Can Regulatory Intervention Save the Sustainability Rating Industry?

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Abstract

Relatively speaking, the so-called sustainability rating industry has been witnessing rapid growth since the Financial Crisis. More recently, the industry is continually reorganising through a series of mergers and acquisitions. However, recent research has slowly turned away from what the sustainability rating industry can do, and moved towards what the investor base wants from them. In this direction, the findings are becoming particularly clear. The concept of a 'mainstream' investor base, and its growing tolerance of sustainability as a concept, is leading towards to a defining point. That defining point is whether the sustainable-related service marketplace is suitable for the mainstream marketplace. By utilising recent research into this junction, the article will consider both whether the industry can meet the needs of the marketplace as it continues to grow, and also whether any regulatory intervention could assist with the achieving of this hypothesised goal.

Introduction

Sustainability, as related to the financial system, has been at the forefront of many analyses since the Financial Crisis. Whole global initiatives have been developed to encourage that expansion. Also, there have been both new approaches taken by existing industries to facilitate this growth, and new industries sprouting rapidly to meet the challenge. In terms of

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encouraging this development, the provision of information has been identified as a key element. How investors can further understand the ‘materiality’ of ESG-related information is high on the agenda, as too is how better issuers can communicate their consideration of sustainability to the market. For the respective parties to achieve these important goals, third-party rating organisations exist to theoretically act as an independent go-between who can liaise with issuers, and then utilise this information to provide information to investors which can be assimilated into their investment decision-making processes. There are also suggestions that greater regulation, specifically with regards to disclosure, could assist with resolving these issues. However, recent research suggests that a number of these organisations are not successfully fulfilling this purpose. The question has not yet been asked what the consequences of this may be, both for the future of such organisations, but also for the wider picture of the mainstreaming of the concept of sustainability. This article asks that question.

In attempting to find an answer for that question the article will review the research that is being conducted in this area which seeks to assess how effective sustainability rating organisations are. A number of useful and impactful studies exist with regards to assessing the sustainable rating organisations, whilst other studies exist which focus upon the movement of the credit rating agencies into the mainstream sustainable finance sector. By combining these different fields of study, and attaching them to the studies that focus on the mainstreaming of the concept of sustainable finance, this article aims to contribute to the gap that exists when the three are brought together; all three are slowly converging on each other but the gap that exists in the centre of that convergence is one which is potentially defined by incompatibility – I suggest that three must go into two if the development of *sustainability* is to continue, with the sustainable rating industry being incorporated into the credit rating arena. Towards the end of this article, we will consider the regulation of a key area – non-financial disclosure – as this area has been identified as being crucial for the sustainability rating agencies’ efficient functioning. The need for the rating dynamic to be enriched with high quality information is of paramount importance to the future of the rating industry, and recent regulatory initiatives suggest that financial regulation may be ready to step in and play a part, although there are crucial exceptions to this as we shall see. In assessing the internal dynamics of the sustainability rating industry, its larger credit rating industry brethren, and the desires of investors and issuers who will be the central components in pushing the mainstreaming of sustainability, and the role that regulators may play to that same end, the article aims to contribute to the literature so that the effects of a change in this specific arena can be considered more moving forward.

The Move to the Mainstream

The development of 'sustainable finance' as a concept has been ongoing since the 1960s, with a number of clear milestones along the way. Ballestero et al. discuss how the modern-day concept of 'socially responsible investment' morphed from the post-Vietnam War era, although the concept of investing for an outcome other than purely financial gain has much longer roots.[1] After a series of related UN Meetings designed to develop the concept for a broader reach – starting in Stockholm in 1972, through the Brundtland Report-inspired Rio De Janeiro UN Conference in 1992 to the UN Sustainable Development Summit in New York in 2015 – a definition was developed for 'sustainable finance', which was that 'sustainable finance is finance that meets the social, environmental, and livelihood needs of the present generation without compromising the ability of future generations to meet their own needs and that creates a fair balance between societies in the north and the south'.[2] This definition is helpful, but there is no one comprehensive definition. Miles suggests that, at its broadest, sustainable finance refers to the 'mainstreaming of environmental and socio-economic criteria into lending, investment and other financial services'.[3]

This aim to bring the often-derided aim of investing for an outcome other than for a purely financial one to the mainstream marketplace is at the core of the modern-day concept and, according to the figures and associated research, it is having success. Though Krosinsky and Purdom identify that 'the first waves of socially responsible investing were implemented too

[1] Enrique Ballestero, Blanca Perez-Gladish, and Ana Garcia-Bernabeu, 'The Ethical Financial Question and the MCDM Framework' in Enrique Ballestero, Blanca Perez-Gladish, and Ana Garcia-Bernabeu, *Socially Responsible Investment: A Multi-Criteria Decision Making Approach* (Springer 2014) 9.
[2] Olaf Weber 'Finance and Sustainability' in Harald Heinrichs, Pim Martens, Gerd Michelsen, and Arnim Wiek *Sustainability Science: An Introduction* (Springer 2015) 121.
[3] Kate Miles *The Origins of International Investment Law: Empire, Environment and the Safeguarding of Capital* (CUP 2013) 240.

soon, were at times too politically focused, and attempted to use poor to non-existent data',[4] it has also been recognised that the market is developing 'rapidly'[5] and is currently operating at 'record levels'.[6] Lubin and Esty are of the opinion that sustainability, in relation to the world of business, qualifies as a 'megatrend'. They reach this conclusion because environmental issues, as well as governance and latterly 'social' issues, have been steadily 'encroaching on the capacity of business to create value to customers, shareholders, and other stakeholders'. What were often considered as 'externalities' – like carbon dioxide emissions or water usage – are quickly and irreversibly becoming 'material', which the scholars suggest will lead to whole new informational infrastructures designed to increase the collective knowledge on the materiality of such elements.[7]

Arguably, the event which hastened the development of the concept was the Global Financial Crisis in 2007-08. The wide and devastating impact of that particular crisis has left a large proportion of the global society asking many questions, including the 'viability, effectiveness, and social utility of the financial market system'.[8] There are several issues within the modern financial model which the Financial Crisis brought to the fore, and which the concept of sustainable investing hopes to resolve in some form. Chief amongst these issues is the time horizon that many investors and corporate managers have been taking. The focus on a short time horizon was identified as being one of the major issues in the financial system, with an almost quarter-by-quarter mentality taking hold within the financial marketplace. The concept of sustainable investing, and corporate sustainability moreover, relies upon a much longer time horizon. However, with even just this one issue in mind, the question then becomes whether this change in perspective is even possible within the financial system as we know it. The option of a completely new financial system is not a realistic one, so the issue then becomes whether the current financial system can adapt to this newly-imagined sustainable mindset, or whether it will dictate the concept of sustainability so much that the

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[4] Cary Krosinsky and Sophie Purdom 'Introduction: The Future of Investing is Sustainable' in Cary Krosinsky and Sophie Purdom *Sustainable Investing: Revolutions in Theory and Practice* (Taylor & Francis 2016) 2.
[5] Sakis Kotsantonis, Chris Pinney, and George Sarafeim, 'ESG Integration in Investment Management: Myths and Realities' (2016) 28 Journal of Applied Corporate Finance 2 10-96.
[6] (n 4).
[7] David A Lubin and Daniel C Esty 'The Sustainability Imperative' in Cary Krosinsky, Nick Robins, and Stephen Viederman *Evolutions in Sustainable Investing: Strategies, Funds and Thought Leadership* (John Wiley & Sons 2011) 2.
[8] Thomas Walker, Stéfanie D Kibsey, and Stephanie Lee, 'Impact Investing' in Cary Krosinsky and Sophie Purdom *Sustainable Investing: Revolutions in Theory and Practice* (Taylor & Francis 2016) 17.

concept itself becomes diluted beyond recognition, leaving just a shell of a concept to which many can provide lip-service to.

Conventional financial and economic theory has, quite considerably, been traditionally dismissive of the concept of sustainability-related investment. Economic heavyweights, such as Milton Friedman and the Chicago School of thought, have long been critics of the approach, arguing that the incorporation of 'corporate social responsibility' is a 'constraint' on the profit maximisation of a capitalist company; such insights are shared by other notable economists like Fama, Markowitz, and Sharpe.[9] Whilst Friedman has also been quoted as saying that 'if people want to invest in that way, that's their business. In most cases such investing is neither harmful nor helpful',[10] it is the case that sceptics of the approach are of the opinion that the introduction of non-financial aspects into the investment decision process will harm the efficiency of the process, harm the necessary diversification, and 'thereby incur penalties in terms of risks and returns'.[11] There has been an array of research conducted on whether the inclusion of ESG-related concerns into the investment process produces positive or negative performance, with that wide body of research coming to mixed conclusions.[12]

However, whilst we know that the major 'battleground' is this issue of financial performance,[13] a more philosophical question is what the effect of 'mainstreaming' may have upon the concept of sustainable investing, sustainable finance, and sustainability moreover. Within the dynamic, there are perhaps three outcomes. The first is that modern finance would be influenced by the concept of sustainability, meaning that its practices will change in line with the principles of the concept. The second is that there would be no impact in either direction. The third is that the concept of sustainability would need to change in order to be

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[9] Christophe Revelli, 'Socially Responsible Investing (SRI): From Mainstream to Margin?' (2017) 39 Research in International Business and Finance 711-717.
[10] John Cullis, Philip Jones, and Alan Lewis, 'Ethical Investing: Where are we Now?' in Morris Altman, Handbook of Contemporary Behavioural Economics: Foundations and Developments (Routledge 2015) 605.
[11] Nick Robins, 'The Emergence of Sustainable Investing' in Cary Krosinsky, Sustainable Investing: The Art of Long-Term Performance (Earthscan 2012) 11.
[12] See Mansi Jain, Gagan D Sharma, and Mrinalini Srivastava, 'Can Sustainable Investment Yield Better Financial Returns: A Comparative Study of ESG Indices and MSCI Indices' (2019) 7 Risks 1; Giovanni Landi and Mauro Sciarelli, 'Towards a more ethical market: the impact of ESG rating on corporate financial performance' (2019) 15 Social Responsibility Journal 1 11-27; Michael Cappucci, 'The ESG Integration Paradox' (2018) 30 Journal of Applied Corporate Finance 2 22-28.
[13] Cary Krosinsky, 'Sustainable Equity Investing: The Market-Beating Strategy' in Cary Krosinsky, *Sustainable Investing: The Art of Long-Term Performance* (Earthscan 2012) 19.

adopted by the 'mainstream' financial system. It is arguable that the ideal scenario is the first scenario, based upon the adoption of principles like working towards different and longer time horizons, prioritising groups that have often been disregarded under traditional financial models (the workforce, for example), and also spreading wealth and opportunity across different societies. If the second scenario was imagined, in that there was no impact either way, then the outcome would be that the two endpoints, as we are imagining them, would be able to continue (at least in the short term) unabated – the financial system would continue as usual, and the sustainability concept would continue as a somewhat niche, or specialised field. The third scenario is arguably the worst-case scenario, in that the concept of sustainability is swallowed by the financial system, in that it is no longer able to achieve its principled objectives, and no longer exists as a stand-alone entity in which to develop itself. For a number of scholars, this scenario is quickly becoming the case.

Whilst the uptake of the principles of sustainability is encouraging, the oft-cited signatory base to the Principles of Responsible Investment (PRI) initiative, developed by the UN, is arguably only a superficial measure. Kotsantonis et al. argue that the high level of uptake regarding the signatories to the PRI is actually a 'misleading indicator', mostly because 'the reality is that PRI signatories commit only to behaving in accordance with a set of principles for responsible investment, a commitment that falls well short of integrating ESG considerations into all of their investment decisions'.[14] It has also been argued that the 'mainstreaming' of the sustainability concept has led to the 'financialisation' of the concept, which was never its most important aim.[15] It has been noted that this financialisation of the sustainability concept is part of a wider financialisation of society in general,[16] but for the financialisation of the sustainability concept, Revelli helpfully provides a delineation that is useful; the mainstreaming of sustainability can be characterised by the concept of 'ESG integration', as it is known. This has been identified as being a less restrictive version of traditional sustainability-related approaches. Yet, for the concept of sustainability, Robins discusses how this movement into a phase of 'integration', and the wide support this phase has been receiving, has led to a 'suspension of its critical edge'. Interestingly, some research has revealed that a number of sustainability-related mutual funds performed no better than

[14] (n 5).
[15] (n 9).
[16] (n 11) 5.

conventional funds, and were deemed as ‘virtually no different’. Robins cites Hawken, who argues that ‘striving to attain the highest rate of financial return is a direct cause of social injustice and environmental degradation as it constantly leads to the externalisation of costs on the environment, the future, workers, and others’. This is indeed a damning indictment of the mainstreaming of the concept, which others have noted is only concerned with the integration of ESG-related issues as long as they are financially material – this is known as the ‘materiality gap’.[17] This prioritisation of the concept of financial materiality has led to scholars questioning whether the integration of ESG-related issues and a renewed approach to corporate sustainability is merely ‘market rhetoric’, rather than a sign of a serious commitment to the underlying principles of sustainability.[18]

If it is indeed the case that what we have witnessed since the Financial Crisis is merely ‘market rhetoric’, then this raises a number of questions. One question is what this means for the concept of sustainability? Another would be whether it is the case that, rather than for any cynical reason, the concept of sustainability has not been taken on board fully because of a lack of know-how, or perhaps a lack of a tool-kit with which corporate entities could efficiently incorporate sustainability-related issues. Mendell and Barbosa suggest that not only is the mainstreaming of the concept of sustainability developing particularly creatively-fertile grounds, but that there is a distinctive need for new informational frameworks that cover risk assessments, and also measurement and evaluation tools.[19] In addition to this, McCluskey discusses how investors require complicated issues to be simplified for their purposes (which for sophisticated investors often means the incorporation of a vast array of knowledge into their decision-making processes), both in terms of data provided by issuers, and data as interpreted by informational vendors.[20] If the financial system had such a tool-kit available to them, then this would enable us to decipher whether it really was the case that the conventional system is dictating the concept of sustainability in this post-Crisis age, or whether they were truly adopting the principles of sustainability. Perhaps this is too clear-cut in an arena infamous for its nuanced dynamics. However, it would raise serious questions if

[17] ibid 15.
[18] (n 9) 713.
[19] Marguerite Mendell and Erica Barbosa, ‘Impact Investing: A Preliminary Analysis of Emergent Primary and Secondary Exchange Platforms’ [2012] 3 Journal of Sustainable Finance & Investment 2 111-123.
[20] Amanda McCluskey, ‘ESG analysis as a predictor of quality in management in investment decision-making’ in Iveta Cherneva, *The Business Case for Sustainable Finance* (Routledge 2012) 27.

the financial system were to dismiss that particular tool-kit because the tool-kit did not suit *its* approach; it would arguably confirm that the mainstreaming of the concept will always be on the terms of the financial system, and not on the terms of the ideological concept of sustainability. Fortunately, that tool-kit exists in the so-called sustainability rating industry. In the next section we will learn more about this tool-kit that is available to the financial system, so that we can then understand further how the financial system has been using it, its general thoughts on its usage, and how it is imagining the industry will best be developed in the future.

The Sustainable Rating Industry

Sustainable Rating Agencies play a role in a number of markets and areas of the economy, ranging from providing information for investment indices to providing information for particular groups of investors – think of those who may want to invest based on ethical grounds, or based on a particular screen (positive or negative). However, the sustainable rating industry also plays an important role, theoretically speaking, in the functioning of the mainstreaming of sustainability. If investors and corporate managers are to 'integrate' ESG-concerned principles into their decision-making processes, then they will need the informational foundation upon which to do so. For investors, and particularly sophisticated or institutional investors, the investment managers will need to know what they are investing in and the risks that come with that investment but, perhaps more crucially, also be able to *signal* that decision to their investee base. For corporate entities issuing debt, they will need to *signal* to the marketplace that they are indeed considering ESG-related issues much more than they have. They will also need to obtain more information so that they can operate more sustainably as a corporate entity; for example, a large corporate entity may want to know that its supply chain is operating as sustainably as can be expected, or perhaps even as much as it can. As *integration* is increasingly becoming the most palatable version of sustainable investing for mainstream investing, the role of sustainable rating agencies is important.

Immediately, the definitional basis of this industry needs to be confirmed because, as I and others have discussed elsewhere, the lack of a definitional foundation may prove costly to the industry.[21] One of the major issues is that there is an almost natural similarity to the much more established credit rating industry, that is dominated by *agencies*. Agencies such as Moody's, Standard & Poor's, and Fitch are almost household names at this point in time. However, although in the sustainable rating industry there are 'agencies', some of whom are leading forces in the sustainable rating marketplace, this is not a uniform categorisation. This is because there are informational providers who also provide ratings, there are index providers that provide ratings, and there are stand-alone agencies. For that reason, and in following the lead of Diez- Cañamero et al., I will be using the term Corporate Sustainability Systems (CSS) from this point on because, as the scholars helpfully illustrate:

> The financial market is pushing the development of Socially Responsible Investment, which has led to the rise of Corporate Sustainability Systems. These CSSs are tools that rate corporate performance on sustainability. However, they constitute a chaotic universe, with instruments of different nature. This paper identifies and groups the common characteristics of the CSSs into three different typologies: Indexes, Rankings, and Ratings.[22]

This categorisation is helpful because, in the ever-growing literature, there are a variety of definitions and examples of who the major players in the field are. The scholars utilise the 'Rate the Raters Report 2019' from SustainAbility to compile their list of who the major players are, but in updating that list and including some other growing players in a recent piece, I provide the most current list to which I will be referring. In terms of who the CSSs are, the list is as follows:

- CDP Climate, Water & Forests Scores
- SAM (Sustainable Asset Management)
- Sustainalytics
- MSCI ESG Ratings
- Bloomberg ESG Scores
- ISS-Oekom
- FTSE Russell ESG Ratings

[21] Daniel Cash, 'Sustainable Rating Agencies' in Magdalena Ziolo, *Sustainable Financial Systems: The Global Context, Risks, and Responsibility* (Routledge 2020).
[22] Borja Diez-Cañamero, Tania Bishara, Jose Ramon Otegi-Olaso, Rikardo Minguez and José María Fernández, 'Measurement of Corporate Social Responsibility: A Review of Corporate Sustainability Indexes, Rankings and Ratings' (2020) 12 Sustainability 2153.

- EcoVadis
- Refinitiv
- Vigeo-Eiris
- Standard Ethics

From the list above it can be seen that there are clear differentiations in what is offered to the market. For example, the CDP, MSCI, Bloomberg, and FTSE Russell offerings are all part of a much wider service by those entities. Alternatively, EcoVadis is an agency of sorts, but specialises only in the rating of supply chains. There is also constant movement within the market itself, with Refinitiv – a recent entity created between Thomson Reuters and BlackRock in 2018 – now being sold to the London Stock Exchange at the time of writing. Vigeo-Eiris, one of the oldest entities in terms of a sustainable rating *agency*, was recently acquired by Moody's, whilst Morningstar acquired a 40% stake in Sustainalytics in 2017; in 2020 Morningstar acquired the remaining 60%. In a similar vein, RobecoSAM, a company which collated the 'Corporate Sustainability Assessment' (CAS) which saw more than 2,500 of the world's largest firms participate in an ESG-related survey, was split and the ESG rating division (the home of the CAS) was transferred to Standard & Poor's in 2019 under the SAM brand (with Robeco maintaining access to its data). Both MSCI and Bloomberg's offerings are just components of much bigger entities, and feed into relative indices. Also, even the proxy-rating industry via ISS have a stake in the rating landscape, having acquired Oekom Research AG (with ISS itself being spun off from MSCI in 2014). The landscape for ESG-related ratings is indeed plentiful, but with this comes a number of associated issues.

One of the first issues that has been identified within the CSS universe is that, unlike the credit rating industry, the methodologies and the methodological considerations that underpin the processes are not made public. Whilst the credit rating industry has been forced to make its methodological processes public, the issue in that industry is whether the agencies follow what they publicly disclose. In the CSS industry, one result of this is that it is difficult to compare one offering to another.[23] However, the starting point of critiquing the methodological processes within the CSS industry brings forth a much larger issue.

[23] Elena Escrig-Olmedo, Maria A Fernandex-Izquierdo, Idoya Ferrero-Ferrero, Juana M Rivera-Lirio and Maria J Munoz-Torres, 'Rating the Raters: Evaluating how ESG Rating Agencies Integrate Sustainability Principles' (2019) 11 Sustainability 915, 1601.

Commensurability, which means ‘having a common measure’, has been identified as perhaps the largest issue affecting the CSS universe. It has been noted by a number of researchers that each CSS has its own methodology. Whilst this is their right of course, Escrig-Olmedo et al. note how agencies may measure the same concept in very different ways.[24] Landi and Tomo explain how the divergence may not only be in the final ratings, but in the structural processes that underpin the methodologies. Whether the information provided by issuers is externally validated or not, and whether the information is solicited or derived from publicly-available data, is all of concern. Additionally, some CSSs operate an issuer-pays model like the leading credit rating agencies, whilst some operate an investor-pays model. Also, some may have an analyst-driven methodological process that rests predominantly upon the expertise of the analyst, whilst other operate survey-driven approaches which have standardised formats that can be mechanically compared. Finally, there is also the issue of weighting. For example, one firm may place a heavier weight on environmental-related concerns, whilst another may focus on the materiality of the concept of ‘G’overnance.[25] Without these weightings being made public, it is difficult for outsiders to either know, or predict. Eccles et al. argue that this may be down to the fact that there is no clear and agreed definition of ‘sustainability’, especially in relation to ESG.[26] So, whilst credit rating agencies can focus on the concept of ‘creditworthiness’ that has a clear definition – how likely is the investor to receive their investment back, in full, and on time – there is no such ease in finding the definition for sustainability in the corporate context. It has also been pointed out that all of the CSSs have a clearly commercial character, and that this will naturally affect their willingness to reveal their methodological underpinnings as it may mean a potential loss in market share, which could be costly in such a contested marketplace.[27]

Nevertheless, there has been a lot of study on the concept of divergence within the CSS universe. Berg et al. produced research recently consisting of a divergence-based study into a number of leading CSSs. Their study found that a massive 53% of the discrepancies found

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[24] ibid 921.
[25] Giovanni Landi and Andrea Tomo, ‘The Dark Side of Ethics in Finance: Empirical Evidences from the Italian Market’ in Agata Stachowicz-Stanusch, Gianluigi Mangia, Adele Calarelli, and Wolfgang Amann, Organisational Social Irresponsibility: Tools and Theoretical Insights (IAP 2017) 164.
[26] Robert G Eccles, Linda-Eling Lee, and Judith C Stroehle, ‘The Social Origins of ESG: An Analysis of Innovest and KLD’ (2019) Organization & Environment 1-22, 2.
[27] (n 24) 929.

amongst the CSSs' ratings were because they were all measuring the same concept differently. The researchers find that this is not necessarily because of the use of different methodologies exactly, but more because of what they label as the 'rater effect' – this means that if an entity is judged well in one particular category by a CSS, then that CSS is more likely to judge that corporate entity well in all of the other categories too, with the opposite being found to be the case as well. The second issue the researchers found was that there were large differences in correlation levels between the CSSs. For example, their ratings on Environmental policy had a correlation of 0.57. This can be explained in a number of ways and may be considered more of a subjective conclusion to arrive to. However, there are others which are not so easy to explain. The CSSs in question had a correlation of 0.86 and 0.56 on whether an entity was a member of the UN Global Compact, and whether there was CEO/Chairperson separation within that entity, respectively. There are also instances of negative correlation between the CSSs (regarding elements of the 'S'ocial dimension, such as responsible marketing and occupational health and safety); this indicates that not only are there divergences between the CSSs, but that sometimes they are actively disagreeing.[28] Whilst it seems almost farcical that they would not be able to agree on whether an entity was a member of a global initiative, some have suggested there may be reasons for this. Drempetic et al. suggest that data availability is a massive issue for the CSSs, with smaller firms simply not being able to disclose information in the same manner as the larger firms.[29] Hill agrees, noting that there are a number of issues relating to disclosure, both from the CSS's side, and the firms' side; questionnaires and surveys may make aspects standard when they perhaps should not be, but there is also the fact that less than 5% of the world's publicly-listed companies report their emissions, with lower percentages on other aspects even lower – the effect being that the rating process may often be compromised from the outset.[30]

Irrespective of these mitigating factors, the issue at hand is that this rate of divergence presents a 'fundamental problem of the ESG rating industry'.[31] Berg et al. conclude by suggesting that these revelations could have implications for the structure of the CSS

[28] Florian Berg, Julian F Koelbel, and Roberto Rigobon, 'Aggregate Confusion: The Divergence of ESG Ratings' (2019) MIT Sloan School Working Paper 5822-19.
[29] Samuel Drempetic, Christian Klein, and Bernhard Zwergel, 'The Influence of Firm Size on the ESG Score: Corporate Sustainability Ratings under Review' (2019) Journal of Business Ethics 1, 16.
[30] John Hill, *Environmental, Social, and Governance (ESG) Investing: A Balanced Review of Theoretical Backgrounds and Practical Implications* (Elsevier 2020) 175.
[31] (n 28) 33.

universe, with Chatterji et al. concluding that the high rate of divergence, which represents a low level of commensurability, translates into the output of the CSS universe actually having very low validity.[32] The scholars agree with Escrig-Olmedo et al. from earlier when they argue that if such low levels of commensurability continue to be witnessed, then the hypothesised benefits of corporate social responsibility, and by extrapolation sustainability in the corporate context, *cannot occur*.

The question then becomes 'why?' Why is it that low commensurability is such an issue in the CSS field? The answer lies in the function of the CSS field and, most crucially, how its 'users' or 'consumers' react to the dynamics of the field. The CSS industry and the credit rating industry share many similarities as has been mentioned before, and nowhere is this more true than when we look at the *internal dynamics* of the respective fields; what are the function of the 'agencies', and whom do they serve? In reality, the answer is the same for both industries. The 'agencies' in both cases function to reduce the informational asymmetric gap between investor and issuing entity, whilst also providing for key 'signalling' services which both parties (investor and issuer) require for their own purposes – that, in a nutshell, is the fundamental dynamic of the two industries. However, whilst the credit rating industry is dominated by two agencies in particular – S&P and Moody's – with a third (Fitch) representing a much smaller player, the CSS industry is awash with players. In discussing why a number of competition-inducing initiatives and legislation/regulation failed in the credit rating industry in the aftermath of the Financial Crisis, Schroeter notes, citing Schroeder, that 'the market for credit ratings is an investor-driven natural oligopoly'.[33] This is purely because of the *fundamental function* of the rating industry; investors need to have the asymmetric gap closed by a third party because the cost of doing so themselves would likely outweigh the investment opportunity, and the issuers need a third party to disclose often commercially sensitive information to the marketplace via a method that, at once, both conveys the information required whilst protecting the content of that information. Furthermore, large investors (who make up the majority of the consumers of ratings) use the ratings to convey to their investee base their investment actions in an easy-to-understand

[32] Aaron Chatterji, Rodolphe Durand, David I. Levine, and Samuel Touboul, 'Do ratings of firm converge? Implications for managers, investors and strategy researchers' (2016) 37 Strategic Management Journal 8 1597-1614, 1607.
[33] Ulrich G Schroeter *Credit Ratings and Credit Rating Agencies* in Gerard Caprio (Ed) *Handbook of Key Global Financial Markets, Institutions, and Infrastructure* (2013) 387.

manner (i.e. alphanumeric ratings), issuers need to signal to the marketplace that they are worthy of investing in, and regulators have traditionally (although in a reactive manner to the marketplace) utilised ratings to constrain the actions of important elements of the financial system, like banks or institutional investors. Also, investee bases may constrain their managers, or agents, in the same manner i.e. only bonds rated as AAA may be invested in, to provide a crude example.

If we look above at this so-called 'investor driven natural oligopoly', the question of 'why would all of these parties want *more* information providers?' results in an obvious answer: they would not. They would not want more providers of information because for issuers it increases the costs of signalling to the marketplace, and for investors it increases the amount of information which must be incorporated into already complicated informational systems, so much so that it would likely constitute white noise. When we then consider that CSSs' methodologies are not only all different, but often conflicting, then the problem only worsens. If a natural oligopoly is therefore considered appropriate within the current dynamic, then it is worth understanding that concept further. Perhaps the best way to understand this concept more, particularly as it is evident within a closely related industry, is to examine the credit rating industry's organisational structure.

The Dynamics of a Natural Oligopoly

The word oligopoly is derived from the Greek word 'Oligos' and means 'few sellers'. It describes a market that contains few sellers but within which those few sellers wield tremendous power.[34] Schroeter discusses how, according to traditional economic theory, a natural oligopoly does indeed contain few sellers, but that there are natural or legal barriers that restrict the entry of new firms.[35] Hall suggests that even though oligopolistic firms may not always earn economic profit from their position, it does not affect the limited entry to the oligopolistic marketplace.[36] Interestingly, and seemingly at odds with most of the literature, Friedman pays attention to both the supply side of the marketplace, as well as the demand in

[34] William A McEachern *Economics: A Contemporary Introduction* (Cengage Learning 2011) 226.
[35] (n 33) 387.
[36] Robert E Hall and Marc Lieberman, *Economics: Principles and Applications* (Cengage 2007) 302.

his definition of oligopolistic markets when he explains that 'an oligopoly is a market having few firms (but more than one firm) on the supply side and a very large number of buyers on the demand side, each of whom makes a negligible contribution to the market demand function. A buyer will take market conditions as a given, for he cannot affect them, but a seller will inevitably be preoccupied with guessing the behaviour to be expected from rival sellers'.[37] This inclusion of the role of the demand side of the marketplace is an important factor that is rarely considered when scholars explain what an oligopoly is. One immediately wonders whether investors within the rating dynamic fit into Friedman's definition because, as Schroeter said earlier, the credit rating oligopoly is an 'investor-driven natural oligopoly'. Therefore Friedman's model may be questionable at first glance, but upon closer inspection the application to the credit rating field is probably accurate. This is because investors, whilst determining the dynamic as Schoeter, Schroeder, and many others argue, are actually passengers within the dynamic as Friedman suggests – what control do they have over the construction of the dynamic really? They are, arguably, as bound by the dynamic of the rating industry – complete with its asymmetric gaps and need to 'signal' – as any of the other components of the dynamic.

Returning to the concept of an oligopoly, Puu helpfully charts the development of the theory. He acknowledges Augustin Cournot as the originator of the theory in his 1838 work *Researches sur les Principes Mathematiques de la Theorie des Richesses*, whilst he also attempts to correct the common narrative that states that Joseph Bertrand then took up the mantle and moved the theory forward. Essentially, Cournot's model of competition, based upon observations of Spring Water-producing companies, argues that companies will compete on the basis of the amount of output they produce, and will change their actions based upon their competitor's actions. Bertrand's model, which Puu suggests is labelled as such because of habit (in reality, Bertrand did not formalise his model as others did so after him), essentially argues that the firms in a market will compete on price, rather than quantity.[38] In developing the Cournot model further, Stackelberg's observations are well known. Stackelberg focuses on the actions of the oligopolistic members in relation to each other. Cournot observed that each firm takes the actions of the other in the oligopoly as a

[37] James Friedman, *Oligopoly Theory* (CUP 1983) 1.
[38] Tonu Puu, 'A Century of Oligopoly Theory 1838-1941' in Tonu Puu and Irina Sushko, *Oligopoly Dynamics: Models and Tools* (Springer 2013) 1-4.

given, whereas Steckelberg analysed whether it is of benefit for a firm in an oligopoly to be a leader or a follower. According to his theory, if one firm leads in the oligopoly and the other(s) follow, then this would lead to equilibrium (known as the Stackelberg equilibrium). If each firm chooses to the follower, then the Cournot equilibrium will be the outcome. However, if each firm chooses to be the leader, then the outcome will be 'Stackelberg warfare'.[39]

If we relate these theoretical models to the credit rating industry, then we can see that it is difficult to translate the models. One reason for this is that the agencies do not reveal, at least in any clear format, the prices they charge issuers for the ratings they produce. Joffe has noted how the Big Three rating agencies will only ever release 'granular' details of their income from ratings which, when combined with a lack of detail over their pricing structures leads only to estimates on the prices being paid by market participants.[40] One agency (S&P) has released its pricing structure for 'US Rating Fees', but these are similarly vague, with an example being that there is a 'minimum fee of $110,000 for most transactions'[41] – this clearly does not reveal accurate information regarding pricing structures. Therefore, it is difficult to see whether the rating industry participants compete on price, or whether one of the Big Three may be considered a leader whilst the others follow; the only differentiation we can see is with regards to market share, with S&P holding a slight advantage of Moody's, who both hold a considerable advantage over Fitch.

However, in looking to confirm the rating industry as a natural oligopoly, certain elements of the theory do neatly translate. One of the clearest translatable elements is the concept of competition, with a particular focus on the barriers to entry. With regards to the concept of 'barriers to entry' and what that actually means, it has been suggested that the key question is 'what factors enable an incumbent or incumbents to earn profits in excess of normal profit levels while other equally or more efficient firms are excluded'. It has also been put forward that there exist three main categories of a barrier to entry, with those being: artificial; natural;

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[39] Sigrid Stroux, *US and EC Oligopoly Control* (Kluwer 2004) 10.
[40] Marc Joffe, *Doubly Bound: the Cost of Credit Ratings* (Haas Institute 2017) 15.
[41] Standard & Poor's, 'S&P Global Ratings US Ratings Fees Disclosure' (2020) https://www.standardandpoors.com/en_US/delegate/getPDF?articleId=2396451&type=COMMENTS&subType=REGULATORY (accessed 30/07/20).

and strategic barriers to entry.[42] Interestingly, the credit rating industry arguably fits into none of these categories. If artificial barriers include aspects of regulation, then whilst proponents of the 'regulatory licence' theory would argue that the SEC's designation of a 'Nationally Recognised Statistical Rating Organisation' (NRSRO) in the mid-1970s would constitute an artificial barrier,[43] I have suggested elsewhere that the SEC were merely *responding* to the marketplace in an *ex post* fashion[44] (each argument could be argued at length). Natural barriers have been described by using the examples of technical advancements, which relate to increased costs to meet the increasing standards. This is not the case for the rating agencies. The last is strategic barriers, which have been described as being implemented by the incumbents in order to deter new entrants i.e. predatory pricing. The credit rating agencies do not fall into this category either. I argue that they fall into the natural category, but for the reason that the rating dynamic, as we have discussed earlier, is the *natural* barrier that prevents new entrants. As Schroeter discusses, new firms are essentially caught in a 'Catch-22' situation in the credit rating field, in that consumers want to deal with a known quantity i.e. the established rating agencies, and the only way to become known is to rate.[45] If nobody trusts a new entrant to rate, they will never garner the experience and reputation required to be accepted. When we consider that new entrants are competing against companies that are well over 100 years old, one can see why such difficulties exist. Interestingly, even attempts to manufacture this development of a reputation have been rejected by the market.[46] It would be a natural conclusion to reach if one were to suggest that such barriers would result in a lack of quality. Whilst many critics of the rating industry would agree with this, we can see that the rating agencies are leading the way in developing innovative solutions for issues affecting the marketplace (either internally, or via acquisitions). Why would they do this, at great expense, if their position was irretrievably secure? Ellickson provides a potential answer for this via his research on the supermarket industry in the US. He identifies that oligopolistic markets do tend to expand, but that this expansion is superficial, and around the 'fringe'. These fringe players do offer competitive pressure, but only in as much as it keeps the oligopolistic leaders honest in terms of the quality they are producing – even with a feint

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[42] (n 39) 8.

[43] Frank Partnoy, 'The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies' (1999) 77 Washington University Law Quarterly 3 619, 681.

[44] Daniel Cash 'Credit Rating Agency Regulation Since the Financial Crisis: The Evolution of the "Regulatory Licence" Concept' in Daniel Cash and Robert Goddard (eds) *Regulation and the Global Financial Crisis: Impact, Regulatory Responses, and Beyond* (Routledge 2020).

[45] (n 33) 386.

[46] Daniel Cash 'Credit Rating Agency Regulation: Has the "Rule 17g-5 Program" Worked?' (2018) 29 International Company and Commercial Law Review 7.

outside chance of a challenger taking one of the leaders' places, the existence of this faint pressure is enough to stop the leaders *exclusively* relying on their traditional position (though this is not to say that there is not an element of this, of course).[47]

The credit rating industry has been used here to illustrate that a 'natural oligopoly' is very difficult to affect. This is because, for the most part, the users of the oligopolistic marketplace do not want the structure to be affected – quite simply, it works for all of the players within that space. Whilst this does not address other stakeholders like the public, for example, this is probably because other stakeholders, like the investors as we discussed earlier, are arguably passengers within the system. Friedman's definition earlier is particularly apt regarding the position of the user within a natural oligopoly; they accept the situation as it is. This leads to a question of whether the user – in our case the investor – accepts the situation as it is, and therefore perpetuates it, because a. they have no say in the development of the *system* anyway, or b. they have no appetite to affect the situation because their needs are being met? The answer to that may dictate the future successes of the CSS industry.

Misalignment

It is very difficult to say, with any sort of authority, 'what investors want'. This is simply because investors come in all sorts of forms, and even within those forms there is a large amount of variation. Even dividing between the 'retail' and 'institutional' or 'sophisticated' investor is not helpful, because there are so many underlaying influences that may affect the approach a particular investor may take.[48] However, in this section we will look at the research and responses from some of the *largest* investors to see how they interpret the marketplace, simply in the hope of providing at least some sort of basis upon which we can extrapolate.

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[47] Paul B Ellickson, 'Supermarkets as a Natural Oligopoly' (2013) 51 Economic Inquiry 2 1142-54, 1142.
[48] Mercedes Alda, 'ESG fund scores in UK SRI and conventional pension funds: Are the ESG concerns of the SRI niche affecting the conventional mainstream?' (2019) Financial Research Letters (January) 2.

Before we analyse how 'investors' understand the dynamic we are focusing upon in this article, it is prudent to look at how that function is influenced from outside of the investors' sphere. Jebe makes the insightful point that the focus on investors' views on what is 'material', and then how that understanding integrates itself into their decision-making processes, are not the only views that matter. She makes the helpful delineation between regulatory-based understandings of the concept, and market-based understandings. It is suggested by Jebe that regulators (in her example, the SEC) actually enforce and perpetuate the notion that materiality should only ever be connected to financial information. She suggests this is because, for the State, their focus is on protecting the consumer. However, Jebe then argues that the market understands materiality differently, and that the traditional definition of materiality has changed so that the financial relevance of ESG is now being considered more and more by the mainstream investor base.[49] However, if it is the case that ESG is being incorporated more into the investors' decision-making processes, then what is it that they really want from the vast array of information available?

Whilst the literature in this sector looks at a number of issues and elements that investors may want, there are some that are universal. The first is that, as Jebe notes, investors need the information to be 'decision-useful'. In essence, the investor base is consistently calling for the wide array of information that stems from what is disclosed to the market to be configured so that it can fit into their processes as seamlessly as possible. Investors have been noted as focusing both on the original disclosure from issuers, and also how that information is transmitted into the marketplace. It is here that, again, the external force of the State plays a role, because in enforcing which information must be disclosed to the marketplace, it has created a culture of issuers majoritively disclosing information that is deemed to be 'financially material', which is based on traditional understandings as we know. Although work is being done around the developed world to increase disclosure standards in relation to a wider understanding of what is 'financially material', there is still plenty of work to be done.[50] However, there is the additional issue of an increase in the amount of ESG-data providers in the marketplace (it has been noted that more than 80 entities exist which aim to

[49] Ruth Jebe, 'The Convergence of Financial and ESG Materiality: Taking Sustainability Mainstream' (2019) 56 American Business Law Journal 3 645-702, 647.
[50] Daniel Cash 'Can Credit Rating Agencies Play a Greater Role in Corporate Governance Disclosure?' (2018) 18 Corporate Governance: The International Journal of Business in Society 5.

provide such data),[51] which has been put down to the lack of an agreed-upon definition and direction for what 'sustainability' actually is in the financial context.[52]

Investors have been clear with what they need. In listening to what they say, there is a strong message for the CSS universe. For example, in a recent SASB (Sustainability Accounting Standards Board) Symposium, a number of *leading* investors made their thoughts clear. Whilst all were in agreement that ESG-related issues were of relevance to their operations, some declared that certain elements – such as the 'G'overnance element – were deemed to be more material than the rest. Interestingly, the CSS universe has been identified as specialising in the 'E' and 'S' sectors more than the 'G',[53] which leads one to wonder if this is because the credit rating agencies are making such a concerted move to focus on the 'G'-related issues, as requested for by leading investors. The investors at the SASB Symposium continued, with CalPERS stating that 'standardised information and data' is of paramount importance to their operations. CalSTRS agreed, arguing that 'comparable data' is vital as, on the basis they utilise so many different resources, being able to compare allows them to be confident in the validity and reliability of the information they are using and incorporating. On top of this, CalSTRS also made the point that the *speed* of integration is also key for their operations, which naturally feeds into the comparability and easy assimilation of data that they require. BlackRock provided a different, but no less important stance, in that the information they want to receive should be as *objective* as possible, with subjectivity proving to be a source of particular frustration for them, and presumably every other large-scale institutional investor.[54]

In using these observations as a starting point for our analysis of the CSS universe, the problems quickly come into view. Whilst the CSS universe is, as discussed earlier, almost entirely dependent on the quality of the information disclosed by the issuers they rate, the question then becomes whether it is a systemic problem for the CSSs. For example, with few utilising the notorious issuer-pays remuneration model, just how efficient is the

[51] (n 5) 14.
[52] (n 49) 682.
[53] María Jesús Muñoz-Torres, María Ángeles Fernández-Izquierdo, Juana M. Rivera-Lirio, and Elena Escrig-Olmedo, 'Can environmental, social, and governance rating agencies favour business models that promote a more sustainable development? (2019) 26 Corporate Social Responsibility and Environmental Management 439-52, 447.
[54] SASB 2016 Symposium, 'The Next Wave of ESG Integration: Lessons from Institutional Investors' (2017) 29 Journal of Applied Corporate Finance 2 10-109.

survey/questionnaire approach? Such an approach does not get the CSS in front of representatives of the issuer. If we accept that this puts the CSSs at an informational disadvantage, then the question becomes whether this issue of exposure puts the credit rating agencies at an *advantage*? Yet, there are a number of issues related to this problem of disclosure. First, issuers have been identified as potentially 'gaming' the system, which describes the process whereby issuers will only make changes that affect their external rating, and not make changes to become *more sustainable*.[55] Whilst some may argue that this will end in the same outcome anyway, further analysis into the viewpoint of issuers suggests a widely-held frustration with the CSS universe, in that there is too much variation in the market and, therefore, too many requests for their information.[56] The result may be that issuers pick and choose which CSS to work with depending on their debt-issuance needs, which is not the goal of sustainability as a financial concept. Further, issuers may just move to work with another CSS if it does not receive the grading/assessment it wants.

Second, whilst disclosure rates are an issue, what CSSs do with the information that is disclosed has also been highlighted as a particular issue. When analysing the major CSSs we looked at earlier, it quickly becomes apparent that many do not have the processes to *audit* the information they receive. Research into the views of investors on this issue found that the vast majority of investors surveyed responded that a lack of auditing standards, in addition to a lack of disclosure standards, is a worry for large-scale investors in particular;[57] one reason for this is because such large-scale investors have to *signal* the basis for their decisions to others (regulators or their investee base) and a lack of audited information is extremely problematic. Third, and finally, a plethora of research confirms that comparability is indeed one of the most important factors for investors.[58] With these issues in mind, it is clear that something has to give with regards to the sustainable rating industry moving forward. Whilst internal reorganisation within the industry may be on the cards, regulations do have a potential role to play in impacting upon that development. Nowhere is this more the case than with regards to regulations concerned with disclosure. However, with the EU and the US

[55] Ester Clementino and Richard Perkins, 'How do Companies Respond to Environmental, Social and Governance (ESG) Ratings? Evidence from Italy' (2020) Journal of Business Ethics 11.
[56] ibid 13.
[57] Amir Amel-Zadeh and George Serafeim, 'Why and How Investors use ESG information: Evidence from a Global Survey' (2018) 74 Financial Analysts Journal 3 87-103, 93.
[58] ibid.

taking vastly different approaches to the disclosure of non-financial information and the enforced usage of such information, perhaps a much larger issue is whether a lack of conformity on the global level will scupper any impact that such regulatory initiatives may have.

The Role of Regulation

Nevertheless, the EU and US are pushing ahead within the realm of non-financial reporting, albeit in very different directions. The importance of the development (or lack of) non-financial reporting initiatives to the survival of the CSS marketplace, and the continued growth of the Credit Rating Industry, is perhaps substantial. Yet, a question may be asked whether regulators and legislators are doing enough in this regard, and then even more so whether they can actually assist with this required development when we consider the structural dynamics at play within the financial sector.

The EU has been, arguably, the most active entity with regards to pushing the concept of incorporating the principles of sustainable business and investment. This is evidenced by the development of the EU's *Action Plan*, which will be achieved through the enactment of the proposed 'Taxonomy Regulation', 'Disclosure Regulation', and the 'Low Carbon Benchmarks Regulation' which, when combined, should coalesce into an effective basis for the delivery of the *Action Plan*.[59] This is in addition to a number of directives, like certain elements of the *Shareholder Rights Directive*, and something which we will pay closer attention to in this article, the original "Corporate Social Responsibility Directive" (Directive 2014/95/EU) and its recent amendments which are currently being considered and enacted. All of these actions are encased within the bloc's *European Green Deal*, which aims to make the bloc carbon-neutral by 2050. The Directive helps the private sector move towards meeting the targets set by the UN via the development of the Sustainable Development Goals initiative, as well as complying with the Paris Climate Agreement. With regards to the original Directive, which came into force effectively in 2018 for eligible companies, the EU

[59] Matthew Townsend, Isabella Kelly, and Tamara Cizeika, 'Sustainable Finance: The EU Taxonomy' (2019) Allen & Overy https://www.allenovery.com/en-gb/global/news-and-insights/publications/sustainable-finance-the-eu-taxonomy (accessed 20/08/20).

regarded its enactment as ‘vital’[60] whilst the move has also been cited as being ‘groundbreaking’.[61] In the preamble to the Directive itself, the EU Parliament state that they ‘acknowledged the importance of businesses divulging information on sustainability such as asocial and environmental factors, with a view to identifying sustainability risks and increasing investor and consumer trust. Indeed, disclosure of non-financial information is vital for managing change towards a sustainable global economy by combining long-term profitability with social justice and environmental protection’.[62]

The Directive dictates that all companies within the bloc, that are publicly-listed and have over 500 employees, must disclose certain non-financial information. It dictates that the annual reports for those companies should include a fair review of the company’s performance, impact, and position in relation to environmental, social, and employee matters, respect for human rights, anti-corruption, and bribery matters. Crucially, the Directive operates on a ‘comply-or-explain’ principle, so that where a company cannot describe a particular policy it is pursuing in relation to the aforementioned elements, it must explain why not. The theory is that ‘the introduction of an obligatory mode of preparation on non-financial reports should provide for a better information disclosure which, together with calculation on non-financial indicators, may result in improvement of efficiency in the spheres which are most important for the shareholders, other concerned parties and the society in general’.[63] However, in reality, there are a number of issues which have been identified by varied parties.

Perhaps one of the largest issues identified, which is a critique on the development of the concept of sustainability more than a critique on the Directive itself, is that the concept of sustainability and sustainable finance, and its definitional basis, is too vague. Critics have

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[60] Fabien Hertel, *Effective Internal Control and Corporate Compliance: A Law and Economics Impact Analysis of the Mysteries of a German Aktiengesellschaft Listed on the NYSE* (Nomos Verlag 2019) 263.
[61] CSR Europe and GSI, *Member State Implementation of Directive 2014/95/EU: Policy and Reporting* (CSR Europe/GSI 2017) 5.
[62] Directive 2014/95/EU of the EP 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, OJEU no. L330.
[63] Alexander Khorin, Andrey Bulgakov, and Arseniy Krikunov, ‘Financial Effects of Corporate Social Responsibility and Information Transparency (the research for the pharmaceutical industry)’ (2020) 14 Journal of Corporate Finance Research 1, 37.

suggested that corporate sustainability reporting and accounting will *never* be of use because the concept is too ambiguous and obscure for the purpose of corporate reporting, with others agreeing that it is difficult for companies to know which sustainability activities it should report on, how they engage with such activities, and just how they should report on them.[64] Barat and Helrich discuss how the complexity involved in the concept, especially with regards to the incredibly varied and complex dynamic that exists between the company and all of its many stakeholders, is proof of a 'complex socio-cognitive system' that is inherently difficult to define for the purposes of reporting i.e. how can one non-financial statement be of use to so many potential users of that information?[65] Furthermore, the scholars discuss how most stakeholders do not engage with such documents anyway, or may not have the necessary skillsets to analyse them efficiently.[66] If it is the case that the concept is difficult to define, then it stands to reason that an agreed-upon benchmark may stand to alleviate that problem. It is in this realm that we see the second criticism of the Directive, in that it does not dictate which international standard companies should use. The rationale behind this is to allow companies the flexibility to peg their sustainability approach to a standard which works best for them and allows them signal their developments most effectively. However, in line with the sentiment of this article, this is arguably yet another example of the *reality* of the dynamic between investors and private business not being considered properly.

De Luca, citing La Torre et al, discusses rightly how the flexible Directive has the effect of putting the responsibility of harmonisation in this field on the companies, which they are not inclined to do; because of this, 'the purpose of harmonisation remains quite far while the comparability is weakened'.[67] There are a number of different standards that can be used by companies to explain their performance, including the GRI, ISO, OECD, IIRC, and UNGC, as well as the Sustainability Accounting Standards Board, AccountAbility, European Federation of Financial Analysts Societies, and the Foundation for Environmental Education. De Luca helpfully notes that some of these entities provide for detailed methodologies for

[64] Susanne Arvidsson, 'An Expose of the Challenging Practice Development of Sustainability Reporting: From the First Wave to the EU Directive (2014/95/EU)' in Susanne Arvidsson (ed), *Challenges in Managing Sustainable Business: Reporting, Taxation, Ethics and Governance* (Springer 2018) 8.
[65] Pierre Barat and Vincent Helrich, 'The "Trilemma" of non-financial reporting and its pitfalls' (2018) 23 Journal of Management and Governance 485-511, 489.
[66] ibid 495.
[67] Francesco De Luca, *Mandatory and Discretional Non-Financial Disclosure After the European Directive 2014/95/EU: An Empirical Analysis of Italian-based Companies' Behaviour* (Emerald 2020) 76.

reporting (GRI, SASB, EFFAS, and ISO), some take more stakeholder-friendly perspectives (GRI, AA, ISO, and FEE), and others focus more on financial stakeholders (IIRC, SASB, and EFFAS). The effect of this is that companies can utilise the methodologies and approaches which better suit their needs, culture, and strategy. The Directive dictates that the company must consider all of their stakeholders, and that the details within the report must be audited by an independent assurance services provider. To further ensure transparency, a 'protocol document' must also be developed in order to clarify the methodology utilised in developing the report.[68] However, in this regard, there are two specific issues which have been identified. The EU recently presented a consultation which garnished 588 responses regarding the Directive.[69] First, from that consultation it was found that two-thirds of respondents believe that it is now time for stronger assurance requirements for non-financial information, based upon a common assurance standard which would preferably be developed by the IAASB. There was less consensus on which form of assurance should be prioritised, with users of non-financial information preferring reasonable assurance and preparers of non-financial information preferring limited assurance on the basis of increased costs with reasonable assurance. Most, but not all, of the respondents agreed that auditors were best placed to provide such services.[70] Second, with regards to the different standards available, more than 80% of respondents believed that this should change and that the mandating of a common standard would be beneficial. The respondents suggested that there would be support for backing a standard like that of the GRI, which is commonly accepted anyway with them being one of the first set of guidelines developed,[71] whilst hoping to foster global support for a global standard – we shall cover shortly why this may be some way off. This is widely considered to be vitally important to the development of the broader mission, because as De Luca states, 'as long as the organisations that promote different guidelines and standards will compete with each other for a leading position, sustainable development will be difficult to achieve'.[72] Yet, this is not so straightforward. Arvidsson notes that the GRI has been criticised for a while for having 'arrived at its maturation stage facing a plethora of challenges, many of which are grounded in the strategies adopted by its founder', and that

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[68] (n 65) 495.
[69] European Union, *Summary Report of the Public Consultation on the Review of the Non-Financial Reporting Directive* (Ares[2020]3997889).
[70] ICAEW, 'European Companies Support Non-Financial Reporting Rule Changes' (2020) https://www.icaew.com/insights/viewpoints-on-the-news/2020/aug-2020/european-companies-support-nonfinancial-reporting-rule-changes (accessed 20/08/20).
[71] (n 67); (n 64) 12.
[72] ibid.

there is ‘an incredible amount of diversity as to which GRI indicators companies included in their reports. This impairs comparability and the process of developing standard sets of indicators with broad acceptance among companies’.[73] Furthermore, it has even been noted that in countries where non-financial reporting has been mandated by law, the *informational value* of those reports has been particularly low, whilst full compliance with said laws has also been witnessed to be low.[74]

This provides for a number of dilemmas. On one side, it shows that regulators and legislators have not been considering what the market *needs*, which in this realm is simplified, standardised, and succinct information that is easily comparable and valuable. Though it is no small feat obtaining and then delivering information in that format, it is what the marketplace requires. Yet, do those requirements fit within the sentiment and mission of essentially mainstreaming the concept of sustainable business? This potentially points to the marketplace requiring the same quantifiable financial reporting approach to be taken to the non-financial reporting realm, which Barat and Helrich rightfully note is not possible as a. the non-financial reporting approach considers elements that are impossible to quantify, or are b. too complex to quantify. Furthermore, the scholars make the observation that doing so would go against the ethos of the drive for sustainability within business, in that reducing to such an approach would make it a tick-box and regulatory exercise, whereas the sustainability mission is to entrench the vision into the very fibres of modern business.[75] On the other side, the EU has consulted with the marketplace and we await the actions taken upon such consultation at the end of 2020.

This concept of there being a vision to be implemented is crucial to the development of sustainability within business practices. It is not just an adaption to business practices that are being suggested, but an evolution of deeply-engrained business practices and values that have been developed over hundreds of years, especially within the western world. It is that philosophical evolution that would be this movement’s greatest achievement, but is perhaps its greatest weakness. Nowhere is this battle more evident than in the United States, which at

[73] (n 64) 12.
[74] ibid 13.
[75] (n 65) 498.

the moment is demonstrative of a live battle ground for such philosophical supremacy. Whilst respondents to the EU's consultative request suggest the need for a global standard that non-financial reporting initiatives can attach themselves to, the situation in the United States suggests that the world is a long way from reaching such a point.

There are statistics available that suggest that, in theory, the US is taking action on pushing the concept of non-financial reporting. The World Business Council for Sustainable Development stated in 2018 that there were 211 reporting provisions in the United States regarding non-financial reporting, although 154 of them were on a voluntary basis. Additionally, the mandated provisions mostly related to sector-specific issues, like the impact of drilling on sea ice movement for companies involved with petroleum and natural gas extraction. However, the Council found that the US lags well behind the majority of other countries with regards to non-financial reporting, particularly on issues such as human rights, health and safety, and modern slavery. In contrast to this, the Council noted that the US is towards the top of the list when it comes to financial reporting, which hints at the philosophical issue mentioned earlier. The Council did conclude that almost 80% of the provisions for non-financial reporting were produced within the 5 years before the report was issued, suggesting that there is a positive shift towards non-financial reporting in the US.

Yet, many disagree with this. Professor Ho has noted that this philosophical battle has been developing and recent events have perhaps highlighted that it is now coming to the fore.[76] In 2016 the SEC asked for comments on whether the Commission should press ahead with new non-financial reporting disclosure rules. The response was emphatic. Nearly all took the position that shareholder engagement and shareholder activism was the best way to improve non-financial reporting and that the SEC had no business enforcing what was seen as a private matter for companies. Not only have the SEC supported this idea, but a number of Commissioners have been openly hostile to the idea, with the current Chairman, Jay Clayton, acknowledging but effectively dismissing the need for a larger focus on non-financial

[76] Virginia H. Ho, 'From Public Policy to Materiality: Non-Financial Reporting, Shareholder Engagement, and Rule 14a-8's Ordinary Business Exception' (2019) 76 Washington and Lee Law Review 3 1231-57, 1243.

reporting within the sentiment of the need to focus on the concept of 'materiality'.[77] An example of such investor action can be seen in the actions taken by shareholders within ExxonMobil, which aimed to have the company publish how it aims to meet global standards relating to environmental impact among other elements.[78] However, the SEC have since blocked, for two years running, shareholder proposals on the same basis to ExxonMobil, coming from the Church of England and the New York State Common Retirement Fund, on the basis that the resolutions amount to the 'micromanaging' of the company.[79] Ho had foreseen this when she discussed the many ways in which shareholder activism, as the vehicle for driving sustainable business practices, is ineffective.

The first element to consider is that shareholder activism is costly and, according to the US law, advisory. On this basis the board is free to disregard even a majority vote. Furthermore, such large-scale shareholder proposals only target a handful of companies a year, so attempting to advance the agenda of sustainable business practices via this vehicle is not appropriate. As Ho intimates in her article, perhaps that is the point. If it is the case that, structurally, the US is not in favour of pushing for the concept of sustainability within business, then there still exists the chance of shareholders enforcing this change via shareholder actions. That potential is also covered within American corporate law, by way of the concept of the 'ordinary business' exception. This is perhaps the second component of the country's philosophical approach to what business should be, and how it should be conducted. The Exception is based upon the belief that ordinary business problems should be resolved by the management and board of directors, and not shareholders, as it would be impracticable for them do so – this may be based on the inability to obtain the necessary information required to make the decision, a lack of specialised knowledge and/or experience, or perhaps a lack of legal foundation to promote such business practices. If the

[77] Jay Clayton, 'Statement on Proposed Amendments to Modernise and Enhance Financial Disclosures; other Ongoing Disclosure Modernisation Initiatives; Impact of the Coronavirus; Environmental and Climate-related Disclosure' (2020) https://www.sec.gov/news/public-statement/clayton-mda-2020-01-30 (accessed 20/08/20).
[78] Laura Hurst, 'Exxon, Chevron Targeted by Climate-Activist Investor Group' (2019) Bloomberg (Dec. 16) https://www.bloomberg.com/news/articles/2019-12-16/exxon-and-chevron-targeted-by-climate-activist-shareholder-group (accessed 20/08/20).
[79] The Church of England, 'SEC blocks Exxon shareholder proposal co-filed by As You Sow and the Church Commissioners for England for second consecutive year' (2020) Church of England (March 23) https://www.churchofengland.org/more/media-centre/news/sec-blocks-exxon-shareholder-proposal-co-filed-you-sow-and-church (accessed 20/08/20); Sergio Moraes, 'US Regulator Rules out Exxon Shareholder Vote on Climate Resolution' (2019) Reuters (Apr. 2) https://uk.reuters.com/article/us-usa-exxon-mobil-climatechange/us-regulator-rules-out-exxon-shareholder-vote-on-climate-resolution-idUKKCN1RE2E5 (accessed 20/08/20).

shareholders want to work around this clear divide, then they must frame the proposals as a 'significant policy issue', but these must transcend the day-to-day running of the business. To accompany this approach, there is a second way for the company's management and/or board to prevent a proposal from being implemented, and that is if the proposal can be considered as 'micro-management'. The more prescriptive a proposal, the more likely it is to be seen as micro-managing the company, which is prohibited. This was the case with ExxonMobil. To force a company to consider a particular methodology, or operate in conjunction with a specific standard – which shareholders would likely push for on account of the need for standardisation and comparability – would certainly be considered prescriptive, which would constitute micro-management.[80]

Ho suggests that the insistence, for nearly five decades, from the SEC for shareholders to frame proposals relating to 'social' and 'policy' considerations can be seen as the basis for businesses now interpreting pushes to consider ESG issues into mandatory disclosure regimes as the politicisation of the SEC and financial regulation moreover. Furthermore, Ho is of the opinion that such terminologies lead into the thinking that ESG-related concerns are themselves political or social in nature, and not 'material' or 'economic', which leads to the continued rejection of such notions. This issue of the integration and consideration of non-financial information being politicised is perhaps demonstrative of the culture within the US. Recent developments from within the Chamber of Commerce and the Department of Labor point towards the philosophical battle being waged. In 2017, the Chamber of Commerce questioned the rationality of investors who would consider ESG in their investment decisions, stating that 'an investor that bases its voting and investment decisions on promoting social or political goals is not a "reasonable" investor when it comes to what materiality means under the federal securities law', which is something ExxonMobil picked up when defending its decision to dismiss the shareholder actions that were being presented: '[t]he concept of "reasonable investor" should govern the SEC's consideration of disclosure requirements, which necessarily should exclude disclosures promoted by narrowly-focused special interest groups. The SEC should avoid promoting political, social, and public policy objectives, or attempting to drive related corporate behaviour advocated by special interest groups'.[81] This is part of a wider American focus on the politicisation, as it is framed, of crucial global issues

[80] (n 76).
[81] ibid 1253.

such as environmental protection, as evidenced by the US' decision to leave the Paris Climate Accord on that very same basis (and, in truth, countless threats to do so in other realms). In June of 2020, the Department of Labor went further, by proposing a rule that would push for pension fund managers to actively disregard ESG within their analyses. This is based upon the belief that they have fiduciary duties that can only be met by considering financially-based and 'material' information that can be quantified.[82] Whilst investors have banded together in order to provide themselves with weapons against what seems to be an systemic structure that prevents them from taking progressive action, like the creation of the *Investor Stewardship Group*, the reality is that shareholders are now turning against the system. Some of the world's leading investors have spoken out against the Department of Labor's proposal,[83] whilst there have been a number of investor petitions to the SEC to change its approach.[84]

So, in reality, the suggestion that there may be some form of global standard when it comes to non-financial reporting may be some way off and, in fact, I would suggest almost impossible given the heightened politicisation of almost every facet of life in recent years. The EU are taking bold strides, but yet they continue to prescribe regulations that simply do not take into account to required needs of the marketplace. Perhaps that is because, fundamentally, the position of the State and the market may always be at odds (unless the State is controlled by those who are *particularly* pro-business, of course). For example, the EU wants to allow for flexibility and also for competition to flourish, whilst the marketplace wants neither of those things in this instance. With the new amendments coming shortly, it will be telling to see whether the EU moves more towards the market, or attempts to maintain its authority by insisting on the way forward. Meanwhile, in the US, the State is actively protecting the companies' controlling bodies, not those who are invested in them. It is a peculiar approach given the post-Crisis quest to 'protect the consumer' and investors, but in reality that may be more representative of the change in political leadership that has occurred since the Crisis. Or, alternatively, it may just be representative of the Country's cultural understandings of how business should be run; the disparate investor base should be

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[82] US Department of Labor, 'U.S. Department of Labor Proposes New Investment Duties Rule' (2020) https://www.dol.gov/newsroom/releases/ebsa/ebsa20200623 (accessed 21/08/20).
[83] Cyrus Taraporevala, 'US regulators wrong to dismiss ESG investing for pensions' (2020) Financial Times (Aug 2) https://www.ft.com/content/81b267f4-414b-4c5a-b775-91c2f1a2f661 (accessed 20/08/20).
[84] (n 76) 1241.

contained, and normally only financially-related information can be 'material'. If this is the case, then the development of the concept of sustainable finance and business, on a truly global scale, could be some way off indeed.

Yet, is there anything more regulators could do? In the US, it would take a sea-change in sentiment from the regulators themselves firstly in order to implement even the early stages of the cultural change required. It seems that there are many constituent parts that need to change in order for the US to adopt the changes needed, and it is questionable whether the regulators would make those changes. It appears that investors want change, but that the system is against that happening. One approach which could be taken is investor activism, but against regulators rather than companies. In that sense, the very large investors have a massive role to play in engaging with, and perhaps putting pressure on regulators and legislators, arguably just as much if not more than the companies do via their leadership for very different ends. In the EU, the legislators would do very well to heed the suggestions put forward within their recent consultative process. Their lofty ambitions, as a bloc, will only be realised through practical means. The development of the *Action Plan* as a method of achieving the aims set out in the *Green Deal* is progressive, but will not come to fruition if participants cannot truly engage. To that end, legislators should aim to work with one or two standard setters, and push for them to streamline their own services and methodologies so that those principles and the benefits that derive from them are fed through the system. The GRI is a perfect example of a body that has the capacity to become the standard, but needs to be pressurised to re-align their own processes with the overarching principles of streamlined but useful information. To supplement this, the EU should then enforce the usage of this streamlined service and take away the increased optionality for companies to report through; it may be distasteful for a liberal economy to take such actions, but the investor base and reporting entities are crying out for this and will, ultimately, be more productive and aligned to the overarching goals of sustainable business as a result. It could be tempting to reduce the concept of this movement away from being a 'vision' to more of a set of adaptations to business practices that may be more palatable to those who object to being dictated to, but that will not be enough. It is crucial that the *ideal* of creating an environmentally and socially sustainable business realm is maintained and championed, so that members can not just buy into the ideal, but *embody* it. Those are very different aspects.

The Future for the Sustainability Rating Agencies

The sustainability rating agencies, or CSSs as we are referring to them in this article, are at a crucial juncture in their development. They are being criticised by researchers, industry participants, and more recently even regulators are warning against their usage and complaining of their lack of usefulness.[85] In this article we have seen that there are two major issues with the industry; first, there are perhaps too many providers within the industry for the purposes of their users (both issuers and investors), and second the agencies are slaves to the information the issuers provide, and have little influence over affecting that stream of information. These two issues lead to inherent problems such as a lack of informational value, and the inability to compare. When we consider that the sole reason for their existence is to both alleviate asymmetry in the field, and to provide for signalling opportunities to their users, such inherent problems have the potential to be a death knell for the industry.

However, even before we consider the actions the much larger credit rating industry may take in this field, there is hope for the CSSs. If, and one must seriously stress the word *if* here, the EU does take progressive and particular action like that proposed above, then the changes to the reporting of non-financial elements may alleviate one of those issues for the industry. It will not alter the issue that the users of the industry require an oligopolistic model, but it will allow for CSSs to compete, truly, upon quality because they will have access to high quality, and appropriately audited non-financial information. As they do not have the resources, nor the structural positioning to pressure issuers like the credit rating agencies have, this could be the thing that saves the CSS industry in its current form. However, this scenario playing out in exactly that manner is nowhere near guaranteed.

The credit rating agencies are no longer sitting on the side-lines either. They are actively devouring the market for sustainable-related data and information and are incorporating it

[85] Bhakti Mirchandani, 'What to Make of the SEC's Warnings and Recommendations for ESG Investing' (2020) Forbes (May 29) https://www.forbes.com/sites/bhaktimirchandani/2020/05/29/what-to-make-of-the-secs-warnings-on-esg-ratings-and-recommendations-for-esg-disclosures/#30c3d0073184 (accessed 20/08/20).

into their own offerings. The market is not far from reaching a point whereby if an investor where to be looking for ESG-related data, they would go to a credit rating agency – even if they were not concerned with the creditworthiness of an entity (for example). In reality, the divergence between creditworthiness and proficiency with regards to ESG and sustainable practices, is decreasing all the time. Perhaps that is a good thing, in that the mind may eventually see no demarcation between the "E", "S", "G", and the "F" (financial) when it comes to 'materiality', and that one is just concerned with *materiality* in a truly holistic form. If that ideal is reached, then surely that would mean that the concept of sustainable business has been absorbed into the human psyche, and probably irreversibly within that scenario. However, in that scenario, there would be no demarcation either between financially-based credit risk data, and non-financially-based credit risk data, and in that scenario it would be a straight battle between the CSSs and the credit rating agencies, and I can only see one winner in that scenario. The only aspect that would be left for the CSSs would be providing information to be fed into indices, but would the credit rating industry leave that provision alone? If it provided for profit, then surely not. Many critics have warned about the size of the rating industry and, since the Crisis, its continued growth has only heightened those warnings. At some point that growth will come into contact with the CSS universe – and, in truth, already has - and it is unlikely to stop.

Conclusion

The CSS universe grew during a time of great hope for the development of sustainable finance. After the Financial Crisis, their mission aligned to calls for a different way of business to be conducted. However, that vision is now starting to crystallise into something tangible, and the *reality* is starting to creep in. For mainstream business practices to become sustainable, the concept of sustainability must become mainstream too. If that is to happen, then the mainstream must be catered to, as dictating to it will not be fruitful. To that end, there are certain things that modern business and modern finance needs in order to function. Standardisation, clear information which is both easy to communicate and easy to assimilate, and a reduction in duplication and wasted resources.

The CSS universe is currently struggling to meet that demand. The CSS universe is, essentially, struggling with the mainstreaming of the wider concept of sustainability. As is often the case, that void can and will be filled by somebody or something else, and the credit rating industry looks poised to cater to the mainstream's needs. There are aspects that the CSS universe needs, but which it cannot affect on its own because of its size and lack of reputational capital considering its nascent stature. One particular element, improving the quality and dissemination of key information from companies, is something that could go a long way to providing a foundation upon which the CSS universe could grow and develop. As the CSS universe cannot pressure the issuers to provide this, regulators have considered whether they should do it instead. Fortunately, the EU also believes that the publication of rich non-financial information by issuers can aid with the development of a sustainable economy, and is taking action to that end. The EU has taken a starting point, which I have criticised in this article, but crucially is seeking to learn from the market and develop palatable, practicable, and progressive policies as we speak – the results of a recent consultation relating to amendments to the Directive in this field will be of crucial importance at the end of 2020. Unfortunately, on the other side of the Atlantic Ocean, the sentiment is not shared. Politicians, regulators, and legislators are lining up to denounce the impact and potential of non-financial factors on the efficient running of business, and are essentially dismissing the concept of sustainable business as an agenda which is to be countered. This is, of course, related to the political agenda being pursued in the US and this may change pending the outcome of the Presidential elections in November, if indeed they take place at all given the current climate. However, the fortitude of the EU in this regard is a green-shoot for the concept of sustainable business, and one that may save the sustainable rating industry in some form. However, there is a chance that the damage has already been done and that the wounds that are being inflicted at the moment, from researchers to regulators, may be too deep to recover from. The credit rating agencies smell the blood in the water that is emanating from those wounds, and it is in their nature to strike.

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