline Plc.

Thomas Hancocks is an ESG manager at Squire Patton Boggs. His background is in academia, where he has taught on a wide range of ESG and business ethics topics at the University of Leeds.

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