Securities Regulation Daily Wrap Up, TOP STORY—Commissioner Peirce chides 'shrill, self-righteous' overuse of ESG ratings, (Jun. 24, 2019)

Securities Regulation Daily Wrap Up

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By Lene Powell, J.D.

ESG scorecards containing errors and using widely varying methodologies can have far-reaching negative consequences for companies.

Likening the criticism of companies for low environmental-social-governance (ESG) ratings to the public shunning in Nathaniel Hawthorne's *The Scarlet Letter*, SEC Commissioner Hester Peirce highlighted numerous shortcomings in ESG ratings including inconsistency, inaccuracy, and arbitrariness. "[W]e 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," said Peirce in prepared remarks at the American Enterprise Institute.

Not always financially relevant. Peirce stressed that ESG issues may well be relevant to a company's long-term financial value—*if* they are financially material. According to recent testimony before the Senate Banking Committee, research has found that firms in the top quintile of performance on financially material ESG issues significantly outperformed those in the bottom quintile. However, the key factor is whether the issues are "financially material."

"If ESG disclosures mean disclosing what is financially material, there is little controversy, but the ESG tent seems to house a shifting set of trendy issues of the day, many of which are not material to investors, even if they are the subject of popular discourse," said Peirce.

Arbitrary and error-ridden. Peirce sees the problem as originating with non-shareholder activists, including "a growing group of self-identified ESG experts that produce ESG ratings." These organizations base their ESG scorecards on surveys sent to companies and company-issued sustainability reports, which use inconsistent terminology that can arbitrarily result in good or bad ratings. In turn, a bad rating can cause investors to shun a company's stock. This may be the correct result if based on accurate information, said Peirce, but the accountability mechanism does not work properly when based on poor methodology.

Also, some information is simply wrong or misleading, said Peirce. Barrick Gold Corporation publicly criticized an ESG rater for making major errors, including a claim that it operated a mine that it did not operate. And Tesla, the electric car manufacturer, received some lower environmental ratings than many traditional auto makers, not because of non-green activity on Tesla's part, but because rating companies did not consider its disclosures sufficiently robust.

Negative fallout. Bad ratings matter in several ways. Investors are increasingly paying attention to ESG scores, and ESG influences not only where investment dollars go, but at what cost and on what terms. Inclusion of companies in ESG-related indices is based in part on ESG ratings, and can substantially increase the ratings' impact on the market's allocation of capital. In addition, in order to court a vocal subset of investors demanding that their money be invested in accordance with ESG principles, investment advisers "grab hold" of credentials to demonstrate their ESG bona fides, including buying an ESG scorecard, hiring a proxy advisor, or investing according to an index that incorporates an ESG filter.

Government actions. Government entities have fostered the ESG ecosystem in a few ways, said Peirce. First, Department of Labor and SEC rules and no-action letters have entrenched the use of proxy advisors. As a result, companies often align their policies with proxy advisors, even though the recommendations may be rooted in inaccuracies and proxy firms do not always provide the opportunity to contest errors. Proxy firms justify their

interest in ESG issues as a reflection of shareholder interest, but often shareholder proposals are pushed by very small groups. In 2018, nine shareholders were responsible for almost half of all shareholder proposals, said Peirce.

Some government entities have also directly embraced ESG factors as drivers of investment choices. In Europe, the revised Shareholder Rights Directive, which takes effect this year, includes a recommendation that director performance "be assessed using both financial and non-financial performance criteria, including, where appropriate, environmental, social and governance factors. And without the participation of the SEC, the International Organization of Securities Commissions (IOSCO) issued a statement "setting out the importance of considering the inclusion of environmental, social, and governance matters when disclosing information material to investors’ decisions." Some U.S. state and local governments have embraced ESG factors as well.

Beware oversimplification. In closing, Peirce urged wariness in response to "shrill cries from a crowd of self-appointed, self-righteous authorities" calling for a "single, standardizable score."

"People are free to invest their money as they wish, but they can only do so if the peddlers of ESG products and philosophies are honest about the limitations of those products," said Peirce.

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