FIXING ESG: ARE MANDATORY ESG DISCLOSURES THE SOLUTION TO MISLEADING ESG RATINGS?

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ABSTRACT

This Note provides an overview of the debate around the current state of ESG disclosure practices, and the perceived need for the SEC to establish a system of mandatory ESG disclosures. Part I explores the inherent difficulty of defining ESG, the problematic nature of quantifying and measuring ESG factors, and the tools currently being used by market-leading ratings firms and investment vehicles. In particular, this part addresses the inconsistencies of ESG self-reporting, the influence of this practice on the ensuing ratings, and the potential for investors to be misled as a result.

Part II of the Note explores the possible consequences of a system of mandatory ESG disclosure, weighing the main arguments in favor and against the establishment of a regulation that mandates ESG disclosures. Drawing from a 2018 SEC submission by the law professors Cynthia A. Williams and Jill E. Fisch, Part II explores the arguments around general market efficiency, U.S. capital markets competitiveness, and the ultimate goal of giving investors access to better, more consistent, and fairly comparable information, while keeping the costs of increased reporting outweighed by the benefits of it.

Part III closes by describing current proposals in favor mandating ESG disclosures. In particular, the Note presents the proposal by

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Professor Fisch, under which the SEC may mandate a discussion on ESG, while allowing companies the flexibility to decide what factors to address and how to address them in view of materiality considerations for their specific industries.

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INTRODUCTION

The COVID-19 pandemic and ensuing economic crisis are bringing increased attention to the already hot topic of Environmental, Social, and Governance ("ESG") investing.[1] As ESG disclosure initiatives and metrics have gained popularity in the functioning of capital markets worldwide, the United States faces a regulatory dilemma.[2] Should the U.S. Congress or the U.S. Securities and Exchange Commission (SEC) make broad ESG disclosures mandatory, or will specific climate change-related disclosure guidelines under Regulation S-K continue to be the norm?[3] The argument for mandating some form of broad ESG disclosure is manifold, but centers chiefly on the increasingly pervasive reality of ESG-influenced capital markets, as well as the need to promote accuracy and market-efficient standardization as an alternative

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1. *See, e.g.*, Laurence Fink, *Larry Fink's Chairman's Letter to Shareholders*, BLACKROCK (Mar. 29, 2020), https://www.blackrock.com/corporate/investor-relations/larry-fink-chairmans-letter [https://perma.cc/5NTG-5NGZ] ("[T]he pandemic we're experiencing now highlights the fragility of the globalized world and the value of sustainable portfolios. We've seen sustainable portfolios deliver stronger performance than traditional portfolios during this period."); Kristin Broughton & Maitane Sardon, *Coronavirus Pandemic Could Elevate ESG Factors*, WALL ST. J. (Mar. 25, 2020), https://www.wsj.com/amp/articles/coronavirus-pandemic-could-elevate-esg-factors-11585167518 [https://perma.cc/N4EJ-EKL5]; *see also Coronavirus Pandemic Will Drive Responsible (ESG) Investing "Skywards*,*"* MONDOVISIONE (Mar. 27, 2020), https://mondovisione.com/media-and-resources/news/coronavirus-pandemic-will-drive-responsible-esg-investing-skywards-nigel-gr [https://perma.cc/AC8X-TCQF] [hereinafter *Driving ESG Skywards*]; Nick Marsh, *The $30 Trillion Trend That's Bigger Than the Entire U.S. Stock Market*, OILPRICE (May 05, 2020), https://oilprice.com/Energy/Energy-General/The-30-Trillion-Trend-Thats-Bigger-Than-The-Entire-US-Stock-Market.html [https://perma.cc/M72B-23M8] ("While COVID-19 is trouncing traditional investment themes, sustainable investing—already a $30-trillion mega trend—is calling all the shots.").

2. *See* CYNTHIA A. WILLIAMS & JILL E. FISCH, REQUEST FOR RULEMAKING ON ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) DISCLOSURE 1, 8 (Oct. 1, 2018), https://www.sec.gov/rules/petitions/2018/petn4-730.pdf [https://perma.cc/TW4J-YFEG].

3. *See* Apostolos Gkoutzinis et al., *The SEC Adopts Amendments to Modernize and Enhance MD&A and Other Financial Disclosures*, MILBANK 3 (Nov. 30, 2020), https://www.milbank.com/images/content/1/4/v4/144237/SEC-Adopts-Amendments-to-Modernize-and-Enhance-MDA.pdf [https://perma.cc/8CL5-7TCM] ("[T]he SEC stated that it has declined to add any requirements relating to [ESG] and sustainability matters, citing its principles-based approach to the MD&A . . . in line with the SEC's past guidance set forth in the Commission Guidance Regarding Disclosure Related to Climate Change.").

to the currently costly and unreliable market-driven self-regulated ESG ratings system.[4]

Those against mandatory disclosure indicate skepticism that it will be able to fix the underlying difficulties that, for example, make current ESG ratings unreliable and inefficient. Instead, they assert that mandatory disclosure would have the unintended effect of increasing costs of doing business across the board, and even of devaluing the significance of any material industry-specific and company-specific required disclosures.[5] They further assert that mandatory disclosure will further increase the prospect of costly plaintiff-driven securities fraud litigation.

This paper provides an overview of this debate. Part I of the paper describes the problematic nature of ESG tools currently being used by the market-dominant investment vehicles. Part II weighs the main arguments in favor and against mandatory disclosure regulation as a way to fix these problems. And Part III describes current proposals in favor of an incremental mandatory disclosure system.[6]

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4. For recent explanations of the policy dilemma, see Peter Rasmussen, *Analysis: Will Investors Get the ESG Data They Want in 2021?*, BLOOMBERG LAW (Nov. 16, 2020), https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-will-investors-get-the-esg-data-they-want-in-2021 [https://perma.cc/WYF7-S9CZ] ("A January SEC interpretive release, addressing the disclosure of key performance indicators and metrics in MD&A, stated in a footnote that the climate change guidance does apply to ESG metrics such as the employee turnover rate, workforce factors, total energy consumed, and data security measures."). *See also* Stacey H. Mitchell et al., *Biden's "Money Cop" to Shine a Light on ESG Disclosure as SEC Requirements—and a Potential Universal Reporting Framework—Appear Imminent*, AKIN GUMP (Feb. 1, 2021), https://www.akingump.com/a/web/sPBE72pXuuZC6oQirkB3iA/2kqc2e/bidens-money-cop-to-shine-a-light-on-esg-disclosure-as-sec-requirements.pdf [https://perma.cc/65TH-H4JX] ("With respect to the E category, such requirements would not require legislation and could take the form of an expansion to the Commission's 2010 [Guidance] or, more likely, a new rulemaking (e.g., another 'modernization' of Regulation S-K or an entirely new rule altogether).").

5. *See infra* Part II.

6. *See generally* Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L.J. 923 (2019).

I. THE PROBLEM WITH CURRENT VOLUNTARY ESG DISCLOSURES AND MARKET-DRIVEN RATINGS

There are several problems with the current approach to making ESG disclosures. This section lays out the inherent problems in defining ESG; how inconsistently defined ESG factors lead to problematic ESG ratings; and the problems caused by the current framework of voluntary disclosures and inconsistent methodologies.

A. DEFINING ESG

The first difficulty presented by the current role of ESG factors in capital markets and corporate governance is defining which ones they are and what exactly they are attempting to indicate or measure.[7] Broadly speaking, in addition to corporate governance (which stands for the "G" in ESG), ESG factors typically include a wide range of issues that are not part of traditional financial analysis, but may still have investment relevance or materiality.[8] These factors may cover discrete aspects such as "how corporations respond to climate change," how well they manage their water use, whether their supply chains fall short of international human rights standards, how they treat their labor force, and whether they have a corporate culture that fosters innovation.[9]

Very importantly, most information that is currently factored into ESG analysis largely comes from companies' voluntary disclosures or survey responses to rating firms' questionnaires.[10] The market for ESG definitions and standards is heavily influenced by four market-leading rating companies that compete among themselves to provide ESG metrics: MSCI ESG, Sustainalytics, RepRisk, and ISS.[11] Together, these

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7. *See generally* TIMOTHY M. DOYLE, AM. COUNCIL FOR CAP. FORMATION, RATINGS THAT DON'T RATE: THE SUBJECTIVE WORLD OF ESG RATINGS AGENCIES 1 (2018).

8. *See* Georg Kell, *The Remarkable Rise of ESG*, FORBES (July 11, 2018), https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg [https://perma.cc/J7DW-ARPX].

9. *Id.* ("The term ESG was first coined in 2005 in a landmark study entitled 'Who Cares Wins.' Today, ESG investing is estimated at over $20 trillion in AUM or around a quarter of all professionally managed assets around the world.").

10. DOYLE, *supra* note 7, at 13.

11. *See id.* at 7; *see also* Billy Nauman, *Credit Rating Agencies Join Battle for ESG Supremacy*, FIN. TIMES (Sept. 16, 2019), https://www.ft.com/content/59f60306-d671-11e9-8367-807ebd53ab77 [https://perma.cc/42FU-X8JZ] ("Now Moody's and S&P Global, two of the big three credit rating agencies, are elbowing their way in, offering

companies rate over 100,000 companies across dozens of industries and sectors and also rate more than 400,000 equity and fixed-income securities.[12] They are said to heavily influence the market for ESG ratings because they are consistently chosen by the world's leading investment vehicles, namely BlackRock, State Street Global Advisors, and others.[13]

Not only the methodology, but also the quantity and quality of data factors that each of these four firms employ, are disparate. As analyzed by Timothy M. Doyle from the American Council for Capital Formation (ACCF) in a groundbreaking 2018 report:

> [E]ach rating agency has a customized scoring method which evaluates different non-financial metrics and frequently disagree about the components of ESG . . . . Core ESG metrics vary from as few as 12 performance indicators to as many as 1,000 for other agencies.[14]

MSCI, for example, "evaluates 37 key ESG issues divided into three pillars (environmental, social, and governance) and ten themes (climate change, natural resources, pollution & waste, environmental opportunities, human capital, product liability, stakeholder opposition, social opportunities, corporate governance, and corporate behavior)."[15] Alternatively, Sustainalytics examines a minimum of 70 ESG indicators in each industry, and breaks them down into "three distinct dimensions: preparedness, disclosure, and performance."[16]

RepRisk, on the other hand, intertwines ESG issues—including environment, community relations, employee relations, and corporate governance—with the Ten Principles of the UN Global Compact.[17] RepRisk also measures ESG risk exposure using twenty-eight ESG

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separate ESG scores on companies in addition to their traditional assessments of creditworthiness.").

12. DOYLE, *supra* note 7, at 7–8.

13. *Id.* at 7.

14. *Id.* at 8; *see also* Timothy Doyle, *The Big Problem With "Environmental, Social and Governance" Investment Ratings? They're Subjective*, INVS. BUS. DAILY (Aug. 9, 2018), https://www.investors.com/politics/commentary/the-big-problem-with-environmental-social-and-governance-investment-ratings-theyre-subjective [https://perma.cc/NT4R-24JN].

15. DOYLE, *supra* note 7, at 8.

16. *Id.*

17. *Id.*

issues and forty-five "hot topics."[18] Finally, the ISS E&S Quality Score evaluates more than 380 factors, with "at least 240 for each industry group, divided into environmental and social factors . . . includ[ing] management of environmental risks and opportunities, human rights, waste and toxicity, and product safety, quality, and brand."[19] These distinctive approaches may still provide useful broad signals to the market, but they lead to significant differences in results, and this, as discussed below, undermines the quality of information the market is relying on when making sustainable investment decisions.[20]

Compounding the problem, ESG rating agencies do not fully disclose their methodologies or the material impact of selected indicators, likely as a result of overprotectiveness of their proprietary methodologies.[21] This, in turn, leads to an overall lack of transparency over ratings and the inexistence of rating firm-prompted agreements on best practices.[22]

B. CURRENT USE OF INCONSISTENTLY DEFINED ESG FACTORS

ESG factors are used primarily in three ways: traditional investing, sustainable investing, and investment stewardship.[23] ESG integration in traditional investing consists of the introduction of ESG factors into traditional financial analysis to account for risks that may diminish a company's long-term valuation; for instance, regulatory action due to environmental violations.[24]

Sustainable investing is the "explicit incorporation of ESG objectives into investment products and strategies," including maximizing exposure to companies with high ESG ratings to increase a fund's average ESG score.[25] More narrowly, it can mean focusing on

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18. *Id.*
19. *Id.*
20. *See infra* Section I.C.
21. *See* DOYLE, *supra* note 7, at 8 (quoting Michael Sadowski et al., *Rate the Raters Phase Three Uncovering Best Practices, SustainAbility* (Feb. 2011)).
22. Sakis Kotsantonis & George Serafeim, *Four Things No One Will Tell You About ESG Data*, 31 J. APPLIED CORP. FIN. 50, 58 (2019).
23. Barbara Novick et al., *Exploring ESG: A Practitioner's Perspective*, BLACKROCK 1, 2 (2016), https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-exploring-esg-a-practitioners-perspective-june-2016.pdf [https://perma.cc/592G-8T4S].
24. *See id.*
25. *Id.*

companies with low carbon emissions, or screening out companies with significant labor violations.[26]

Finally, investment stewardship is a synonym for corporate governance.[27] It typically involves the leading proxy advisory firms engaging with companies as shareholders in an attempt to enhance the value of investments, or, increasingly, promote what they consider to be the right public policy.[28] This takes place through dialogue with officers and proxy voting "to build a mutual understanding of the material risks facing companies and the expectations of management to mitigate these risks . . . and to encourag[e] sustainable financial performance over the long-term."[29]

Considering that asset management leaders like BlackRock,[30] Vanguard Asset Management,[31] Charles Schwab,[32] State Street Global

26. *Id.*

27. *Id.*

28. *Id.* In practice, this means that shareholder proxy leading firms, such as Institutional Shareholder Services (ISS) and Glass, Lewis & Co. "will make voting recommendations based on ESG positions taken by a company." Dennis T. Whalen, *It's Time to Reassess ESG and Sustainability Reporting*, NACD BOARDTALK (Oct. 28, 2019), https://blog.nacdonline.org/posts/reassess-sustainability-reporting [https://perma.cc/6FMS-QLEW]. *But cf.* Neil Whoriskey, *The New Civil Code: ISS and Glass Lewis as Lawmakers*, CLS BLUE SKY BLOG (July 28, 2020), https://clsbluesky.law.columbia.edu/2020/07/28/cleary-gottlieb-discusses-the-new-civil-code-of-iss-and-glass-lewis [https://perma.cc/J66W-N384] ("ISS and Glass Lewis have arrogated to themselves the power to make law, promulgating a civil code of astounding breadth and detail . . . and, increasingly, ESG policies ranging from animal welfare to climate change, diversity, data security and political activities.").

29. Novick et al., *supra* note 23. For examples of investments of the second and third type, see Amin Rajan, *Enlightened ESG Investors Engage, But Retain Right to Divest*, FIN. TIMES (Dec. 9, 2019), https://www.ft.com/content/3b10c36c-eb80-4971-aa74-10a8079fc3e7 [https://perma.cc/PU9V-QUP7]. *See also* Michelle Scrimgeour, *Index Investors Should Not Be Passive Owners When It Comes To ESG*, FIN. TIMES (Dec. 12, 2019), https://amp-ft-com.cdn.ampproject.org/c/s/amp.ft.com/content/210a6c79-2be4-47f0-a99c-aa4b821d0330 [https://perma.cc/E97Z-JCJK].

30. Novick et al., *supra* note 23.

31. *See generally ESG investing: Discover funds that reflect what matters most to you*, VANGUARD, https://investor.vanguard.com/investing/esg/ [https://perma.cc/8C6C-4XFG] (last visited Aug. 20, 2021).

32. *Socially Responsible ETFs*, CHARLES SCHWAB, https://www.schwab.com/etfs/types/socially-responsible-etfs [https://perma.cc/V8NP-SLB4] (last visited Aug. 20, 2021).

Advisors,[33] Fidelity Investments,[34] and BNY Mellon Investment Management[35] each pursue a combination of these three forms of ESG investing and corporate governance advocacy, their actions or failures to act may significantly shape the functioning of both capital markets and corporate boardrooms.[36]

Over the last 25 years, in addition to the market-dominating rating firms, over 100 ESG standard-setting initiatives have emerged, causing "option overload" for companies.[37] These include the Sustainability Accounting Standards Board (SASB) and the Climate Disclosure Standards Board (CDSB), which have jointly created the influential[38] Task Force on Climate-Related Financial Disclosure (TCFD), as well as the Global Reporting Initiative (GRI) and the Carbon Disclosure Project (CDP), among others.[39] These initiatives, while well-intentioned, contribute to poor market-wide communication and lack of transparency.[40]

Despite efforts at streamlining disclosures,[41] the overcrowding of initiatives continues to make the market for suggested methods and

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33. *Our ESG Solutions*, STATE STREET, http://www.statestreet.com/solutions/by-capability/esg.html [https://perma.cc/24DD-B6DK] (last visited Aug. 20, 2021).

34. *Fidelity U.S. Sustainable Index Fund*, FIDELITY, https://fundresearch.fidelity.com/mutual-funds/summary/31635V398 [https://perma.cc/W4V9-85GM] (last visited Aug. 20, 2021).

35. *ESG Analytics*, BNY MELLON, https://www.bnymellon.com/us/en/what-we-do/investment-services/asset-servicing/esg-analytics.jsp [https://perma.cc/8XFF-BAPX] (last visited Aug. 20, 2021).

36. Edward Helmore, *Wall Street Investment Giants Voting Against Key Climate Resolutions*, GUARDIAN (Sept. 19, 2019), https://www.theguardian.com/environment/2019/sep/17/wall-street-asset-management-climate-change-blackrock-vanguard [https://perma.cc/N9BA-YE63].

37. Whalen, *supra* note 28; *see* WILLIAMS & FISCH, *supra* note 2, at 9 ("Over the last twenty-five years, voluntary disclosure of ESG information, and voluntary frameworks for that disclosure, have proliferated to meet the demands for information from investors, consumers, and civil society.").

38. *Id.* at 12–14.

39. Whalen, *supra* note 28.

40. WORLD ECON. F., SEEKING RETURN ON ESG: ADVANCING THE REPORTING ECOSYSTEM TO UNLOCK IMPACT FOR BUSINESS AND SOCIETY 1, 18 (2019), http://www3.weforum.org/docs/WEF_ESG_Report_digital_pages.pdf [https://perma.cc/9VG4-5D42].

41. NASDAQ, ESG REPORTING GUIDE 2.0: A SUPPORT RESOURCE FOR COMPANIES 1, 13 (2019) ("Divergent metrics have been streamlined, as have divergent ESG reporting frameworks . . . Nasdaq even narrowed the list of 33 ESG metrics in the previous

purposes for ESG disclosures confusing for investors.[42] This inconsistency, combined with the powerful moral rhetoric behind ESG advocacy, has led SEC commissioner Hester M. Peirce to liken ESG ratings to "scarlet letter[s] . . . we see labeling based on incomplete information, public shaming, and shunning wrapped in moral rhetoric preached with cold-hearted, self-righteous oblivion to the consequences, which ultimately fall on real people."[43]

C. Practical Problems of Voluntary Disclosures and Inconsistent Methodologies

The fact that ESG ratings are driven largely by inconsistent data providers—typically rating firms—creates practical problems for the operation of market actors, including investors and issuers, all of which affect the integrity and efficiency of global capital markets.

1. Inconsistent Methodology Leads to Different Data Being Sought From the Same Company Leading to Different Results

The lack of standardization among ratings firms—or market data providers—can be confusing for companies and misleading for capital market actors as company ESG scores frequently vary across rating firms.[44]

Research conducted by Florian Berg of the MIT Sloan School of Management, shows ESG ratings from different sources are aligned in only about 6 out of 10 cases, compared to creditworthiness ratings, which match 99% of the time.[45] Similarly, Doyle's research for the

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version to just 30 in this one . . . to focus more effort on . . . the most . . . achievable ones.").

42. Williams & Fisch, *supra* note 2, at 9–10 ("By 2017, 83% of the top 100 companies in the Americas published a corporate responsibility report, as do 77% of top 100 companies in Europe and 78% in Asia. Of the largest 250 companies globally, reporting rates are 93%.").

43. Hester M. Peirce, Comm'r., SEC, Scarlet Letters: Remarks Before the American Enterprise Institute (June 18, 2019), https://www.sec.gov/news/speech/speech-peirce-061819 [https://perma.cc/W76C-BKTQ].

44. *See* Kotsantonis & Serafeim, *supra* note 22, at 57 ("In discussing the methods they use to assess a company's performance, data providers should include not only a list of material issues and a description of their scoring methodology, but more detail on the peer groups used, and clearly distinguishing between real and imputed data.").

45. Nauman, *supra* note 11.

ACCF, citing CSRHub, shows that ESG rating agencies frequently disagree even when evaluating the same company.[46] "When comparing MSCI's and Sustainalytics' ratings for companies in the S&P Global 1200 index, CSRHub found a weak correlation (0.32) between the two firms' ratings."[47]

As Doyle has pointed out, "[r]ating agencies in other capital markets are much more closely aligned."[48] For example, "Moody's and S&P's credit ratings have a very strong positive correlation (0.90)."[49] The main difference between credit ratings and ESG ratings is attributed to the fact that credit ratings use consistent information, in the form of standardized financial disclosures, while ESG ratings do not.[50]

2. Whether Self-Serving or Not, Current Disclosures Can Mislead the Market

Most ESG data ultimately used by rating firms and other ESG factor integrating institutions is voluntarily reported by the companies being rated. The reporting occurs through the publication of annual sustainability reports or through informal responses to voluntary surveys driven largely by rating firms.[51] This way, voluntary reporting allows for near complete customization of style, format and content of disclosures,[52] and "provides ample room for companies to manipulate the disclosure process."[53] Unlike financial statements used for investment analysis, these ESG disclosures are unaudited, which creates further incentives for companies to try to adjust favorably to rating methodologies and to consequently always put the company in a good light.[54]

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46. DOYLE, *supra* note 7, at 13.
47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.*
51. *See id.*
52. SOL KWON, INV. RESP. RSCH. CTR. INST., STATE OF SUSTAINABILITY AND INTEGRATED REPORTING 2018 5 (Heidi Welsh et al. eds., 2018), https://www.weinberg.udel.edu/IIRCiResearchDocuments/2018/11/2018-SP-500-Integrated-Reporting-FINAL-November-2018-1.pdf [https://perma.cc/TJ7J-JSM9].
53. DOYLE, *supra* note 7, at 9 ("According to the Sustainability Accounting Standards Board, roughly 75% of the information reported in sustainability reports is already addressed by issuers in their SEC filings. However, 90% of known negative events are not disclosed in either the SEC filings or sustainability reports.").
54. *See id.*

The Doyle report provides an example of the limitations of voluntary disclosure with the case of the Goodyear Tire & Rubber Company.[55] Sustainalytics gave the tire company a higher score than industry standard, presumably on account of the comprehensiveness of the information they disclosed, despite being a company "fraught with ESG issues and exposure, such as asbestos-related claims, various OSHA fines, and litigation settlements."[56]

The ACCF report also highlights inconsistent ratings by RepRisk and Sustainalytics over Bank of America ("BofA"), which has high exposure to ESG-related risks involving business ethics, including exposure to litigation, suspicion over mortgage-backed securities scandals, and a political loan scandal involving Countrywide Financial.[57] While both rating firms factored in the same issues, they produced "dramatically different [scores] due to inconsistencies in how the ratings providers interpreted these issues."[58]

Whether voluntary disclosures are self-serving or merely idiosyncratic, the data processing and ultimately the scores produced by the different rating agencies show a similar degree of inconsistency that can mislead investors and materially affect investment decisions.[59] Moreover, companies lack consistent benchmarks necessary to properly measure "peer groups" for meaningful comparison, and to encourage measurable improvement.[60]

3. Ratings Biases

Beyond the lack of consistency resulting from both the methodology used by rating firms and the quality of information being reported by companies, the ACCF report has identified and carefully documented three kinds of biases across ratings methodologies.

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55. *See id.*
56. *Id.*
57. *Id.* at 13–14.
58. *Id.* at 14.
59. *See id.* at 14 ("In addition to inconsistencies in how various issues are interpreted by ratings agencies, differing methodologies only compound the lack of clarity for investors. Without standardized grading methodologies, these scores may lead investors in different directions and certainly cause confusion if compared.").
60. Kotsantonis & Serafeim, *supra* note 22, at 53–54.

a. Size Bias

Regarding size bias, ESG ratings by Sustainalytics show that larger companies tend to obtain better ESG ratings.[61] The ACCF report used a sample size of over 4,000 companies, and the result suggested that the larger companies' ability to devote more resources to preparing non-financial disclosures is the key factor leading to higher ratings.[62] MSCI addressed a similar "imbalance indicating that '[c]ompanies with higher valuations might be in better financial shape and therefore able to invest more in measures that improve their ESG profile; such investments might lead to higher ESG scores.'"[63] As a result, according to the ACCF report, small and mid-sized companies would seem to be "at a competitive disadvantage" in ESG ratings, even when these companies may "create the most jobs and tend to be the most innovative."[64]

For example, as cited by the ACCF report, the Bristol-Myers Squibb ("BMS") pharmaceutical company has an $83 billion market capitalization and a Sustainalytics ratings score of 73, which is 20 points better than the healthcare industry average and 25 points above the overall Sustainalytics average.[65] The company has been involved in high-profile controversies including "questionable experimental testing methods and Foreign Corrupt Practices Act violations," but as a high market cap company, it "implements GRI Sustainability Reporting Standards and has established high-profile ESG goals,"[66] which account for its high ESG ratings.

The ACCF report then compared BMS with the performance of Phibro Animal Health, a smaller pharmaceutical company operating "as a diversified animal health and mineral nutrition" organization.[67] Despite its comparatively small $1.7 billion market capitalization, "Phibro employs over 1,400 professionals and 'has a responsibility to deliver safe, effective, sustainable products and to provide expert

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61. DOYLE, *supra* note 7, at 9–10.

62. *See id.*

63. *Id.* at 9 (quoting Guido Giese et al., *Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance*, 45 J. PORTFOLIO MGMT. 1, 2 (2017), https://www.msci.com/documents/10199/03d6faef-2394-44e9-a119-4ca130909226 [https://perma.cc/5C4B-FZQ2]).

64. *Id.* at 10.

65. *Id.*

66. *Id.*

67. *Id.*

guidance about their use.'"[68] Phibro also "runs the educational website animalantibiotics.org [that] engage[s] stakeholders about animal health issues, including responsible antibiotic use and resistance."[69] Despite its mission statement-based track record and operational alignment with ESG concerns, Phibro has a Sustainalytics score of only 46, "which is 3 points worse than the healthcare industry average and 8 points below the overall Sustainalytics average."[70] "Instead of providing transparency, [size] bias shows how such ratings systems are not only subjective, but can also leave investors in the dark about the actual strength of a company's ESG practices."[71]

MSCI, one of the rating firms, has responded to this alleged size bias—namely, that "small-cap stocks have low ESG ratings"—calling it a "myth [that] stems from the early years of ESG research when larger companies were better able to disclose ESG-related data compared to smaller ones."[72] According to the company, their research now shows that this "reporting bias was mitigated due to more disclosures by mid-cap companies, as well as enhancements made to the MSCI ESG Ratings model."[73]

b. Geography Bias

Comparing ESG ratings across geographies in a global market is difficult for several reasons. The ACCF report, however, has identified a bias in favor of European companies vis-à-vis North American ones, which may be based on persuasive reporting and investor sentiment towards the materiality of ESG reporting, rather than on actual ESG practices:

> A telling example of geographic bias is evident when comparing the BMW Group and Tesla. BMW has a high rating (93rd percentile) despite a slew of controversies, including anti-competitive practices, illegal marketing practices, business ethics violations relating to

68. *Id.* (quoting *Responsibility*, PHIBRO ANIMAL HEALTH CORP., https://www.pahc.com/responsibility [https://perma.cc/26SU-6M36]).

69. *Id.*

70. *Id.*

71. *Id.*

72. Guillermo Cano, *Factors and ESG: The Truth Behind Three Myths*, MSCI (Mar. 20, 2019), https://www.msci.com/www/blog-posts/factors-and-esg-the-truth/01291000034 [https://perma.cc/8EQA-CMA3].

73. *Id.*

> intellectual property, employee and human rights violations along their supply chain, and even animal rights violations. The company is facing accusations of collusion with Volkswagen, Audi, Porsche, and Daimler on various technological issues and systems to evade environmental and safety regulations.
>
> In contrast, Tesla (38th percentile) is below every single European auto manufacturer, including the companies named in the collusion accusations above. Most notably, Tesla's score even lags Volkswagen, which . . . has been implicated in a major environmental violation. Meanwhile, Tesla is the world leader in technology to reduce carbon emissions from automobiles.[74]

According to the ACCF report, if we consider the conspicuous environmental and ethical violations committed by BMW and other European automakers,[75] their comparison in ratings performance with Tesla strongly suggests that their "score is more a reflection of the amount of information disclosed—a requirement in Europe—than a company's adherence to ESG practices."[76]

c. Industry Sector Bias

Also following the ACCF report, ratings agencies seem to assign E, S, and G weights to companies without correctly factoring in company-specific risks, despite their stated objective to "normalize" ratings by industry.[77] While it is important to establish industry benchmarks in an attempt to standardize disclosures and metrics within an industry, industry-weighting standardization may also bias ratings and be misleading to investors:

> One example of unbalanced industry exposure is iShares MSCI KLD 400 Social ETF, the largest ESG focused ETF fund. Currently the fund invests heavily in information technology companies. In fact, information technology investments account for 31% of the $1

74. *See* DOYLE, *supra* note 7, at 10–11 ("In Europe, the EU requires companies with 500 employees or more to publish a 'non-financial statement' as well as additional disclosures around diversity policy. North America has no such requirement for disclosure, which is one source for the positive bias toward European companies.").

75. *See* Alex Gibney, *Dirty Money: Hard NOX*, NETFLIX (Jan. 26, 2018), https://www.netflix.com/watch.

76. DOYLE, *supra* note 7, at 11.

77. *Id.*

> trillion in assets under management, with the top three investments being Microsoft, Facebook, and Google.[78]

The ACCF report suggests that, while common for ESG ratings, categorizing all companies similarly within each industry, underlines the "need for a more tailored approach to the ratings process."[79] For example:

> In its own evaluation of ESG investing, MSCI acknowledges that *company-specific risks* are not a focus and the systematic issues that face a given industry play a more important role: 'In essence, the MSCI ESG Rating is a reflection of companies' residual risk exposure to their industry's most significant key issues after taking into account companies' risk-mitigation techniques.'[80]

4. *Failure to Identify Risk*

The methodological inconsistencies and biases identified above in the ACCF report are magnified when scandals representing the materialization of risks resulting from poor corporate governance or intentional damage to the environment fail to substantially affect a company's high ratings. In September 2015, the Environmental Protection Agency (EPA) found that Volkswagen was guilty of intentionally using a "defeat device" to circumvent official emissions-testing software, effectively causing 11 million vehicles worldwide produced from 2009 to 2015 to pollute at a much higher rate than advertised.[81] The company was sanctioned with more than $25 billion in fines and penalties to account for one of the worst violations of the Clean Air Act by a corporation ever.[82]

Despite this, Volkswagen continued to have an "ESG rating higher than its peer average. The ratings dropped from well above average at

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78. *Id.* at 11–12.

79. *Id.* at 12.

80. *Id.* (quoting Giese et al., *supra* note 63).

81. *See id.* at 11–12; *see also* GIBNEY, *supra* note 75; Jack Ewing, *Volkswagen Says 11 Million Cars Worldwide Are Affected in Diesel Deception*, N.Y. TIMES (Sept. 22, 2015), https://www.nytimes.com/2015/09/23/business/international/volkswagen-diesel-car-scandal.html [https://perma.cc/H6N8-TLG5].

82. *See* Roger Parloff, *How VW Paid $25 Billion for "Dieselgate"—and Got Off Easy*, PROPUBLICA (Feb. 6, 2018), https://www.propublica.org/article/how-vw-paid-25-billion-for-dieselgate-and-got-off-easy [https://perma.cc/ZW8M-ZBXP].

77 to still 6 points above average at 66 following the scandal becoming public."[83] According to the ACCF report, "[t]his example is concerning because it shows a complete failure by the ratings agencies to accurately capture ESG risk, even after a blatant attempt at bypassing environmental regulations."[84] The report continues to state that while this arguably constituted clear environmental and corporate governance failures, "the subjectivity and biases inherent to ESG ratings ensure[d] that ratings agencies [were] either unable or unwilling to both identify risk and properly protect investors from mismanagement."[85]

5. Overall Insufficiency

Given this myriad of problems with the quality of voluntary ESG disclosures and ratings, large asset managers like Blackrock and important industry players like Bloomberg have publicly expressed their discontent. Blackrock has asserted that current reporting practices are insufficient for the kinds of in-depth investment analysis that it seeks with its ESG integration, making it "difficult to identify investment decision-useful data."[86]

Similarly, in 2016, Bloomberg, a company that sells capital markets data, reached conclusions similar to those of BlackRock about the quality of ESG data. Even though Bloomberg has incorporated ESG factors into the data that it sells to dealers, brokers, and investors around the world, its CEO Michael Bloomberg said that "[f]or the most part, the sustainability information that is disclosed by corporations today is not useful for investors or other decision-makers . . . ."[87]

The current situation of voluntary ESG disclosures and market-driven ratings is full of problems, throwing its usefulness into question. Part II below lays out the arguments in favor of and against making disclosures mandatory, potentially resolving these issues.

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83. DOYLE, *supra* note 7, at 16.

84. *Id.*

85. *Id.*

86. *See* Novick et al., *supra* note 23, at 4.

> In our experience, current corporate sustainability reporting often includes disclosure about factors that, while honorable, are less relevant to investment decision making (e.g., corporate philanthropy). As a result, current reporting practices may make it difficult to identify investment decision-useful data (e.g., water usage and risks in the aforementioned beverage company example). *Id.*

87. WILLIAMS & FISCH, *supra* note 2, at 11 (quoting BLOOMBERG, IMPACT REPORT UPDATE 2015 2 (2015), http://www.bbhub.io/sustainability/sites/6/2016/04/16_0404_Impact_report.pdf [https://perma.cc/84MJ-6BZ5]).

II. WEIGHING ARGUMENTS FOR AND AGAINST MAKING ESG DISCLOSURES MANDATORY

ESG-factor integration and general use in global capital markets is growing, and this includes the United States. U.S.-domiciled assets using sustainable, responsible, and impact investing ("SRI") strategies grew from $8.72 trillion in 2016 to $12.0 trillion at the start of 2018.[88] This was a 38% increase, and the amount went from representing 21% to 26% of the total assets under professional management in the U.S.[89]

As Williams and Fisch have noted, "[t]hese latter data starkly contrast with the facts when the SEC last considered the issue of expanded social and environmental disclosure in comprehensive fashion, between 1971 and 1975."[90] At the time, "there were two active 'ethical funds' in the United States, which by 1975 collectively held only $18.6 million assets under management, or 0.0005% of mutual fund assets."[91]

The growing importance of ESG factors, in addition to the myriad of problems with the current system as highlighted in Part I, have led many market players, including the largest asset managers and rating firms, as well as some capital markets academics, to call for the SEC to issue a regulation making at least some form of ESG disclosure mandatory. "The economically advanced nations of the world are transitioning toward mandatory broad ESG disclosures, and this is a transition the United States, however reluctantly, is likely to make in time."[92]

In 2018, the corporate law professors Cynthia A. Williams and Jill E. Fisch submitted a petition to the SEC advocating in favor of SEC

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88. *Compare* WILLIAMS & FISCH, *supra* note 2, at 8–9 (providing figures as of 2016), *with* U.S. SIF FOUND., REPORT ON U.S. SUSTAINABLE, RESPONSIBLE AND IMPACT INVESTING TRENDS (2018), https://www.ussif.org/files/2018%20_Trends_OnePager_Overview(2).pdf [https://perma.cc/ATX7-774M] (providing updated numbers as of late 2018).

89. *Id.*

90. WILLIAMS & FISCH, *supra* note 2, at 8.

91. *Id.* (quoting Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1267 (1999)).

92. Leonard W. Wang, *Insight: ESG Disclosures—Prospects for the Future*, BLOOMBERG TAX (Aug. 30, 2019), https://news.bloombergtax.com/financial-accounting/insight-esg-disclosures-prospects-for-the-future [https://perma.cc/RMG9-68M3].

regulations to mandate ESG disclosure.[93] The petition further acknowledged and incorporated the requests by important market players.[94] Below are the main arguments in favor of this ESG disclosure regulation, as well as the potential drawbacks and arguments against them.

A. MARKET EFFICIENCY: INVESTORS WILL HAVE BETTER, MORE CONSISTENT, COMPARABLE INFORMATION

The efficient capital markets hypothesis includes two different types of efficiency: first, "informational efficiency," meaning the existence of "market mechanisms able to process new information quickly and with broad distribution," and, second, "allocative efficiency," or the ability to "distribut[e] capital resources to their highest value use at the lowest cost and risk."[95] According to Williams and Fisch, capital markets are constrained in promoting allocational efficiency when they do not have "consistent, comparable, reliable, and complete information."[96]

To achieve the second type of efficiency it is key that the information being quickly transmitted under the first type is in fact providing reliable signals so that market participants can choose to allocate capital efficiently.[97] As seen in Part I, however, the current ESG ratings system hardly allows participants to make even reasonably informed decisions in allocating capital in an ESG-conscious way. For example, despite the fact that climate change poses both risks and opportunities to companies in most industries, it is proving very difficult under the current system for companies to achieve efficiency as they attempt to "manage the transition to a low-carbon future by supporting the allocation of capital to its risk-adjusted highest-value use in that transition."[98]

As we have seen above, under the current system of market-driven, self-regulated, voluntary disclosure, the information produced by companies and ratings firms is often incomplete, inconsistent, and not comparable between companies or industries.[99] Citing a 2015 paper on

93. *See* WILLIAMS & FISCH, *supra* note 2.
94. *See id.*
95. *Id.* at 4.
96. *Id.*
97. *Id.*
98. *See id.*
99. *Id.* at 10.

market reactions to mandatory nonfinancial disclosure, Williams and Fisch suggest that "when ESG disclosure becomes mandatory, standards become clearer and reporting becomes more consistent and comparable."[100]

B. COMPETITIVENESS FOR CAPITAL FORMATION VIS-À-VIS OTHER CAPITAL MARKETS

Proponents for mandatory ESG disclosure argue that, by implementing this regulation, the SEC would be, among other things, spurring competitiveness of U.S. capital markets and public companies.[101]

According to a 2015 report by the Initiative for Responsible Investment at Harvard University's Kennedy School of Government, more than 20 countries have passed legislation within the last 15 years to require publicly-traded companies to issue reports that include environmental and social information.[102] Also, seven stock exchanges, including the London Stock Exchange, now require social and environmental disclosure as part of their listing requirements."[103]

> To the extent that US companies fail to disclose information which global investors are being encouraged, and in some cases required, to consider, they will be at a disadvantage in attracting capital from some of the world's largest financial markets. This highlights that US corporate reporting standards will soon become outdated if they are not revised to incorporate global developments regarding the materiality and disclosure of ESG information.[104]

Williams and Fisch further assert that mandatory disclosure would promote capital formation. By providing more, and better, information

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100. *Id.* (citing Jody Grewal et al., *Market Reaction to Mandatory Nonfinancial Disclosure* 27 (Harvard Bus. Sch., Working Paper No. 16-025, 2015), http://www.ssrn.com/abstract=2657712 [https://perma.cc/JHF8-D62K] (arguing that "firms having high ESG disclosure and stronger governance performance will be able to institute the [EU Directive on non-financial reporting] more efficiently and cost-effectively" because the reporting is mandatory, thus creating consistency)).

101. Grewal et al., *supra* note 100, at 4.

102. *Id.* at 5.

103. *Id.* (noting that the remaining six are ASX, Brazil's Bovespa, India's Securities and Exchange Board, the Bursa Malaysia, Oslo's Børs, and the Johannesburg Stock Exchange).

104. *Id.*

about risks and opportunities to investors, and by "standardizing what is currently an uncoordinated and irregular universe of ESG disclosures," the SEC would increase confidence in capital markets, a deciding factor in attracting capital:[105]

> This confidence may well mobilize sources of capital from investors who are currently unwilling to invest given knowledge gaps or information asymmetries. Particularly retail investors, who are important as long-term investors and investors in small and medium enterprises, may be emboldened by a clearer sense of the social and environmental aspects of companies' activities as a guide to companies' longer-term risks and opportunities.[106]

Alongside the discussion about increasing U.S. regulatory competitiveness with respect to other major capital markets, there is the potential issue of additional costs for companies to comply with an additional set of rules. The positions around this issue are laid out below.

C. BURDEN ON ISSUERS: HIGHER COSTS VS. REDUCED COSTS

In Hong Kong, proposals to make ESG disclosures mandatory have already triggered mixed responses between those who find they will unduly and excessively burden companies, and others who are more open to what they see as an inevitable prospect.[107] Similarly, in the United States, voices have been heard from members of Congress opposing a bill that would make ESG disclosures mandatory.[108]

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105. *Id.* at 5–6.

106. *Id.*

107. Patrick Temple-West, *Companies Resist Hong Kong ESG Disclosure Proposal*, FIN. TIMES (Jul. 30, 2019), https://www.ft.com/content/026ee8f2-b2de-11e9-8cb2-799a3a8cf37b [https://perma.cc/S44E-U8MB] ("In May, HKEX proposed forcing listed companies to publish statements about ESG-related risks. But the Chamber of Hong Kong Listed Companies, whose members include Tencent and China Mobile, said it wants the exchange to leave disclosure to the discretion of companies.").

108. *See* ESG Disclosure Simplification Act of 2019, H.R. 4329, 116th Cong. (2019–2020); *see also* Patrick Temple-West, *U.S. Congress Rejects European-Style ESG Reporting Standards*, FIN. TIMES (Jul. 12, 2019), https://www.ft.com/content/0dd92570-a47b-11e9-974c-ad1c6ab5efd1 [https://perma.cc/PTE5-J96R] ("In interviews with the Financial Times before the hearing, Republicans said they did not want to hit companies with additional disclosure obligations. Corporate rules for environmental protection already exist and adding disclosure costs could have a

Other critics in the United States like the Manhattan Institute, a libertarian think tank, argue that the "most obvious . . . [danger] in using government as a tool to enforce [SASB-like ESG] standards" is the cost burden of increased reporting.[109] From the Institute's view, reporting and compliance costs, which have already increased in recent years, ultimately favor larger firms because they already have large legal and regulatory compliance staffs.[110] Similarly, a point has been raised that publicly-traded corporations have already been falling in number and that "throwing the government's weight behind [mandatory ESG disclosure] risks driving even more companies from America's publicly traded stock markets, which have fewer corporate listings today than in 1975."[111]

Alongside these risks, however, we may also weigh possible benefits of more robust ESG disclosures. For example, from a securities fraud risk perspective, it is in the best interest of all public companies—large and small—to provide meaningful ESG disclosures, to the extent they relate to specific factors material to their businesses and industries. But disclosures that are too general and aspirational in an attempt to prevent shareholder and SEC lawsuits may end up "frustrating important stakeholders instead of impressing them."[112] This uncomfortable middle ground could be preparing companies for the transition to some form of mandatory disclosure, while allowing them to take the full benefit of reduced costs of standardization.[113] As a result, companies could "be better prepared for compulsory disclosure rules if and when they are mandated by the SEC."[114]

The fact is that, as discussed above, industry-led standardization has already been underway over the past few years spurred by stock

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negative material financial impact on companies, said Republican representative Warren Davidson of Ohio.").

109. Howard Husock & James R. Copland, *"Sustainability Standards" Open a Pandora's Box of Politically Correct Accounting*, INVS. BUS. DAILY (Aug. 9, 2018), https://www.investors.com/politics/commentary/sustainability-standards-open-a-pandoras-box-of-politically-correct-accounting [https://perma.cc/98RU-AYB6].

110. *Id.*

111. *Id.*

112. Wang, *supra* note 92.

113. *See id.*

114. *Id.*

exchanges and industry leaders—for example, through the Nasdaq ESG initiative, and under influential initiatives like the TCFD.[115]

Moreover, as noted by Williams and Fisch, companies today are already burdened with meeting investor expectations for sustainability information even though they lack clear standards on how to do so. "[B]ecause there isn't clear guidance . . . different companies are using different frameworks and multiple mechanisms to disclose sustainability information."[116] In other words, companies have already been pushed to heavy burdens of voluntary disclosure, and yet "investors are still dissatisfied with the comparability of sustainability information, even between companies in the same industry."[117]

Taking this into account, mandatory disclosure regulation could, instead of increasing it, reduce the cost burden for companies:[118]

> That ESG disclosure requirements could actually reduce burdens on America's public companies was well-stated in the CFA Institute's Comment Letter to the Concept Release: "Many issuers already provide lengthy sustainability or ESG reports to their investors, so many issuers will not face a new and burdensome cost by collecting, verifying and disclosing ESG information. Costs may be saved if instead of producing large sustainability reports that cover a broad range of sustainability information, issuers can instead focus on only collecting, verifying and disclosing information concerning the factors that are material to them and their investors."

The arguments regarding costs seem to be strong on both sides of the debate. Next, we address the potential for higher litigation risk emerging from mandatory disclosure regulation.

D. HIGHER RISK OF LITIGATION?

The Manhattan Institute has argued that "[t]he more significant costs of mandatory SASB-style disclosures, however, are those flowing

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115. *See* WILLIAMS & FISCH, *supra* note 2, at 9–10; *see also* Blaine Townsend, *The Case for Standardized, Audited ESG Reporting*, ACCT. TODAY (May 15, 2019), https://www.accountingtoday.com/opinion/the-case-for-standardized-audited-esg-reporting [https://perma.cc/2VPN-8MJG].

116. WILLIAMS & FISCH, *supra* note 2, at 12.

117. *See id.*

118. *Id.* (quoting CHARTERED FINANCIAL ANALYSIS INSTITUTE, COMMENT LETTER TO THE CONCEPT RELEASE: BUSINESS AND FINANCIAL DISCLOSURE REQUIRED BY REGULATION S-K 18–19 (Oct. 06, 2016), https://www.sec.gov/comments/s7-06-16/s70616-375.pdf [https://perma.cc/PU64-82DQ]).

from the leverage that such mandated disclosures would necessarily give to politicized enforcement agents at the SEC and Department of Justice."[119] For this libertarian think tank, mandatory disclosure would give excessive power "to politically ambitious state attorneys general, and to class-action plaintiffs' lawyers seeking to pounce on alleged misstatements."[120]

This argument, however, fails to acknowledge the fact that, currently, companies who choose to make voluntary disclosures are already subject to the risk of anti-fraud securities litigation.[121] Moreover, while companies may still be found liable over misleading climate risk disclosures, comparative legal analysis suggests that failing to carry out climate-risk disclosures (a traditional ESG factor) is also likely to prompt litigation.[122]

Finally, climate-change litigation occurring under the current system has the potential to pressure the SEC to act and impose at least climate-related ESG disclosures.[123]

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119. Husock & Copland, *supra* note 109.

120. *Id.*

> To be sure, state AGs and plaintiffs' lawyers may be able to harass or sue companies for voluntary disclosures using old-fashioned tort claims or overly broad state statutes like New York's Martin Act securities law. But with a mandatory SEC disclosure rule, the potential for regulation through litigation or prosecution outside the normal legislative lawmaking process would be greatly multiplied.

121. *See* Jonathan D. Guynn, *Insights: Managing Legal Risks for ESG Disclosures Under U.S. Law*, JONES DAY (July 2019), https://www.jonesday.com/en/insights/2019/07/managing-legal-risks-for-esg-disclosures-us-law [https://perma.cc/FXX3-L8DK].

122. Robin Hamaker-Taylor et al., *Voluntary Climate Disclosures Can Reduce Litigation Risk*, ACCLIMATISE UK (June 13, 2019), http://www.acclimatise.uk.com/2019/06/13/voluntary-climate-disclosures-can-reduce-litigation-risk [https://perma.cc/9HU9-QBMV].

123. Wang, *supra* note 92.

> In a landmark 2016 decision captioned *Juliana v. United States*, 217 F. Supp. 3d 1224 (D. Ore. 2016), the federal district court in Oregon ruled, that there is a fundamental right under the Constitution to a climate that would sustain human life. The novelty of the decision triggered a frenzy of appellate activity that continues to date.

E. Despite the Risks, Investors and Companies are Pro-Reporting

A survey from 2014 showed that practically 80% of investors were dissatisfied with the comparability of ESG reporting between companies in the same industry.[124] In May 2020, an SEC subcommittee acknowledged this reality, and further recommended the Commission to require issuers to "directly provide material information to the market relating to ESG issues used by investors to make investment and voting decisions."[125] Leonard W. Wang, a former SEC official, has noted that "as ESG disclosures grow in importance . . . [t]he potential for losses from inaccurate or fraudulent ESG disclosures will rise."[126]

As Wang put it, "[f]raud and deception gravitate toward unguarded venues, [and so] [i]nvestor losses from ESG disclosure failures could increase pressure for broad mandatory disclosure requirements."[127] These future losses, according to Wang, "will increase the already significant pressure for mandatory broad disclosures" because "[u]ltimately, regulation cannot lag too far behind the market."[128] Moreover, recent attempts in Europe at increasing mandatory ESG disclosures provide, in Wang's view, an example of the global push in that direction.[129]

Other industry concerns with the status quo suggest mandatory disclosure may also serve to reduce potential ethics controversy or litigation risks, especially to the extent that it will level the playing field. Blackrock researchers found that, contrary to conventional wisdom, "ethics controversies are *more* likely for firms that adopt popular ESG policies," as opposed to those that keep their ESG disclosures to a

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124. PRICEWATERHOUSECOOPERS, SUSTAINABILITY GOES MAINSTREAM: INSIGHTS INTO INVESTOR VIEWS 8 (May 2014), https://www.pwc.com/us/en/pwc-investor-resource-institute/publications/assets/pwc-sustainability-goes-mainstream-investor-views.pdf [https://perma.cc/F4FE-QQJ9].

125. *See* SEC. & EXCH. COMM'N, RECOMMENDATION FROM THE INVESTOR-AS-OWNER SUBCOMMITTEE OF THE SEC INVESTOR ADVISORY COMMITTEE RELATING TO ESG DISCLOSURE 8 (May 14, 2020), https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-of-the-investor-as-owner-subcommittee-on-esg-disclosure.pdf [https://perma.cc/UAK3-UQP4].

126. Wang, *supra* note 92.

127. *Id.*

128. *Id.*

129. *Insights: Investors' ESG Demands Drive Regulation*, KPMG (May 2019), https://home.kpmg/xx/en/home/insights/2019/05/investors-esg-demands-drive-regulation-fs.html [https://perma.cc/67QT-HKCY].

minimum.[130] Along the same lines, important ESG indexes are said to "favor companies that disclose more ESG policies and as a consequence generally have greater controversy exposure than an ESG-unaware benchmark."[131] Despite the obvious risks, the current mix of incentives and market practices seems to have made companies generally more inclined to robust ESG reporting.

III. THE CHALLENGE OF IMPLEMENTING MANDATED DISCLOSURES

The sensible implementation of any degree of mandatory ESG disclosures is likely to compound the challenges already presented by the difficulty of defining ESG and by current market-influenced practices in ESG reporting. This section sets out to describe some of these additional challenges and lays out what seem to be the more sensible proposed solutions.

A. A TASK FOR THE SEC

While some standardization has come about by way of industry-led initiatives and self-regulation, complete standardization is unlikely short of disclosures being made mandatory. Both Congress and the SEC have the ability to mandate such ESG disclosures.[132] Though the prospect of Congressional action was not high under the Trump administration judging by the reaction when the idea was floated in early 2019, that animus appears to have changed rapidly under the current Biden administration.[133] In any case, the only legislative initiative currently

130. Gerald T. Garvey et al., *A Pitfall in Ethical Investing: ESG Disclosures Reflect Vulnerabilities, not Virtues*, 15 J. INV. MGMT. 1, 2 (Sept. 19, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2840629 [https://perma.cc/7KAK-J59F].

131. *Id.*

132. *See* Townsend, *supra* note 115.

133. *Compare* Temple-West, *supra* note 108, *with* Kristin Broughton & Mark Maurer, *Companies Could Face Pressure to Disclose More ESG Data*, WALL ST. J. (DEC. 6, 2020), https://www.wsj.com/articles/companies-could-face-pressure-to-disclose-more-esg-data-11607263201 [https://perma.cc/TP8X-SZKD]. *See also* Mitchell et al., *supra* note 4.

being discussed limits itself to mandating the SEC to "define ESG metrics."[134]

Of the two policymakers, the SEC is more likely to act, whether it is mandated to do so by an act of Congress such as the ESG disclosure bill mentioned above, or in implementation of the SEC's current regulatory powers, even at the risk of being challenged in court.[135] In 2014, the SEC already solicited public comments to its "Disclosure Effectiveness" initiative, seeking to "evaluate and potentially reform corporate disclosure requirements."[136] "As part of that initiative, a 2016 Concept Release on Business and Financial Disclosure Required by Regulation S-K ("Concept Release") solicited opinions" from the public on ESG disclosures.[137]

Williams and Fisch, who led the submission of the most authoritative brief advocating for mandatory disclosures, noted that "[r]equiring firms to disclose more ESG information is . . . consistent with the SEC's authority to promote market efficiency, and within its broad mandate 'to promulgate rules for registrant disclosure as necessary or appropriate in the public interest or for the protection of investors.'"[138]

While as of late November 2020 the SEC had all but ratified its continued approach of taking small interpretive steps in addition to the 2010 Commission Guidance Regarding Disclosure Related to Climate Change, by February 2021 the drumrolls seemed to be announcing imminent approval of a regulation for broad and mandatory ESG disclosures.[139]

134. *See* ESG Disclosure Simplification Act of 2019, H.R. 4329, 116th Cong., § 2(a) (2019–2020).

135. Wang, *supra* note 92 ("The SEC may have doubts about its legal authority to promulgate broad ESG disclosure standards. It may hesitate because of judicial rulings against its regulation for conflict minerals disclosure . . . The potential for litigation to challenge new broad rules may also discourage the SEC.").

136. WILLIAMS & FISCH, *supra* note 2, at 1.

137. *Id.*

138. WILLIAMS & FISCH, *supra* note 2, at 4 (quoting Business and Financial Disclosure Required by Regulation S-K, Securities Act Release No. 33-10064, 2016 WL 1458170 (Apr. 13, 2016)).

139. *See* Rasmussen, *supra* note 4; Mitchell et al., *supra* note 4.

B. MATERIALITY OF ESG DISCLOSURES

The concept of materiality, as defined by the U.S. Supreme Court in *TSC Industries v. Northway, Inc.*, was also emphasized in Williams and Fisch's submission to argue that material disclosures affect the market in a way that SEC action is required to reduce likelihood of fraud:[140]

> As the Court said, "[p]ut another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Thus, what is material depends on reasonable investors' perceptions of what information is already available in the market, and how any new or omitted information changes those perceptions of the quality of management, when voting or engaging with management, or the value of a company or its shares, when investing or selling.[141]

The catastrophic economic effects of the coronavirus pandemic, and the avalanche of securities fraud litigation that is likely to arise from it,[142] may provide support to the claim that at least climate-related ESG information—to the extent that it may have an effect on results, either by adjusting for or by foreseeing a catastrophic risk—is increasingly material for investors generally.[143]

For one, ESG funds seem to have performed better than non-ESG funds, confirming a trend of better performance in recent pre-coronavirus years.[144] Given that oil prices had plummeted just before the coronavirus pandemic hit, the relatively better performance of ESG

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140. WILLIAMS & FISCH, *supra* note 2, at 6 (quoting TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976)).

141. *Id.*

142. *Update: Mitigating Securities Litigation Risks Related to the Coronavirus*, PAUL WEISS (Mar. 31, 2020), https://www.paulweiss.com/practices/litigation/securities-litigation/publications/update-mitigating-securities-litigation-risks-related-to-the-coronavirus?id=32104 [https://perma.cc/B7N5-3K8K].

143. *See* Fink, *supra* note 1; *Driving ESG Skywards*, *supra* note 1.

144. *Id.*; *see also* Sanghamitra Saha, Zacks, *ESG ETFs Appear Unscathed by the Coronavirus Carnage*, YAHOO! FIN. (Apr. 3, 2020), https://finance.yahoo.com/amphtml/news/esg-etfs-appear-unscathed-coronavirus-170005763.html [https://perma.cc/XU4Y-7Y6S].

funds might be a result of overall worse performance of funds that have more investments in the fossil fuel energy industry.[145]

Additionally, the lack of public health preparedness exposed by the coronavirus is likely to make the environmental risk of a catastrophic rise in sea levels[146] posed by climate change more present in the minds of investors.[147]

In this general vein, the ESG Simplification Disclosure Act broadly proposes for ESG factors to be considered "de facto" material:[148]

> MATERIALITY.— It is the sense of Congress that ESG metrics, as such term is defined by the Commission pursuant to paragraph (2), are de facto material for the purposes of disclosures under the Securities Exchange Act of 1934 and the Securities Act of 1933.[149]

More recently, on November 13, 2020, the U.S. Department of Labor (DOL) adopted amendments to the "investment duties" regulation under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), interpreting that, in order to comply with their fiduciary duties under ERISA, pension fund managers should consider only "pecuniary" aspects in determining materiality of ESG considerations—at least for the purposes of ERISA.[150]

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145. *See* Imogen Tew, *What the Oil Shock Means for ESG Funds*, FT ADVISER (Mar. 9, 2020), https://www.ftadviser.com/investments/2020/03/09/what-the-oil-shock-means-for-esg-funds [https://perma.cc/8JXP-W5AH].

146. Nate Chumley, *Are Securities Laws Effective Against Climate Change? A Proposal for Targeted Climate Related Disclosure and GHG Reduction*, 25 FORDHAM J. CORP. & FIN. L. 155, 178 (2019) (outlining the catastrophe risks posed by climate change) (citing DAVID REIDMILLER, U.S. GLOBAL RESEARCH PROGRAM, ET AL., NATIONAL CLIMATE ASSESSMENT ch. 2 (2018), https://nca2018.globalchange.gov/chapter/1 [https://perma.cc/F2S6-N8BH]).

147. Bloomberg TV, *Taleb Says "White Swan" Coronavirus Was Preventable*, BLOOMBERG (Mar. 30, 2020), https://www.bloomberg.com/news/videos/2020-03-31/nassim-taleb-says-white-swan-coronavirus-pandemic-was-preventable-video [https://perma.cc/45N4-XZBL].

148. *See* ESG Disclosure Simplification Act of 2019, H.R. 4329, 116th Cong., § 2(b)(3) (2019–2020).

149. *Id.*

150. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72846, 72848–49 (Nov. 13, 2020) (to be codified at 29 C.F.R. pt. 2509, 2550) (stating that the purpose of the action is "to set forth a regulatory structure to assist ERISA fiduciaries in navigating these ESG investment trends and to separate the legitimate use of risk-return factors from inappropriate investments that sacrifice investment return, increase costs, or assume additional investment risk to promote non-pecuniary benefits or objectives."); *see also* TIMOTHY DOYLE, COMMENTS ON PROPOSED RULE "FINANCIAL FACTORS IN

C. PROPOSALS FOR DISCRETE AND BROAD INCREMENTAL DISCLOSURE REGULATION

As discussed above, current ESG factors used in voluntary disclosures can be wide ranging and cover dozens of different items and subcategories, all of which broadly fall under the environmental, social, and governance categories.[151] Moreover, the material portions of a company's disclosure may correspond to one of these factors or subcategories, and so a one size fits all solution may prove to do little in the way of better informing investors' decisions.[152]

Furthermore, if all private sector initiatives to date, including those by both rating agencies and market-leading wealth management funds, have failed to come up with standardized metrics, it may not be realistic to expect the SEC to be able to "define ESG factors" effectively because of the complexity this task entails.[153]

As a result, an incremental approach for mandatory disclosures is what may be more advisable at this stage. This type of incremental approach towards mandatory disclosure may take two forms. First, it can focus on discrete, specific factors. Second, it can focus on all factors while not settling on a detailed method of line-item disclosures, and allow investors to decide what material factors may be most relevant or "material" for investors in their specific industry.

For an example of the first approach, a 2019 student note proposed targeted climate change disclosure aimed at encouraging green-house gas reductions.[154] Specifically, the note proposed a regulation that would

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SELECTING PLAN INVESTMENTS (RIN 1210-AB95)" (July 30, 2020), https://www.dol.gov/sites/dolgov/files/EBSA/laws-and-regulations/rules-and-regulations/public-comments/1210-AB95/00675.pdf [https://perma.cc/N5CU-LTG4] (explaining that "[w]hile disagreement usually involves how and what to disclose and to whom," the central policy debate is "between disclosing ESG issues that are *material* in nature and will ultimately impact financial performance, and those used to promote a social or political agenda, that have not been shown to create value or the value itself is nonpecuniary."); Neil Whoriskey, *The Department of Labor, ESG and All Those Undirected Votes*, MILBANK GEN. COUNS. BLOG (Jan. 12, 2021), https://www.milbankgeneralcounsel.com/2021/01/the-department-of-labor-esg-and-all-those-undirected-votes [https://perma.cc/P7R7-T2CP].

151. *See supra* Part I.

152. *Id.*

153. *Id.*

154. *See* Chumley, *supra* note 146, at 155. Undoubtedly, climate change is a leading factor behind the interest and popularity of ESG initiatives, so starting with this specific

"mandate[] GHG emissions reduction framework and require[] quarterly reporting of accurate climate change-related internal data" with an aim to tracking—and ultimately penalizing—carbon emissions by large corporations that surpass a certain threshold.[155]

For an example of the second approach for incremental regulation, Fisch proposes for the SEC to adopt an additional Regulation S-K requirement for mandating "Sustainability Discussion and Analysis" (SD&A), where companies may choose three issues within the wide ESG factors for mandatory discussion. Fisch's proposal is modeled after existing Management Discussion and Analysis (MD&A) and Compensation Discussion and Analysis (CD&A) regulations. The proposal addresses the flexibility that may be required as the SEC enters an area where agreement on details has proven difficult:[156]

> It is too early to determine the extent to which sustainable business practices impact economic performance, or the degree to which boards that engage with sustainability can exercise better risk management and monitoring. SD&A disclosure represents a valuable first step that would enable investors and researchers to weigh those questions with minimal burden on corporate issuers.[157]

In our opinion, Prof. Fisch's proposal of an incremental approach towards mandatory disclosure that allows investors to decide what factors to address has the additional benefit of providing the SEC with an opportunity to act now, but in a way that doesn't stifle experimentation or the ability to fine-tune the regulation as reporting practices on ESG continue to evolve.

CONCLUSION

Some form of mandatory ESG disclosure seems to be an impending reality. While an ESG mandatory disclosure regulation is likely to raise many implementation issues, and even create new problems, it may also prove beneficial for a short-term improvement in the efficiency of U.S. capital markets and corporate governance institutions. The current

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factor that falls under the category of "environmental," would make sense. *See Climate Change Has Made ESG a Force in Investing*, ECONOMIST (Dec. 7, 2019), https://www.economist.com/finance-and-economics/2019/12/07/climate-change-has-made-esg-a-force-in-investing [https://perma.cc/9KV9-NZXZ].

155. Chumley, *supra* note 146, at 179–85.

156. *See* Fisch, *supra* note 6, at 966.

157. *Id.*

situation of self-regulated and voluntary disclosures that turn into ratings and metrics which confuse and mislead investors does not seem to be sustainable in the long term.

As described in this Note, the amount, the nature of and market demand for ESG information has changed dramatically over the last 25 years to the point that, today, both academics as well as leading market participants are in agreement that it is time for either Congress or the SEC to seriously consider making some form of ESG disclosure mandatory. On the one hand, mandatory disclosures are likely to eventually lead to standardization and cost reduction for companies currently making them on a voluntary basis. On the other, they will increase the stakes and costs to companies that do not currently factor ESG components in their disclosure analysis. Ultimately, however, standardization would lead to ESG information becoming more reliable and actionable, as other forms of SEC-supervised disclosures.

While standardization is desirable, the difficulty of arriving to a one-size-fits-all rule suggests that the SEC should, at this stage, follow an incremental approach to regulation. The SEC should either focus on mandating disclosure on one specific factor, when applicable—for example, climate change—or allow companies flexibility on deciding what factors to address and how to address them.