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ESG Ratings—Guiding a Movement in Search for Itself

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Abstract

ESG ratings deliver the short-hand evaluation that investors need to incorporate environmental, social, and governance aspects in their decision-making. In this capacity, they give direction to the ESG movement and define its objectives. The paper argues that an ESG rating can serve two distinct purposes: either to inform financial investors about long-term risks and returns from ESG-related factors or to guide prosocial investors in awarding a “greenium” subsidy for social performance. Because the information demands differ, ESG rating providers should commit to either one of these missions. The paper analyzes the specific problems of ratings serving prosocial investors. Implicitly or explicitly, such ratings reflect an ordering of political priorities that rating providers have to set. To maximize the impact of the subsidy, ratings should be tailored to the incentive structure of firms. Standardizing ESG ratings would further strengthen the effect of impact investing but seems unlikely to be attainable.

Keywords: ESG ratings, ESG investing, impact investing, active ownership

JEL Classifications: D21, D62, D64, D71, G11, G32, K22

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ESG Ratings—Guiding a Movement in Search for Itself

I. Introduction

The ESG juggernaut is rattling the world of investment, finance, and business. It is commanding and deafening, but will it bring real change? Any assessment will depend on what ESG is or ought to be. There are two competing visions: One is that ESG is an aspect of enlightened shareholder value, a movement to better attune corporate valuations to drivers of long-term profitability and risk. In this view, ESG is a refined and more sophisticated investment technique with the promise of enhancing investor returns and creating benefits to society from enhanced allocation of scarce capital.[2] The alternative vision is that ESG marks a fundamental transformation of capital markets and private investment. Rather than finetuning the maximization of financial returns, ESG widens investors' perspective from a narrow focus on wealth towards a balanced pursuit of private and social gain. ESG-minded investors are supposed to imprint ethical responsibilities and aspirations for a better society on the economic activities that they finance. These ambitions are more clearly expressed in the older terms "Corporate Social Responsibility," "Socially Responsible Investing," or "value investing." In fact, introducing the term "ESG" for "environmental-social-governance"—a list of topics more than a demand—was meant to make these ideas more palatable to mainstream investors and institutions.[3]

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1 The author gratefully acknowledges financial support from the Federal Ministry of Education and Research under the Excellence Strategy awarded by the Berlin University Alliance.

2 For a recent forceful statement, *see* Alex Edmans, *The end of ESG*, 52 Fin. Mgmt. 3, 4 (2023) (arguing that ESG-based valuation is "both extremely important and nothing special").

3 The emergence of "ESG" is usually credited to a report by a group of financial institutions at the behest of the UN, Global Compact, *Who Cares Wins* (2004), at ii. *See* Elizabeth Pollman, *The Making and Meaning of ESG* (ECGI Law Working Paper 659, 2022), 8–19 (recounting the development of ESG as a partnership between the UN sustainability drive and the financial industry); Iain MacNeil & Irene-Marié Esser, *From a Financial to an Entity Model of ESG*, 23 Eur. Bus. Organ. L. Rev. 9, 12–16 (2022). A legal background is the debate about asset managers' fiduciary duties and, specifically, their mandate to pursue other than purely financial interests, *see infra* note 22. For a critical account of ESG's financial turn Emma Avetisyan & Kai Hockerts, *The Consolidation of the ESG Rating Industry as an Enactment of Institutional Retrogression*, 26 Bus. Strategy & Env't 316, 328 (2017) ("By integrating ESG ratings into the financial rating industry […] the old guard has reaffirmed its norms and values."). *See also* Robert G. Eccles, Linda-Eling Lee & Judith C. Stroehle, *The Social Origins of ESG: An Analysis of Innovest and KLD*, 33 Org. & Env't 575 (2020) (providing a detailed case study of the development leading up to the present-day MSCI ESG Ratings).

Although this chapter is confined to ESG ratings, at its heart is the question whether ESG only augments financial analysis or transmutes capital investment into civic engagement. The reason is that in order to measure a concept, one must define it, at least implicitly. This is true for ESG disclosure standards, but it applies with even greater force to ESG ratings. These measures not only provide data on environmental, social, and governance aspects of firms, but they also fuse these different observations into a single evaluation of a firm's overall ESG performance. The comprehensive judgment, condensed in a numerical value, provides much needed simplification for the wholesale business of investing large amounts of capital in broadly diversified portfolios. ESG ratings articulate what ESG-minded investors demand of firms—they steer the juggernaut's course.

In consequence, ESG ratings are drawing calls for regulatory action and attention from regulators.[4] The chapter refrains from discussing specific policy proposals. Its presumption is that one first needs to reflect what service ESG ratings can and should provide to capital markets. The first claim of the chapter is that any ESG rating can play only one of two distinct roles: either inform the market about environmental, social, or governance drivers of financial performance or, alternatively, guide investors with prosocial motives and a willingness to sacrifice financial returns to channel their subsidies to the most deserving firms. While it seems evident that these are fundamentally different objectives, the chapter needs to weed out much confusion to arrive at this conclusion. A policy implication could be to require ESG ratings providers to be upfront which of the two objectives they serve. Keeping this awkward choice out of sight likely is part of the marketing strategy of ratings providers and the sellers of ESG investment products. Policy makers likewise seem more inclined to push the juggernaut than to interfere with it. There is little optimism that regulation will require ESG ratings providers to be explicit about their purpose.[5]

The chapter then more closely considers ESG ratings that aim at "impact investing." Moving from a focus on financial wealth to a broader pursuit of the common good

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4 The European Commission in June 2023 has tabled a proposal for an ESG Ratings Regulation, COM(2023) 314 final.

5 As expected, the proposed ESG Ratings Regulation misses the point by requiring rating providers to "clearly mark[…] whether the rating is assessing risks, impacts or some other dimension", *see* its Annex III, part 1 (d).

turns investment into a political business.[6] As such, it inherits the glory and luster, but also the woes and miseries of political discourse. In consequence, ESG ratings for prosocial investors grapple with three connected problems: First, investors invariably disagree over which social goods to promote and how to prioritize them. Second, in directing capital flows from prosocial investors, ESG ratings should aspire to produce the greatest impact for the political agenda of their users. Third, to this end ESG ratings should also seek to unite the financial firepower of prosocial investors. Yet greater coordination clashes with investors' inclinations to see their own individual political views promoted. The latter dilemma underscores the special difficulty of harnessing the marketplace to effect social change. Prosocial ESG ratings run a great risk of disappointing their proponents and followers.

All these questions concern mostly the "E" and "S" pillars of ESG; the chapter therefore has less to say about the "governance" component of ESG ratings, except where it relates to political goals, such as diversity. Its remainder is organized as follows: The next section II briefly describes the information that ESG ratings provide. Section III lays out two different functions that ESG ratings can serve. Exploring their roles requires a closer analysis of the two major reasons for investors to seek information about firms' ESG characteristics and outcomes, namely financial valuation and social impact. Section IV argues that ESG ratings cannot deliver on both purposes and, therefore, that they should be designated to either one of them. Focusing on social-impact ratings, section V elaborates on the challenges that ESG ratings providers face in organizing a shared political agenda. Like a government or regulator, they have to aggregate the political preferences of their constituent investors and to allocate scarce common resources to their most effective use. Yet unlike a government or regulator, there is not a single ESG rating as a collective decision maker on behalf of investors. Instead, many competing ESG ratings offer rather diverse directions on what constitutes social performance and which firms deliver it. Section VI addresses this "ratings confusion" and its discontents.

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6 *Cf.* Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L. Fin. & Acct. 247 (2017).

II. What's in a rating?

One can define ESG ratings—sometimes referred to as "metrics" or "scores"—as quantitative measures of a firm's environmental and social impact and of characteristics that affect these outcomes as well as the firm's financial performance.[7] By contrast to credit ratings, ESG ratings are paid for by investors, not issuers.[8] Evaluative approaches differ and market concentration is rather low:[9] MSCI is believed to be the largest provider, but several others appear to be significant market players,[10] including Refinitiv (formerly Thomson Reuter under the brand ASSET4), FTSE Russell, Sustainalytics (acquired by Morningstar), Moody's (formerly Vigeo Eiris), S&P Global (formerly RobecoSAM), Bloomberg, ISS (formerly Oekom), FactSet Truvalue, and RepRisk.[11] The market has experienced steep growth and was expected to hit one billion dollars of sales in 2021.[12] Major providers are reported to employ more than 150 analysts to produce their respective ESG ratings.[13]

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7 *Cf.* Dane M. Christensen, George Serafeim & Anywhere Sikochi, *Why Is Corporate Virtue in the Eye of the Beholder? The Case of ESG Ratings*, 97 Acct. Rev. 147, 150 (2022) ("to measure the ESG performance of a company […,] an assessment of how well a company is managing environmental, social, and governance risks and opportunities").

8 Note, however, that the credit rating industry switched to the issuer-pays model only in the 1970s, Ulrich G. Schroeter, *Credit Ratings and Credit Rating Agencies*, in Handbook of Key Global Financial Markets, Institutions, and Infrastructure 379, 383 (Gerard Caprio, Jr., Douglas W. Arner, Thorsten Beck, Charles W. Calomiris & Larry Neal eds., 2013).

9 A "chaotic universe" according to Daniel Cash, *Sustainability Rating Agencies vs Credit Rating Agencies* 35 (2021).

10 For an in-depth study of the development of MSCI and its precursors, *see* Eccles, Lee & Stroehle, *supra*.

11 *See* the overview in Cash, *id.* at 38–43; *see also* ERM SustainAbility Institute, *ESG Ratings at a Crossroads, Rate the Raters 2023*, https://web.archive.org/web/20230514114414/https://www.sustainability.com/thinking/rate-the-raters-2023 (providing a survey of investors and firms about the quality of competing ESG ratings); Florian Berg et al., *ESG Confusion and Stock Returns: Tackling the Problem of Noise* 6 (NBER Working Paper 30562, 2022). A recent estimate tallies the market share of the three leading ESG data providers MSCI, ISS and Sustainalitics at 60%, Lynn Strongin Dodds, *ESG data spend exceeded $1 billion in 2021*, https://web.archive.org/web/20230513114809/https://www.bestexecution.net/esg-data-spend-exceeded-1-billion-in-2021.

12 Florian Berg, Kornelia Fabisik & Zacharias Sautner, *Is History Repeating Itself? The (Un)predictable Past of ESG Ratings* 1 (ECGI Finance Working Paper 708/2020).

13 Christensen, Serafeim & Sikochi, *supra*, 151.

To arrive at a single numerical assessment, ESG rating providers use a variety of information sources.[14] Many of them are readily accessible, such as corporate disclosures or published reports from government agencies and other organizations; others require more effort, for instance conducting surveys with the respective firms or evaluating media reports at large scale.[15] Collecting this information is the first value created by ESG ratings providers. A second step is making the information comparable across firms by assigning it to categories and then to individual items and forcing the firm-specific information into standardized scales or categorical questions that can be processed quantitatively.[16] For instance, the first of 70 items relating to environmental performance from Refinitiv ESG scores (formerly ASSET4) consists in the yes-no question: "Is the company under the spotlight of the media because of a controversy linked to biodiversity?"[17] The items often require a judgment—when is a firm "under the spotlight of the media"?—and an evaluation whether they enhance or impair the firm's performance.[18] Providers differ in whether they make the component indicators of their ratings accessible to their customers.[19] The last step in the production of ESG ratings is to aggregate the various items into an overall assessment of the firm's ESG outcomes and characteristics, often first separately for the three sub-areas of "E," "S," and "G" and then as a single measure for all of "ESG." For the most part, providers aggregate by simply attaching weights to each indicator and adding them up.[20] This of course requires further value judgments about how individual items and the different aspects of ESG should be

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14 For a description of the methodologies of Sustainalytics and MSCI, *see* Cash, *supra* at 44–50.

15 *See, e.g.,* George Serafeim & Aaron Yoon, *Which Corporate ESG News Does the Market React to?*, 78 Fin. Anal. J. 59, 63 (2022) (using a machine collected and classified dataset of firm-related news reports from Factset's Truvalue Lab).

16 The number of indicators was found to range from 38 to 282 across providers. Some of them also use industry-specific indicators, Florian Berg, Julian Kölbel & Roberto Rigobon, *Aggregate Confusion: The Divergence of ESG Ratings*, 26 Rev. Fin. 1315, 1323–25 (2022).

17 Alexander Dyck et al., *Do Institutional Investors Drive Corporate Social Responsibility? International Evidence* 57 (2018), online appendix of 131 J. Fin. Econ. 693 (2019), https://ssrn.com/abstract=2708589.

18 Id. (designating the "Direction" of the item stated in the text as "Negative"). As to the subjective judgment inherent in indicators, Berg, Kölbel & Rigobon, *supra* at 1338–41 (finding a "rater" or "halo" effect under which evaluation of one indicator influences that of another).

19 Christensen, Serafeim & Sikochi, *supra* at 163.

20 *See* Berg, Kölbel & Rigobon, *supra* at 1330–32 (finding that a linear regression on available indicator values explains ESG ratings fairly well with the exception of MSCI and arguing that regression coefficients can be interpreted as weights attached by providers).

weighted. The resulting aggregate measure is normalized, typically to a range from 0 (worst) to 10 or 100 (best).

III. Functions of ESG ratings

Investors can use ESG ratings for their investment decisions and, once invested, for exercising their rights as shareholders to influence how the firm conducts its business. The difference between financial and prosocial motives of investors figures most prominently in ESG ratings' role in guiding investment (subsection 1). When it comes to engaging with management, ESG ratings can assist active owners in focusing on the most worthwhile targets. There is also a complementarity to the first role of channeling investments in that active owners can hope to benefit increases in market valuation if firms improve their social performance (subsection 2).

1. Guiding investment

a) Financial investing

Environmental and social aspects of a firm's activities can affect its long-term profitability and the systematic, non-diversifiable risk of its securities. ESG ratings thus can provide information about future financial returns and priced risk, helping financially motivated investors in valuing securities. In fact, some ESG ratings providers tout their services as a source of financially "material" information about issuers. For instance, MSCI proclaims its ESG ratings to "aim to measure a company's resilience to long-term, financially relevant ESG risks."[21] The restriction to "financially relevant" risk could be surprising in light of the enthusiasm for socially responsible investing. One plausible explanation is that ratings providers strive to sell their assessments to asset managers who are bound by fiduciary duties. At least in the U.S., important classes of asset managers—notably pension trustees

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[21] MSCI, *MSCI ESG Ratings Methodology* 5 (2023); this objective is in sharp contrast to prosocial precursors of MSCI ESG Ratings, *see* Eccles, Lee & Stroehle, *supra*. Another major provider omits any specific reasons for using ESG ratings, *see* Refinitiv, *Environmental, Social and Governance Scores from Refinitiv* (2022), https://web.archive.org/web/20230607155703/https://www.refinitiv.com/content/dam/marketing/en_us/documents/methodology/refinitiv-esg-scores-methodology.pdf .

under ERISA—face significant legal risk if they admitted to pursuing interests other than the financial well-being of their beneficiaries.[22]

(1) Information about abnormal market returns?

Countless studies have sought to determine whether greater ESG engagement leads to better financial performance.[23] A caveat is that most of it has not appeared in mainstream finance journals.[24] This not only points to a shortcoming of finance, business, and economics scholarship. It also suggests that knowledge from these fields has not been fully incorporated into research on the financial implications of ESG investing. A striking example is that many studies seem ignorant of the notion of capital market efficiency: If a portfolio sorted on publicly available ESG ratings outperformed the market portfolio on a risk-adjusted basis and over long horizons, this would be a flagrant violation of semi-strong market efficiency. Going long on ESG and short on the market is a very simple investment strategy. This makes it less

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22 *See* Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 Stan. L. Rev. 381, 388–89, 399–420 (2020) (recounting the "rebranding" of "socially responsible investing" as ESG and arguing that ERISA and trust law essentially only allows "risk-return ESG"); Freshfields Bruckhaus Deringer, *A Legal Framework for Impact* (2021), para. B58, https://web.archive.org/web/20230703063816/https://www.freshfields.com/4a199a/globalassets/our-thinking/campaigns/legal-framework-for-impact/a-legal-framework-for-impact.pdf (summarizing extensive survey to the effect that most institutional investors are bound to "act primarily to secure optimal financial returns" and that in "some jurisdictions and for some types" of institutions "this should be the sole purpose"); *see also* John C. Coffee, *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk*, Colum. Bus. L. Rev. 602, 632–33 (2021) (likewise explaining the shift to "ESG"); Factset, *ESG Materiality Factors in the Fourth Industrial Revolution* 4, 7 (2021) (describing "materiality" as a strategy to justify ESG investing); Max M. Schanzenbach & Robert H. Sitkoff, *ESG Investing After the DOL Rule on "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights* (Harvard Law School Forum on Corporate Governance, 2023), https://corpgov.law.harvard.edu/2023/02/02/esg-investing-after-the-dol-rule-on-prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights/ (reporting on recent ERISA rule changes).

23 A recent meta-study relied on 1,141 peer-reviewed articles from 2015–2020 alone, Ulrich Atz et al., *Does Sustainability Generate Better Financial Performance? Review, Meta-analysis, and Propositions*, 13 J. Sustainable Fin. & Inv. 802, 805 (2023); *see also* Gunnar Friede, Timo Busch & Alexander Bassen, *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies*, 5 J. Sustainable Fin. & Inv. 210, 215 (2015) (identifying 1,678 academic studies up until 2014).

24 *Cf.* Ivan Diaz-Rainey, Becky Robertson & Charlie Wilson, *Stranded Research? Leading Finance Journals Are Silent on Climate Change*, 143 Climatic Change 243, 245–53 (2017) (documenting a fraction of 0.06% of articles published in 21 leading finance journals 1998–2015 dealing with climate-related issues and a corresponding fraction of 0.24% for the top business journals).

plausible to expect ESG-ranked portfolios to beat the market, at least by more than the implementation costs of the arbitrage trade. If ESG improvements increase expected cash-flows or reduce systematic risk at the level of the individual firm, an efficient market instantaneously incorporates the change in securities prices. The enhanced future profitability accrues to investors as a one-time appreciation of their securities. Once the price has adjusted, expected returns again equal market rates.[25] The same logic applies to systematic, non-diversifiable and therefore price risk: Once investors learn of a decline, they charge a lower risk premium in line with the market rate for systematic risk, leading to a price increase of the firm's securities.

Distinguishing between firm-level fundamentals and their incorporation in market prices is second nature to the finance scholar but, astonishingly, it is sometimes overlooked in empirical studies on the financial performance of ESG.[26] When the difference is taken into account, the empirical evidence tends to favor market efficiency and, accordingly, disfavors the promise of abnormal positive returns from ESG-tilted portfolios.[27] This finding has been cast in a somewhat brighter light by

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25 To illustrate, suppose the required market return of a stock, given its risk, is 10%. Assume further that the stock delivers perpetual expected cash flows of €10 per year to its holder. Using the perpetuity formula, the net present value and hence the efficient price of the stock is €10 ÷ 0.1 = €100. If the firm succeeds in increasing annual cash flows to €11, the stock price rises to €11 ÷ 0.1 = €110. After the one-time price adjustment, the market rate of return is again 10%: An investor has to pay €110 to purchase a stock delivering €11 per year.

26 *E.g.*, Friede, Busch & Bassen, *supra* at 220–21, 225–26 (deploring the results of "portfolio" studies as outliers but missing the key difference described in the text). A very recent primary study with no mention of the problem is Francesco Cesarone, Manuel Luis Martino & Alessandra Carleo, *Does ESG Impact Really Enhance Portfolio Profitability?*, 14 Sustainability 2050 (2022).

27 *See* Chang-Soo Kim, *Can Socially Responsible Investments Be Compatible with Financial Performance? A Meta-Analysis*, 48 Asia-Pac. J. Fin. Stud. 30, 33, 46–53 (2019) (arguing for a hypothesized non-effect and finding it in a meta-analysis of 51 U.S. studies 1978–2016); Christophe Revelli & Jean-Laurent Viviani, *Financial Performance of Socially Responsible Investing (SRI): What Have We Learned? A Meta-Analysis*, 24 Bus. Ethics 158, 160–63, 166–69 (2015) (carefully discussing possible claims and finding a non-effect in a meta-analysis of 120 studies 1972–2012); Atz et al., *supra* at 807, 809–10 (finding "investor" level studies to deliver significantly lower performance effects compared to the firm level); Harrison Hong & Edward P. Shore, *Corporate Social Responsibility* (NBER Working Paper 30,771, 2022), 9–13 (summarizing studies by financial economists and finding most of them to conclude that high-ESG firms and portfolios yield lower returns); Lars Hornuf & Gül Yüksel, *The Performance of Socially Responsible Investments: A Meta-Analysis*, forthcoming Eur. Fin. Mgmt., https://doi.org/10.1111/eufm.12439, 17–26, 31–36 (reporting an overall inconclusive finding on ESG over-performance from a meta-analysis of 124 studies spanning 1981–2020 and documenting that ESG performance tends to be worse in studies controlling for more risk factors and being published in finance journals); *see also* Friede, Busch & Bassen, *supra*, at 220–1 (similarly for their subset of "portfolio" studies); *but see* Mozaffar Khan, George Serafeim & Aaron Yoon, *Corporate Sustainability: First Evidence on Materiality*, 91 Acct. Rev. 1697,

arguing that pursuing better environmental and social outcomes seems not to hurt investors.[28] However, the likely reason is once more that arbitrage in secondary markets aligns prices with expected future cash-flows. If social improvements happened to reduce future profits, the stock price would decline, investors would suffer a one-time loss but would again earn the market rate going forward.[29]

(2) Information about fundamental value

Even for purely financial investment, ESG ratings can still convey relevant information about the fundamental value of firms and particularly their "operating" performance—the expected cash flows to the firm itself (as opposed to investors) and their riskiness. There are various reasons how environmental and social outcomes affect the fundamental value of firms by increasing profits or reducing risk. One is that environmental or social engagement adds an intangible quality to a firm's products and differentiates them from those of competitors. This increases price margins and mitigates exposure to economy-wide demand shocks, leading to higher profits and lower systematic risk.[30] Another reason can be the prospect of future regulation or backlash from stakeholders or the public. A prominent example is climate change where firms with larger carbon emissions face greater risk from regulatory changes. Recent evidence suggests that investors cannot fully diversify the risk and therefore demand compensation for bearing it; the risk decreases the fundamental value of carbon-intensive firms.[31] These are just two illustrations that

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1706–15 (2016) (detecting significant overperformance 1992–2013 for firms with a higher index on those ESG issues that were identified as financially "material" by the Sustainability Accounting Standards Board and attributing this result to the fact that the materiality classification became available only ex post).

28 *See* Revelli & Viviani, *supra* at 169.

29 For the underlying logic *supra* note 25.

30 *See* Rui Albuquerque, Yrjö Koskinen & Chendi Zhang, *Corporate Social Responsibility and Firm Risk: Theory and Empirical Evidence*, 65 Mgmt. Sci. 4451 (2019) (providing a theoretical model and showing an empirical association of higher ESG scores and advertising spending with Tobin's Q and CAPM beta).

31 *See* Emirhan Ilhan, Zacharias Sautner & Grigory Vilkov, *Carbon Tail Risk*, 34 Rev. Fin. Stud. 1540 (2021) (documenting higher insurance cost in option markets for tail risk of carbon-intense firms and in times of increased policy uncertainty); Patrick Bolton & Marcin Kacperczyk, *Do Investors Care About Carbon Risk?*, 142 J. Fin. Econ. 517, 530–41 (2021) (finding a carbon intensity premium in U.S. stock returns); *see also* Robert F. Engle et al., *Hedging Climate Change News*, 33 Rev. Fin. Stud. 1184 (2020) (using ESG ratings to construct a portfolio to hedge against risk from climate-related news); more generally for a systematic risk

"doing well by doing good" could apply to the firm, as opposed to investors who buy securities at prices that already reflect the financial benefits of ESG improvements.[32] One caveat is that causality could run in the opposite direction: Higher profits could induce firms to enhance their social performance.[33] And there is always the opposite possibility that prosocial practices impair the financial bottom line, as Milton Friedman famously suspected when he equated corporate social responsibility to managers "spending someone else's money for a general social interest".[34] Friedman's view aligns with the impact-investing version of ESG—to be contemplated below—where investors trade financial returns for advancing their civic and social causes.

Information about expected firm-level cash-flows and risk is needed for securities prices to reflect fundamental value. To the extent ESG ratings contain such information, they feed it into the market; investors respond by adjusting prices. By implication, one expects *changes* in ESG ratings to affect stock market valuations. In fact, there is evidence that ESG rating downgrades entail somewhat negative abnormal returns, especially in recent years; upgrades seem not to affect stock prices.[35] The asymmetry mirrors that of many event studies on news about firms'

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factor from anti-pollution policy changes Po-hsuan Hsu, Kai Li & Chi-yang Tsou, *The Pollution Premium*, 78 J. Fin. 1343 (2023).

32 One indication are event studies about stock price reactions to news about environmental or social aspects of the firm. They tend to find an asymmetric pattern where only negative ESG news have significant effects, e.g., Philipp Krüger, *Corporate Goodness and Shareholder Wealth*, 115 J. Fin. Econ. 304, 312–13 (2015) (documenting pronounced negative abnormal returns around reports about ESG concerns); Gunther Capelle-Blancard & Aurélien Petit, *Every Little Helps? ESG News and Stock Market Reaction*, 157 J. Bus. Ethics 543, 553–4 (2019) (smaller but significant abnormal returns upon negative ESG news in a large sample of events 2002–2010); *but see* Serafeim & Yoon, Corporate ESG News, *supra* at 64–70 (reverse asymmetry with mostly only positive abnormal returns in response to good ESG reports from a machine-generated large sample 2010–2018).

33 *See* Harrison Hong, Jeffrey D. Kubik & Jose A. Scheinkman, *Financial Constraints on Corporate Goodness* (NBER Working Paper 18476, 2012) (providing evidence that better financial performance causes higher ESG ratings); Thomas Lys, James P. Naughton & Clare Wang, *Signaling through corporate accountability reporting*, 60 J. Acct. & Econ. 56 (2015) (arguing that firms signal improving financial performance to the market by expanding ESG activities).

34 Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times Magazine, 13 September 1970, 32, 33.

35 *See* Savva Shanaev & Binam Ghimire, *When ESG meets AAA: The effect of ESG rating changes on stock returns*, 46 Fin. Res. Letters 102,302, 3–4 (2022) (documenting monthly abnormal returns of around –1.1% of calendar portfolios of downgraded firms 2016–2021); Maximilian Glück, Benjamin Hübel & Hendrik Scholz, *ESG Rating Events and Stock Market Reactions* 20–22 (2021), http://dx.doi.org/10.2139/ssrn.3803254 (finding that MSCI score downgrades by

social performance (as opposed to changes in ESG ratings).[36] The tenuous evidence can have at least two plausible and complementary explanations: One is that the market has impounded much relevant information before it shows in ESG ratings.[37] The second possible reason for the limited price impact is that the financial implications of environmental and social information vary.[38] There is evidence that only some of it affects the fundamental value of firms.[39] For instance, stock price increases from positive environmental or social news appear to be concentrated in the "S" category and, within this category, in information about customers, product quality and safety; employee-related news seem to have little—or mixed—effects.[40] The "S" aspect has only limited weight in ESG ratings, but it could account for most value gains. Also, as mentioned before, certain environmental or social improvements could hurt the financial bottom line.[41] A final caveat is that even if ESG ratings upgrades lift stock prices, this could reflect the willingness of prosocial investors to reward social performance, the topic of the next subsection.

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more than 1 on a scale 0–10 only in the "E" and "S" sections result in significant negative abnormal returns of .36–.67% in a ten-day window for 2007–2018); *see also* Konstantina Kappou & Ioannis Oikonomou, *Is There a Gold Social Seal? The Financial Effects of Additions to and Deletions from Social Stock Indices*, 133 J. Bus. Ethics 533, 543–45 (2016) (documenting negative returns on the day of deletion from a social index and no significant effects upon addition); *but see* Olga Hawn, Aaron K. Chatterji & Will Mitchell, *Do Investors Actually Value Sustainability? New Evidence from Investor Reactions to the Dow Jones Sustainability Index (DJSI)*, 39 Strategic Mgmt. J. 949, 958–62 (2018) (finding even negative two-day returns from addition to and continuation in sustainability index 1999–2015).

36 *See* the studies referred to *supra* note 32.

37 While a recent study shows that ESG ratings predict future ESG news, the market could have anticipated them on its own, *cf.* George Serafeim & Aaron Yoon, *Stock Price Reactions to ESG News: The Role of ESG Ratings and Disagreement*, Rev. Acct. Stud., forthcoming, https://doi.org/10.1007/s11142-022-09675-3, section 4.1.

38 The financial information in ESG ratings also seems to be very noisy. The respective evidence will be presented *infra* VI.1. For now, *see* Serafeim & Yoon, Stock Price Reactions, *supra*, sections 4.1, 4.3 (documenting rating disagreement is associated with lower predictive value of ESG ratings for ESG news and weaker price effects of ESG news); Avramov et al., *supra* at 654–55 (providing evidence for a risk premium for inconsistent ESG ratings).

39 *See* Khan, Serafeim & Yoon, *supra*; Serafeim & Yoon, Corporate ESG News, *supra* at 10–12 (documenting positive abnormal returns to occur only for positive news classified as "material" in a huge dataset of machine-generated news reports 2010–2018).

40 Serafeim & Yoon, Corporate ESG News, *supra* at 12–13 (observing that ESG ratings tend to focus on the firm's operations, not the effects of its products).

41 *See* Krüger, *supra* at 313–16 (finding *negative* abnormal returns around positive environmental or social news and relating them to financial slack as a proxy of agency costs of equity).

(3) No guide to riches

Overall, existing ESG ratings have a rather limited role in guiding financial investment. They can contain information about firm-level cash flows and risk that is less available or accessible elsewhere. However, the limited price reactions to rating changes suggest that they convey little news about the fundamental value of firms. Perhaps sophisticated investors combine ESG ratings with other information to arrive at more accurate valuations and subsequently feed them into prices. For the regular investor, a more important conclusion is that even if ESG ratings predict firm-level operating performance, prices quickly adjust to the new information. Selecting a portfolio based on ESG ratings uses stale information, for which an efficient market offers no reward. This is an unsurprising claim for anyone familiar with the capital markets theory and empirics of the past fifty years. Yet it appears less present in the minds of researchers from other backgrounds and—for different reasons—in the marketing materials of asset managers and ESG ratings providers.[42] Confidence does not increase if one learns that rating providers reserve the right to change ESG ratings retroactively (!) and without notice, and in fact do so to significant effect.[43] This not only puts independent research using ESG ratings on shaky ground but also raises the troubling possibility that past ratings have been retrofitted to subsequent financial performance.[44]

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42 *See* Berg, Fabisik & Sautner, *supra* at note 5 (citing a collection of studies published by ratings providers, asset managers and banks); for an example from an ESG-promoting organization *see* PRI Association, *A Blueprint for Responsible Investing* (2017), 16, https://web.archive.org/web/20230527125417/https://www.unpri.org/about-us/a-blueprint-for-responsible-investment (citing Deutsche Bank meta-study that 63% of more than 2,000 studies supported the claim that ESG performance predicts financial performance).

43 Berg, Fabisik & Sautner, *supra* at 8–14 (documenting the magnitude of one disclosed major change and ongoing but unannounced changes of Refinitiv ESG Scores).

44 *See* Berg, Fabisik & Sautner, *supra* at 14–19 (arguing that contemporary stock returns but not firm-specific ESG news are associated with changes in Refinitiv ratings and that ratings "predict" financial returns only after retroactive changes); Özge Sahin et al., *The pitfalls of (non-definitive) Environmental, Social, and Governance scoring methodology*, 56 Global Fin. J. 100,780 (2023) (showing restated Refinitiv ratings to exhibit greater association with financial risk but also providing legitimate reasons for retroactive ratings changes).

b) Impact investing

For various reasons, investors may care for more than just financial performance. Individuals are interested in not causing harm to others, contributing to the well-being of others, fostering justice, fairness, and political stability and, last but not least, preserving the environment and averting catastrophic climate change. Such ethical, social, and political concerns of individual investors are receiving greater attention recent in finance and economics. This is not because conventional theory had denied their existence. Rather, it had assumed a strict separation between private investments in profit-maximizing firms and the pursuit of social objectives through contractual safeguards, government regulation, and civic engagement.[45] The new interest in prosocial preferences reflects disappointment with this division of responsibilities. One main reason is the alleged failure of democratic governments to regulate firms and internalize the external effects of their activities,[46] for instance in regard to climate change. Irrespective of which position one takes on this fundamental question, moral intuitions lead many individual investors to consider other than purely financial outcomes.[47] The resulting conception of ESG investing is the exact opposite of casting it as a more sophisticated way of pursuing financial gain.[48] While rooted in the prosocial preferences of individual investors, institutional investors as intermediaries can execute an impact investment strategy on their behalf.[49]

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45 *See only* Friedman, *supra*.

46 *See* Hart & Zingales, *supra* at 249; *see also* Eugene F. Fama, *Contract Costs, Stakeholder Capitalism, and ESG*, 27 Eur. Fin. Mgmt. 189, 194–95 (2021) (viewing ESG activism as potentially more effective and more flexible than regulation); Edmans, *supra* at 7–8 (viewing investor activism as justified only in the case of government failure from "lobbying or sluggishness").

47 *See, e.g.,* Samuel M. Hartzmark & Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, 74 J. Fin. 2789, 2825–31 (2019) (providing experimental evidence that demand for sustainability-oriented mutual funds is driven by risk-return expectations but also by non-financial motives); Rob Bauer, Tobias Ruof & Paul Smeets, *Get Real! Individuals Prefer More Sustainable Investments*, 34 Rev. Fin. Stud. 3976, 3992 (2021) (documenting a two-third majority among beneficiaries of a Dutch pension fund voting for expanding the fund's ESG engagement policy in 2018).

48 *Supra* note 34 and accompanying text.

49 *See* Alexander Dyck et al., *Do Institutional Investors Drive Corporate Social Responsibility? International Evidence*, 131 J. Fin. Econ. 693, 705–10 (2019) (showing a positive relationship between institutional shareholdings and social performance of firms, offering evidence for a causal link and showing that the effect is driven by countries with values favoring environmental and social responsibility, mainly from Europe); Philipp Krueger, Zacharias Sautner & Laura T.

A more limited reason for environmental and social concerns to affect investment decisions is diversification. Holders of broad portfolios naturally look at the risk and return of the portfolio, not its component securities. As a consequence, they internalize the external effects that portfolio firms exert on each other, giving them a—purely financial—incentive to control these effects.[50] The much discussed rise of large index fund managers, notably the "Big Three" in the U.S.,[51] has produced plausible examples of how these institutions can use their influence, arguably with a view to aligning firm behavior with the goal of maximizing portfolio value.[52] Having grown into universal owners with significant shares in virtually all sizable public corporations, these institutions also wield sufficient power to influence the economy as a whole, such as by mitigating climate change or risks to political stability; this curbs both negative externalities and non-diversifiable, systematic risk.[53]

Prosocial preferences and portfolio orientation can cause investors to consider social performance in their investment decisions. For the following, it is assumed that investors not only want to express their ethical or political convictions but seek to affect real-world changes in environmental and social outcomes.[54] Yet the only

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Starks, *The Importance of Climate Risks for Institutional Investors*, 33 Rev. Fin. Stud. 1067, 1085–86 (2020) (providing survey evidence of a range of motives for institutional investors to consider climate risks with reputational and ethical concerns being named most frequently).

50 *See* Robert G. Hansen & John R. Lott, Jr., *Externalities and Corporate Objectives in a World with Diversified Shareholder/Consumers*, 31 J. Fin. & Quant. Anal. 43 (1996).

51 *See* Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. Rev. 721, 733–35 (2019) (providing data on voting shares of BlackRock, Vanguard and State Street Global Advisers in U.S. corporations).

52 *See* Madison Condon, *Externalities and the Common Owner*, 95 Wash. L. Rev. 1, 18–26 (2020) (describing successful engagement of institutional investors with oil companies over carbon emission reduction).

53 *See, e.g.*, Condon, *supra*, 16–18; Coffee, *supra* at 619–22 (but presenting it primarily in terms of systematic risk); Jeffrey N. Gordon, *Systematic Stewardship*, 47 J. Corp. L. 628, 652–58 (2022) (likewise).

54 This is not an obvious assumption. For one, ethical motives can vary. For instance, Hart & Zingales, *supra* at 267–69, assume that investors only care if they feel "responsible" for outcomes, such as because they hold shares in a polluting firm. The empirical evidence is mixed, *see* Arno Riedl & Paul Smeets, *Why Do Investors Hold Socially Responsible Mutual Funds?*, 72 J. Fin. 2505, 2528–30 (2017) (finding that investors believing in a "positive influence on society" from responsible investing are significantly more likely to hold responsible funds); Florian Heeb et al., *Do Investors Care about Impact?* 36 Rev. Fin. Stud. 1737 (2023) (finding no or very low sensitivity in willingness to pay management fees in response to amount of carbon emission reduction among experienced investors); Jean-François Bonnefon et al., *The Moral Preferences of Investors: Experimental Evidence* 2–4, 21–2 (2022), http://www.nber.org/papers/w29647 (explaining the relevance of a consequentialist attitude and

plausible way to use investment decisions to steer firms towards social performance is to offer them more favorable financing. More bluntly put, investors must be willing to sacrifice returns in exchange for social performance. If "doing good" were costless or even profitable, prosocial investing would provide no additional support or reward for social performance because, trivially, lower costs of capital for firms are the mirror image of lower returns to investors. If prosocial investors want to have impact, they must pay for it. Impact investing, therefore, is the exact opposite of financially motivated ESG investing.[55] In fact, while many investors are willing to consider ESG investing only if they do not have to compromise on financial outcomes,[56] a sizable group of socially minded investors apparently expects—and accepts—that by doing good, they do less well financially.[57] This is not to say that risk and return would be unimportant for prosocial investors.[58] They will trade off social impact against their own financial well-being. Yet insofar as ESG investing is driven by prosocial concerns, including from portfolio orientation, its characteristic feature is to forgo financial returns from individual firms in exchange for social performance.

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finding no difference in willingness to invest depending on whether this changed firms' behavior in an incentivized experiment).

55 Hong & Shore, *supra*, organize their survey along the contrasting financial and prosocial motives and conclude that the evidence about the effects of ESG investment overall favors the prosocial conception.

56 Investors in regular non-ESG mutual funds still appear to prioritize financial returns, *see* Nickolay Gantchev, Mariassunta Giannetti & Rachel Li, *Sustainability or Performance? Ratings and Fund Managers' Incentives* (ECGI Finance Working Paper 747, 2023) (finding that fund managers who geared portfolios to achieve higher sustainability ratings suffered lower financial performance and net outflows). Wealthier investors appear less socially minded in their investment decisions, Trond Døskeland & Lars Jacob Tynes Pedersen, *Does Wealth Matter for Responsible Investment? Experimental Evidence on the Weighing of Financial and Moral Arguments*, 60 Bus. & Soc'y 650, 664–66 (2021) (finding that wealthier customers of a Norwegian bank were more responsive to a financial than to a moral framing of sustainability investments while no such difference existed for less wealthy customers).

57 *See* Bauer, Ruof & Smeets, *supra* at 3994–98 (documenting widespread variance in return expectations of pension fund beneficiaries from a proposed expansion of the fund's ESG activities, a significant influence of these beliefs on votes for the change, and a majority of return pessimists who still favoring the change); Riedl & Smeets, *supra* at 2520–2528 (showing that social preferences significantly increase the probability of responsible fund holdings while negative return expectations diminish in a sample of Dutch retail investors of 2011).

58 For theoretical analyses of the asset pricing implications of, and interplay between, ESG-related differences in firm-level cash flows and risk, investor beliefs and prosocial preferences, *see* Lasse Heje Pedersen, Shaun Fitzgibbons & Lukasz Pomorski, Responsible investing: The ESG-efficient frontier, (2021) J. Fin. Econ. 572; Ľuboš Pástor, Robert F. Stambaugh & Lucian A. Taylor, *Sustainable investing in equilibrium*, (2021) 142 J. Fin. Econ. 550.

In securities markets, this voluntary subsidy will have to work through the price mechanism. This raises two questions: One is whether prosocial investors have the ability to move prices, the other how changing asset prices in secondary markets can lead to improved behavior by firms. A good starting point for the first question is the capital market equilibrium with only financial investors, where asset prices exclusively reflect expected returns and systematic risk. If one introduces prosocial investors, their willingness to pay deviates from the original market prices. With their higher valuation of firms with strong social performance, they outbid conventional investors; and the same vice versa for firms with poor social performance. The emerging division of assets between investor groups is, however, constrained by the demand for diversification: The more prosocial investors concentrate on high social performers, the more they assume risk that they could diversify away by holding the market portfolio. They pay a dual price, figuratively, for boosting the market valuation of their target securities: first the intended higher market price—the actual subsidy—and then an additional exposure to diversifiable risk. Meanwhile, conventional investors also lose diversification benefits as prosocial investors absorb more of their preferred securities. In consequence, they, too, are willing to pay more for securities of high social performers.

If, in the new market equilibrium, both investor groups continue to hold all securities— although in different quantities—they value all assets equally, at the new, elevated market price.[59] In consequence, prices will be in between the original price (with only financial investors) and the higher valuation of prosocial investors.[60] The immediate upshot of this sketchy analysis is that prosocial investors indeed

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59 Otherwise, the allocation would not constitute an equilibrium. Equal valuation relates to the marginal security. In other words, all investors must be indifferent towards buying or selling an additional security.

60 The intuitive argument in the text seeks to capture the model in Henry L. Friedman & Mirko S. Heinle, *Taste, Information, and Asset Prices: Implications for the Valuation of CSR*, 21 Rev. Acct. Stud. 740, 747–49 (2016); *see also* Eugene F. Fama & Kenneth R. French, *Disagreement, Tastes, and Asset Prices*, 83 J. Fin. Econ. 667, 675–76 (2007). In other modeling approaches, investors separate between high and low social performers. Because social performance is costly, prosocial investors fund fewer firms relative to their share and leave more firms to conventional investors. As a result, the share of firms with high social performance is less than the share of prosocial investors, *see* Eleonora Broccardo, Oliver Hart & Luigi Zingales, *Exit versus Voice*, 130 J. Pol. Econ. 3101, 3117–20 (2022); *see also* Robert Heinkel, Alan Kraus & Josef Zechner, *The Effect of Green Investment on Corporate Behavior*, 36 J. Fin. & Quant. Anal. 431, 435–37 (2001).

wield power to change prices. But the subsidy they are willing to make is being diluted. Simply put, an additional Euro buys less than one Euro in increased market valuation for high social performers.[61] The dilution weakens the incentive of consequentialist prosocial investors—including portfolio maximizers—to use investment decisions to promote social performance.[62]

If prosocial investors nonetheless choose to lift the market valuation of strong social performers, assets with identical cash flows trade at different prices. A gap in the evolving research on ESG investing is the extent to which arbitrage constrains a "greenium" that impact investors strive to create. Acquiring the lower-priced asset and shorting the higher-priced one promises a positive return reflecting the price gap. Such an arbitrage opportunity threatens to become a money pump at the expense of prosocial investors until the "greenium" disappears. The debate about capital market efficiency has, however, pointed to the limitations of arbitrage. One stems from restrictions on short positions. Indeed, sophisticated impact investors will decline to lend securities of high social performers to prevent arbitrageurs from shorting them and reducing the "greenium".[63] Another limitation is that most real-world arbitrage positions entail substantial risk before the expected gain can be realized.[64] Recent studies tend to confirm the existence of a "greenium": They indicate that high-ESG stocks deliver lower risk-adjusted returns but that the surge of ESG capital or additional ESG-related risk temporarily disguises this effect.[65] While these findings

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61 In terms of the intuitive argument, the deadweight loss results from reduced diversification.

62 *See* Broccardo, Hart & Zingales, *supra* at 3122–25 (demonstrating that in plausible settings abstaining from prosocial divestment is the only equilibrium); *see also* Jonathan Berk & Jules H. van Binsbergen, *The Impact of Impact Investing* (2022), https://dx.doi.org/10.2139/ssrn.3909166 (estimating that more than 80% of total capital would need to participate in impact divestment to cause more than one percentage point in cost-of-capital difference for one quarter of public equity value).

63 *See* Broccardo, Hart & Zingales, *supra* at 3118, note 33.

64 *See* Denis Gromb & Dimitri Vayanos, *Limits of Arbitrage*, 2 Ann. Rev. Fin. Econ. 251, 257–61 (2010). Going long in one stock portfolio and short in another can expose arbitrageurs to sizable covariance risk and prevent them from exploiting return differences at large scale, *cf.* Fama & French, *supra* at 678 (highlighting that riskless arbitrage between stock portfolios would require perfect correlation between their returns).

65 *See* Ľuboš Pástor, Robert F. Stambaugh & Lucian A. Taylor, *Dissecting green returns*, 146 J. Fin. Econ. 403 (2022) (arguing that the overperformance of stocks with high environmental ratings 2012–2020 reflected rising investor demand for climate risk hedging); Doron Avramov et al., *Sustainable investing with ESG rating uncertainty*, 145 J. Fin. Econ. 642, 654–56 (2022) (documenting negative excess returns for firms with consistently high ESG scores but no abnormal returns for stocks with contradictory ratings); Berg et al., *supra*, at 22–28 (finding

attest to a lasting impact on prices, they directly contradict the claim that ESG investing is financially profitable or neutral for investors.

The second question concerns the causal link from asset prices to firm behavior. A short-form answer is that lifting the prices of securities reduces the expected return of investors and, by implication, the cost of capital to the issuer. Lower cost of capital could allow the firm to expand its real investments in social improvement.[66] To this end, the firm would have to raise additional capital in the primary market. The significance of this funding effect is in doubt: Equity issuances by S&P 500 companies in the U.S. have fallen short of stock repurchases in all but one year between 2007 and 2016.[67] This observation leads one to suspect that much of the value "donated" by prosocial investors produces a windfall to earlier security holders at the point in time when prices shift, rather than funding improvements in social performance. A second channel through which a premium for social performance can affect the behavior of firms is by incentivizing managers, employees, and (controlling) shareholders. In fact, if the firm heeded Milton Friedman's call and always acted to maximize shareholder value, it would increase social performance whenever the valuation premium exceeded the cost.[68] In varying degrees and depending on the corporate governance particulars, all three groups of corporate insiders benefit from a higher stock market valuation. If stronger social performance induces prosocial investors to elevate the stock price, these stakeholders have an incentive to deliver it. ESG ratings, in this view, serve as a monitoring device for prosocial investors—as principals—to induce agents within the firm to invest in environmental and social improvements.

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significant over- and under-performance of ESG ratings after noise reduction and explaining these findings with shifting demand from prosocial investors).

66 This is the assumption made in Heinkel, Kraus & Zechner, *supra* at 434–6.

67 Jesse M. Fried & Charles C. Y. Wang, *Short-Termism and Capital Flows*, 8 Rev. Corp. Fin. Stud. 207, 220 (2019). Half of the equity issued was used for employee compensation, id., 212–217.

68 *See* Fama, *supra* at 192–93; for an analysis of impact investing as an incentive scheme for managers, *see, e.g.*, Alex Edmans, Doron Levit & Jan Schneemeier, *Socially Responsible Divestment* (ECGI Working Paper 823, 2023), 9–18. Interestingly, if social performance were fully impounded in the stock price, additional incentives—such as through ESG-based variable compensation—would be unnecessary and even harmful for prosocial investors, *see* Pierre Chaigneau & Nicolas Sahuguet, *Executive Compensation with Socially Responsible Shareholders* (Working Paper 2023), 12–15, https://ssrn.com/abstract=4345102.

The discussion so far indicates that impact investing can influence the social performance of firms. The obstacles are, however, formidable. They come in three layers of dilution: First, prosocial preferences of investors fall short of internalizing the full social benefits; likewise, portfolio maximizers capture only part of the externalities caused by their portfolio firms. Second, the cost of impact investing exceeds the change in market valuation that prosocial investors accomplish. How much of their subsidy is lost depends on the share of prosocial investors relative to investors with purely financial motives. Third, insofar as market prices reflect social performance, standard agency costs of equity further dilute the effect of impact investing on corporate behavior. If one remains undeterred, ESG ratings can assist prosocial investors in directing the impact of their investments.

2. Guiding active ownership

Investors can also use ESG ratings in exercising their shareholder rights. Like investment decisions, active ownership can aim at both the financial and social performance of the firm. Compared to impact investing, exercising "voice" can be a superior strategy for prosocial investors: If they hold sufficient voting rights to force their non-financial objectives on a given firm, the cost of greater social performance is spread across all current shareholders, including those with purely financial motives. This allows prosocial investors to implement the full extent of their political preferences instead of losing part of their willingness to pay in the struggle to shift market valuations.[69]

Institutional investors with broadly diversified portfolios—especially universal owners—are prime candidates to pursue this strategy. They are likely to have prosocial leanings due to portfolio orientation and, potentially, the preferences of their clientele. In addition, they wield considerable voting power.[70] A very relevant exception, particularly outside the U.S. and the UK, are firms with controlling

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69 *Cf.* Broccardo, Hart & Zingales, *supra* at 3113–17 (demonstrating in a formal model the effect of cost-spreading and arguing that extremely diversified prosocial investors even have socially optimal voting incentives).

70 *See* Caleb N. Griffin, *Margins: Estimating the Influence of the Big Three on Shareholder Proposals*, 73 SMU L. Rev. 409, 422–39 (2020) (providing evidence that a significant fraction of shareholder votes on ESG proposals in Fortune 250 companies in 2018–2019 were decided by the "Big Three").

shareholders.[71] Another caveat is how willing they are to actively engage with firms.[72] For the five largest passive asset managers in the U.S., a recent study tallies the average monetary gain from a one percent increase in the value of a portfolio firm at 0.0056% of management fees or $114,000;[73] as a matter of course, this estimate ignores potential portfolio spillovers. The limited incentives underscore the importance of cost efficiency. A striking result from a recent study suggests that larger ownership by the Big Three index investors is associated with subsequently lower carbon emissions.[74] There is also evidence that institutions actively engage with portfolio firms over climate change.[75] Much of this activity remains unobserved by the public, as institutional investors seek influence mostly in direct interaction with management, less so visibly in shareholder meetings.[76] There are also records of successful interventions by smaller institutions with a specialization in ESG engagement.[77]

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71 *See* Dhammika Dharmapala & Vikramaditya S. Khanna, *Controlling Externalities: Ownership Structure and Cross-Firm Externalities* (2021) (documenting a much lower incidence of reported "Big Three" engagements in countries with high ownership concentration after including several control variables).

72 For large passive indexers, the skeptical position is summarized in Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 Col. L. Rev. 2029 (2019); more generally for institutional investors Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. Econ. Persp. 89 (2017).

73 Jonathan Lewellen & Katharina Lewellen, *Institutional Investors and Corporate Governance: The Incentive to Be Engaged*, 77 J. Fin. 213, 227, 231–33 (2022). The corresponding estimates for the largest quarter of other, non-index institutional investors are 0.01% and $184,400.

74 José Azar et al., *The Big Three and Corporate Carbon Emissions Around the World*, 142 J. Fin. Econ. 674, 681–84 (2021).

75 *See* Azar et al., *supra* at 679–81 (documenting oral conversations with management by at least one of the "Big Three" for 48% of firms in the MSCI World Index in 2018); Krueger, Sautner & Starks, *supra* at 1086–87, 1091–93 (providing survey evidence for institutional investors' engagement with firms over climate change); *see also supra* note 52.

76 Specifically for ESG engagement, *see* Dyck et al., *supra* at 702-703 (finding that exit is rarely used and—based on a small Canadian sample—that most shareholder initiatives are never voted upon); Krueger, Sautner & Starks, *supra* at 1091–93 (offering evidence from a survey of institutional investors).

77 Tamas Barko, Martijn Cremers & Luc Renneboog, *Shareholder Engagement on Environmental, Social, and Governance Performance*, 180 J. Bus. Ethics 777 (2022) (documenting over 1,500 completed ESG engagements from a sizable asset manager with a success of around 60%); Elroy Dimson, Oğuzhan Karakaş & Xi Li, *Active Ownership*, 28 Rev. Fin. Stud. 3225, 3238–39 (2015) (finding a success rate of 13% for ESG engagements with U.S. firms 1999–2009 in a detailed proprietary dataset of a sizable institutional investor with a history of ESG commitment); Krueger, Sautner & Starks, *supra* at 1093 (documenting survey responses indicating successful interventions).

Which role can ESG ratings play in active involvement by institutional investors? Unlike proxy advisors, ESG ratings offer no direct guidance how shareholders should use their influence. They can nonetheless assist an institution's stewardship by offering a standardized assessment of a firm's ESG performance relative to others. Investors can use them, combined with other information, to select firms where engagement is most needed or most effective, for instance because there are low-hanging fruits.[78] Being the assessment of a third party and the result of a standardized method, investors can introduce them as objective reference in interactions with managers.

In addition to facilitating active ownership of individual investors, ESG ratings can also bolster the mutual commitment among institutions to pursue ESG objectives, for both financial and prosocial reasons. When institutions endorse the Principles of Responsible Investing (PRI), they pledge to "be active owners and incorporate ESG issues into our ownership policies and practices".[79] The (internal) assessments of the PRI likely encourage signatories to establish a formal engagement policy that plausibly includes the use of ESG ratings. Besides being a token of compliance with mutual commitments, a complementarity can arise between adopting ESG ratings in investment and engagement: Insofar as investors rely on ESG ratings for their investments—including their willingness to reward social performance—they also inform active owners about opportunities for increasing the market valuation of target firms. Importantly, this creates a purely financial incentive to push for environmental or social improvements as long as they hurt profitability only modestly or not at all.[80] In this regard, ESG ratings coordinate expectations between active owners and impact investors who are prepared to pay for social performance.

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78 *See* Dimson, Karakaş & Li, *supra* at 3234 (reporting from their case study of an investor's active ownership that "[t]arget companies are often identified by using ESG screening metrics […]."); *see also* Barko, Cremers & Renneboog, *supra* at 788–89, 793–95 (showing that low ESG ratings predict being targeted and that ESG ratings increase after successful engagement).

79 PRI, *What Are the Principles for Responsible Investment?*, https://web.archive.org/web/20230410124926/https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment.

80 *Cf.* Dimson, Karakaş & Li, *supra* at 3252–9 (finding positive abnormal returns in the months after successful engagements and an increase in holdings of institutions with stronger ESG leanings); Barko, Cremers & Renneboog, *supra* at 793–802 (likewise documenting positive abnormal returns and a positive return difference to matched firms without intervention).

IV. Financial versus social performance in ESG ratings

That ESG ratings serve different functions hints at opportunities for variation. A fundamental distinction is whether investors have only financial or broader, prosocial motives, including from portfolio orientation. Against this backdrop, a first question to be addressed is whether the two investor groups make different demands on ESG ratings (subsection 1). Although it turns out that demands diverge, the origins of the ESG movement suggest that policy makers might pursue an opportunistic strategy: They could be tempted to peddle an illusion of "doing well by doing good" with the goal of diverting investor wealth to the common good (subsection 2).

1. Information demands on ESG ratings

In pinpointing the information needs of financial and prosocial investors, a first crucial insight is that ESG ratings should confine themselves to firm-level fundamentals and disregard market prices. This is anything but obvious. Financial investors must take into account market valuation to estimate expected market returns. Prosocial investors, too, need rates of return to gauge the level and cost of the valuation subsidy that they want to provide. Albeit for different reasons and in different ways, both types of investors are interested in firm-level financial performance relative to market valuation. The expertise of ESG rating providers, however, lies in assessing environmental and social engagement and outcomes. They lack a comparative advantage in evaluating or predicting other determinants of financial returns and, *a fortiori*, in detecting over- or under-pricing relative to the purely financial benchmark of a market-wide risk-adjusted rate of return. Attempting to measure how expensive or cheap social performance is for investors in a given stock would force ESG rating providers to compete with securities analysts and financial arbitrageurs in their areas of expertise. Not only would their valuation information be inferior, it would also confound the information that ESG rating provides are uniquely qualified to deliver.

Focusing on environmental and social fundamentals, three pieces of information matter: the performance outcome itself—for instance, a carbon emission reduction or deference to the rights of indigenous peoples—the cost to the firm of achieving it, and its effect on the firm's financial risk and return. Prosocial investors are interested

in the social outcome itself; depending on their objectives and strategy, they might also consider the cost of producing the social good and even the degree of internalization with the firm. Financial investors, by contrast, care only for the costs and benefits to the firm. Since financial statements already report the immediate effects on the bottom line, the additional information value of ESG ratings for financial investors lies in the repercussions for future risks and returns. The two investor types thus differ mostly in the kind of social performance that they incorporate in their investment decisions: prosocial investors consider outcomes that figure in their political preferences or portfolio externalities, financial investors focus on those affecting the firm's future profitability. The weights of social performance aspects in the rating should likewise reflect either their social value or their financial implications for the firm.

ESG drivers of financial and social performance often overlap. Improving the environmental and social footprint of a firm often repays in the form of reputational gains and reduced exposure to government intervention. Yet the two views also diverge. For instance, ignoring certain social concerns can be riskier, from a financial perspective, for firms with well-known consumer brands. Which social causes a firm should prioritize, from a purely financial standpoint, will depend on the preferences and beliefs of its customer base. Conversely, there is only financial, not social gain in avoiding investments that inevitable climate change will degrade. The divergent information demands show in the debate about corporate sustainability reporting. The International Sustainability Standards Board has come to endorse the traditional single standard of financial materiality; sustainability reports are geared exclusively towards assisting investors to assess the "ability to generate cash flows."[81] By contrast, the revamped EU accounting directive embraces a "double materiality" view that seeks to inform about both "impacts of the activities of the undertaking on people and the environment, and on how sustainability matters affect the undertaking."[82] The conflict is less consequential in reporting because it concerns only the costs and benefits of expanding disclosure requirements. Yet "doubling

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81 International Sustainability Standards Board, *IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information* (2023), para. 2.

82 Recital 29 Sustainability Reporting Directive (EU) 2022/2464.

down" on materiality and information is no fix for ratings because their purpose is to condense and simplify information. As such, they can aim at only one target—financial or social.

2. An unnoble lie

Given that financial and prosocial investing require different information, the question arises whether it is justifiable to tolerate ambiguity in the objective of an ESG rating. Glossing over the conflict between financial and social performance relaxes competitive pressure for asset managers and serves politicians' interest in attracting investor capital as a substitute for taxpayer money. From a policy perspective, it could seem defensible to levy a hidden tax on unwitting investors by luring them into subsidizing important social objectives. The approach dovetails with a plausible strategy at marketing investment products: The promise of saving the world and benefiting from it likely has greater appeal than a call to make financial sacrifices.[83]

The upshot of this strategy is that ultimate investors remain in the dark while their agents are driven—by public pressure and higher mark-ups—to invest their money for less private and more social gain. While the approach is tempting, it violates the autonomy of investors. Emphasizing the importance of the prosocial agenda provides no justification: There is theoretical and political disagreement whether private investment is the right lever to promote the common good.[84] Refusing to be a prosocial investor does not make one an anti-social citizen.[85] Also, obscuring the specific purpose of ESG ratings can just as well hurt the preferences of prosocial investors. Instead of sacrificing part of their financial performance, an ESG rating geared towards financial performance would lead them to maximize financial returns and miss their prosocial goals.

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83 *Cf. supra* note 42 and Fama, *supra* at 192 ("Needless to say, lower expected returns are not prominent in the marketing materials of ESG money managers.").

84 *See* Partick Bolton et al., *Investor ideology*, 137 J. Fin. Econ. 320 (2020) (showing that voting behavior of institutional investors in the U.S. localizes them on a "left" to "right" axis from promoting social and environmental causes to focusing purely on financial performance).

85 *Cf. supra* note 45 and *infra* note 86–90 and accompanying text.

ESG ratings are only part of the machinery that helps investors pursue their investment preferences. They will usually be selected and employed by asset managers and other investment intermediaries on behalf of their clients. It is through these intermediaries that most investors choose between purely financial and prosocial investment strategies. ESG investment products with a clear designation encourage ESG rating providers to also commit to a specific objective. Conversely, investment products with a clear mission of either maximizing risk-adjusted returns or balancing financial and social performance depend on the existence of bespoke ESG ratings. If anything, regulation of ESG rating providers should ensure that their ratings commit to a well-defined purpose and are measured against it.

V. Design of prosocial ESG ratings

The valuation of financial assets, as challenging and intriguing it may be, does not pose a problem of public policy. Prosocial investing, by contrast, pursues social ends and, therefore, raises policy issues that touch on the design of ESG ratings. This section will examine the decisions and trade-offs that providers of ESG ratings confront when they seek to assist prosocial investors. It is again assumed that prosocial investors are consequentialists who intend to maximize the real effect of their sacrifices. A first task for the designer of a prosocial ESG rating is to define the social goals that investments should promote as well as their priority ordering (section 1). Given the aim, the ESG rating should chart the route to accomplishing it to the greatest possible degree (section 2).

1. Objective function

In engineering incentives for firms, the creator of a prosocial ESG rating must define the objective that the standard is meant to achieve. The creator could single-handedly pick the most pressing social needs—the most harmful externalities—to be reflected in the standard. Alternatively, she could seek to incorporate the preferences of prosocial investors whose returns will be sacrificed for the cause. Either approach is fraught with difficulty: The former requires an all-encompassing welfare analysis (if

the rating designer subscribes to welfarism),[86] the latter faces the predicaments of collective choice associated with Arrow's impossibility theorem.[87] The controversial value judgments required to cut this Gordian knot are at the heart of what makes shareholder wealth maximization so attractive: By delegating externalities and distributive concerns to contracts and the government, as the Friedman doctrine demands,[88] the interests of shareholders in the corporation shrinks to just two dimensions, financial risk and return. The "unanimity principle" then states that all shareholders agree on the goal of maximizing share value in an efficient stock market.[89] Purely financial investors spare their firms political strife; prosocial investors bring it back.[90] Unsurprisingly, "doing good" is anything but a straightforward prescription.

In theory, investors could entrust democratic governments with resolving their disagreements. The EU "Taxonomy" of sustainable investments could represent an attempt at doing just that.[91] It has already led to a heated debate about whether nuclear energy qualifies as a sustainable mitigant of climate change.[92] The battle over

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86 Based on efficiency, a cost-benefit calculus, or an alternative social welfare function, for an exposition *see* Matthew D. Adler, *Measuring Social Welfare: An Introduction* (2019).

87 *See* Kenneth J. Arrow, *Social Choice and Individual Values* (2nd ed. 1963). In fact, imposing a social welfare function—the first approach—is a way of avoiding the impossibility theorem by setting aside one of its axioms, *see* Amartya Sen, *The Possibility of Social Choice*, 89 Am. Econ. Rev. 349, 355–7 (1999).

88 The doctrine has recently been labeled the "Friedman separation theorem", Oliver Hart & Luigi Zingales, *The New Corporate Governance*, 1 U. Chi. Bus. Law Rev. 195, 201 (2022).

89 *See* Harry DeAngelo, *Competition and Unanimity*, 71 Am. Econ. Rev. 18 (1981).

90 Fama, *Contract Costs*, *supra* at 193–94, suggests that prosocial investors express their preferences exclusively through impact investing to leave the market value maximization rule intact. Of course, this does not solve the collective choice problem of standard setter. Also, active engagement with managers makes prosocial investors' advances more effective.

91 Taxonomy Regulation (EU) 2019/2088; *see also* EU Technical Experts Group on Sustainable Finance, *Taxonomy: Final Report* (2020).

92 *See* America Hernandez, *Brussels faces lawsuits, investor pushback over green label for gas and nuclear* (PoliticoPro, July 6, 2022), https://web.archive.org/web/20230410144823/https://www.politico.eu/article/brussels-faces-lawsuits-investor-pushback-over-green-label-for-gas-and-nuclear. Austria and a German Member of the European Parliament have brought annulment actions against Commission Delegated Regulation (EU) 2022/1214 that recognizes nuclear energy generation as "sustainable", subject to conditions. *Cf.* Simone Lünenbürger, Matthias Kottmann & Korbinian Reiter, *Nuclear Power and the Taxonomy Regulation* (2021), https://web.archive.org/web/20230411101025/https://www.bmk.gv.at/dam/jcr:22c30412-4acd-4b9f-b150-b25998e16d6c/Redeker-Sellner-Dahs_Nuclear-Power-Taxonomy-Regulation.pdf (providing a legal opinion on behalf of the Austrian government).

conflicting social preferences and beliefs has only begun. Of the six environmental sustainability objectives enlisted in the Taxonomy Regulation, only the two climate-related ones have been fleshed out.[93] With its scientific and technical underpinnings, environmental sustainability is arguably less prone to controversy than the social branch of the sprawling concept of sustainability.[94] The EU Commission now is said to have given up spelling out the social taxonomy.[95]

Even if the EU Taxonomy were fully developed, this would barely subtract from the challenge. The Taxonomy only provides a definition of what counts as "sustainable" but without ranking the relative importance or urgency of activities and investments. Weighting and prioritizing them remains the responsibility of investors. The EU Taxonomy also does not claim to preempt competing definitions or standards of sustainability.[96] Investors and asset managers are free to apply alternative, more or less stringent requirements, such as by screening out nuclear energy or ignoring the painstaking demands of the taxonomy.[97] This modesty aligns with the intellectual origin of prosocial investing. If investors take matters in their hands because state regulation is perceived as insufficient,[98] it seems odd to call in the government as a final arbiter of investor disagreement.

Against this backdrop, the preference aggregation rule that many existing ESG ratings implicitly adopt is to take cues from international organizations like the UN,

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93 *See* art. 9 Taxonomy Regulation and Commission Delegated Regulation (EU) 2021/2139.

94 *Cf.* EU Platform on Sustainable Finance, *Final Report on Social Taxonomy* (2022), 30 ("A social taxonomy […] cannot be based on science in the same way" but pointing to "internationally agreed authoritative norms and principles"); Dirk A. Zetzsche, Marco Bodellini & Roberta Consiglio, *Towards A European Social Taxonomy: A Scorecard Approach* (2022), 19 (likewise).

95 Benjamin David, *Social taxonomy: Is the shelving of the EU's social taxonomy all gloom for the financial sector?* (Funds Europe, 2022), https://web.archive.org/web/20230510142727/https://www.funds-europe.com/october-2022/shelving-eu-social-taxonomy-financial-sector.

96 *See, e.g.,* Annex II Commission Delegated Regulation (EU) 2022/1288 ("Sustainable investments […] might be aligned with the Taxonomy or not."). Art. 5, 6 Taxonomy Regulation only requires financial product providers to disclose a percentage of investments in activities that qualify as sustainable under the taxonomy.

97 The taxonomy for climate change mitigation and adaptation—the only one that has been fully elaborated—runs almost 400 pages, *see* the consolidated version as of January 1, 2023, of Commission Delegated Regulation (EU) 2021/2139.

98 *Supra* note 46 and accompanying text.

governments, non-governmental organizations, and the general public. As an environmental or social issue attracts a certain level of attention and interest, it is included as an item in the ESG rating. If one were to translate this approach into a formal voting rule, such as over spending priorities, it would mean that every issue attracting a minimum threshold of votes—say 10% or a third—is included and receives an equal fraction from a limited budget; a more nuanced approach would be to attach different weights according to the number of perceived "votes".[99] Different from common voting procedures, individuals can express concern over as many issues as they wish without prioritizing them; also, more vocal groups have more weight in terms of perceived "votes". This "wish list" approach to defining the objectives of impact investing has the advantage of increasing acceptance of the rating and relieving the rating provider of having to evaluate complex and controversial policy matters. It also allows firms to pick items from the menu that they can address at the lowest cost. How many items the firm will take up depends on the total premium provided by prosocial investors, their voting power, the firm's cost, and competition.

While this is a plausible scheme to allocate the subsidies provided by prosocial investors, one should be clear that it produces tradeoffs without making them explicit. Because the incentive power wielded by prosocial investors is limited, adding items to the list weakens the achievement of other objectives. Innocuous as the "wish list" approach may seem, it leads to a set of priorities at the expense of alternative orderings. The example of carbon abatement illustrates the point. The steep reduction of carbon emissions within a short timeframe arguably requires a decisive shift in firms' real investments. Reasonable prosocial investors might conclude that climate change is of such unparalleled gravity and urgency that they should concentrate their financial potency on meeting this paramount challenge. Such an approach arguably conforms with the portfolio motive for impact investing, which should worry most about the externalities from climate change and insufficient innovation to support the transition. Governments also appear to single out the "race

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[99] Rating providers weight issues, firstly, through the number of items used to measure them and, secondly, through their aggregation method, *supra* text accompanying note 20 and the weights recovered for different ESG ratings by Berg, Kölbel & Rigobon, *supra* at 1331, 1333–34.

to zero" and attach higher priority to it.[100] On the flip side, adopting a more focused, perhaps even single-issued agenda could reduce broader acceptance of the rating. By recognizing and including all vocal concerns, the "wish list" approach nurtures the illusion that no priorities need to be set—when in fact this is only one particular ordering to deploy limited resources.

2. Shaping incentives for firms

Bracketing off the collective choice problem, a rating for prosocial investors should aim at giving the common objectives of investors the greatest impact on firms. ESG ratings effectively stipulate a rule for rewarding firms with valuation premia. A well-known problem of incentive schemes is that they focus an agent's effort on certain criteria and divert it from other, omitted aspects that can nevertheless matter for performance ("multi-task agency").[101] For instance, an ESG rating that contains no indicator of forest preservation encourages firms to concentrate their efforts on other environmental or social issues.[102] In principle, this suggests extending ESG ratings to all relevant aspects that can be measured. There is, however, a tradeoff: The available ESG market premia are, in all likelihood, insufficient to achieve all possible ESG improvements. If the rating stretches over many aspects, it effectively permits firms to decide which ESG performance factors to pursue. This can be cost-efficient, but it deprives investors or rating providers of the ability to press their own priorities. The latter observation ties in with the earlier finding that existing ESG ratings avoid emphasizing certain concerns over others.

A second aspect of maximizing the impact of impact investing is that it should be attuned to a firm's marginal cost of producing a desired outcome. Ideally, an ESG rating should channel the valuation premium to where they produce the greatest gain

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100 Witness the rushing of the climate change taxonomy and the lagging of other aspects, *see* notes 93–94 *supra* and accompanying text.

101 *See* Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J. L. Econ. & Organ. 24 (1991); for an application of this idea to the effect of market valuation on firm behavior Alex Edmans, Mirko S. Heinle & Chong Huang, *The Real Costs of Financial Efficiency When Some Information Is Soft*, 20 Rev. Fin. 2151 (2016).

102 For a list of issues covered in various ESG ratings, *see* Berg, Kölbel & Rigobon, *supra*, 1326–27; *see also* Dyck et al., online appendix, *supra* at 57 (providing a comprehensive list of indicators included in Refinitiv's Asset4 rating).

at the lowest cost. The problem is familiar from the design of government subsidies. Like limited taxpayer money, prosocial investors should focus their funding power on where it makes a difference. An obvious concern is arbitrage—now at the level of real investment—that can thwart the intended effect. Subsidizing the reduction of a profitable activity creates the obvious incentive to both earn the subsidy and realize the capitalized value of the activity by selling it to an acquirer who feels less pressure from impact investors. One would expect, for instance, to see carbon-intensive assets migrate from public to private firms or to specialist holders of "brown" assets with no prospect of ever achieving a high ESG rating.[103]

Apart from arbitrage in real activities, prosocial investment should attune to the direct and indirect costs of changing corporate technologies and practices. Rewards from prosocial investors can be both complements and substitutes to other ways of internalizing the firm's external effects. They are complements if lower capital costs from prosocial investment tip the balance in combination with pressure from consumer or labor markets or with threats of government intervention. Investors should then be willing to support firms that already have incentives to produce the desired social outcome. On other occasions, the social objective pays for itself. In these settings, prosocial investors should put their limited power to more effective use instead of creating a windfall on top of existing incentives. To illustrate, higher ESG ratings have been shown to vary with firm size and country of origin.[104] Large firms tend to have better ratings, arguably because they are more visible and better able to sustain the fixed costs of a corporate responsibility strategy.[105] Likewise, countries differ in the degree to which local laws and institutions encourage or force

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103 *Cf.* Gabriel Malek et al., *Transferred Emissions: How Risks in Oil and Gas M&A Could Hamper the Energy Transition* (Environmental Defense Fund, 2023), https://web.archive.org/web/20230410220659/https://business.edf.org/files/Transferred-Emissions-How-Oil-Gas-MA-Hamper-Energy-Transition.pdf; Alperen A Gözlügöl & Wolf-Georg Ringe, *Net-Zero Transition and Divestments of Carbon-Intensive Assets*, 56 U.C. Davis L. Rev. 1963, 1987–2201 (2023).

104 Hao Liang & Luc Renneboog, *On the Foundations of Corporate Social Responsibility*, 72 J. Fin. 853 (2017), 873–75.

105 *See* Pablo Vilas, Laura Andreu & José Luis Sarto, *In Search of Inclusive ESG Ratings* (2023), 8 (providing a one-paragraph literature overview).

firms to produce social outcomes that ESG ratings reward.[106] Similar arguments apply to industries. Child labor and human rights abuses are more difficult to avoid in the fashion industry than in the media business. Perhaps less intuitively, incumbent "brown" energy producers can have strong incentives to invest in environmental innovation to preempt entrants with a disruptive "green" technology.[107] In all of these instances, the opportunity costs of contributing to social improvements differ significantly. To bring their incentive power to maximum effect, prosocial investment strategies should reflect these differences as well as their own complementary or substitutive effects.

Assuming that ESG ratings aim to provide conclusive guidance to impact investors, a higher rating should indicate greater social value from additional investment, given the objective function. Any workable rating methodology will miss the optimal investment strategy by a wide margin. This should not surprise anyone. Internalizing external effects, especially on public goods such as the environment or social justice, has never been simple. Government subsidies suffer great leakage despite the advantage of a single, centralized administration and its greater ability to adjust spending to information about recipients. Impact investors and their ESG ratings are likely to do worse even if they seek the greatest prosocial bang for their buck. They could also be more susceptible to fairness contentions that undermine impact. For instance, ESG rating providers will want to avoid being condemned as "green washers" for channeling prosocial capital to "brown" firms in exchange for relative improvements, although this could be the most effective approach to their prosocial objectives.[108] ESG ratings run great chances of disappointing on several fronts.

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106 *See* Liang & Renneboog, *supra* at 855–58 (arguing that civil law jurisdictions tend to have stricter environmental and social regulation and to constrain managers less in relation to shareholders).

107 *See* Lauren Cohen, Umit G. Gurun & Quoc Nguyen, *The ESG-Innovation Disconnect: Evidence from Green Patenting* (ECGI Finance Working Paper 744, 2022), 5–6, 9–13 (documenting that belonging to the energy industry and low ESG ratings predict more "green" patents).

108 *See* Edmans, Levit & Schneemeier, *supra* at 15–18 (arguing that the optimal impact strategy can consist in tilting towards brown firms that improve); for a call to provide "fair" and "inclusive" ESG ratings, *see* Vilas, Andreu & Sarto, *supra*, 4 ("[C]urrent ESG ratings have some biases that may unfairly exclude some companies from [socially responsible] investment.").

VI. Standardization of ESG ratings: Unleashing the power of impact investing?

When capital markets and shareholders meetings become political arenas, it seems plausible that investors gather in like-minded groups to make their views heard. ESG ratings could act as an analogue of parties in democratic politics. As it turns out, ESG ratings diverge considerably. Political pluralism could be one explanation (subsection 1). However, splintering the force of prosocial investors across different political platforms threatens to weaken their impact. Rallying around a common ESG standard would give them greater leverage (subsection 2). The vision of consistent ESG ratings raises additional questions, not least whether coordination between rating providers is feasible and how they should be governed once they wield the united clout of prosocial investors (subsection 3).

1. ESG ratings as political parties?

When corporations and securities markets become polities, shareholders as citizens need ways to express their views, to form coalitions, and ultimately to arrive at collective choices. Different models of political intermediation are being discussed and tested in practice: One is to let investment intermediaries assume the role of parties and advance a political platform, another to enable ultimate investors to vote "through" the shareholding institution, possibly based on a menu of voting guidelines offered by proxy advisors for various political orientations.[109] ESG ratings could constitute a complementary technique for investment choices, supporting prosocial investors in implementing an investment strategy tailored to their individual worldviews.

In one important respect, the reality of ESG ratings conforms to this reading: Not only are there competing ESG ratings and providers but also do they diverge substantially: A recent study finds astonishingly little agreement in measuring ESG

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[109] For a brief overview and discussion, *see* Hart & Zingales, *supra* at 212–14; Broccardo, Hart & Zingales, *supra* at 3130–31; for the recent trend towards offering "voting choice" to investors *see* Andrey Malenko & Nadya Malenko, *Voting Choice* (ECGI Finance Working Paper 910, 2023), 2. The painstaking "specialty policies" of Institutional Shareholder Services (ISS) are available at https://web.archive.org/web/20230505063932/https://www.issgovernance.com/policy-gateway/voting-policies (as of May 5, 2023).

performance. Correlation coefficients between six ESG ratings of the same firms ranged from 0.38 to 0.71 with an average of 0.54.[110] The contrast to the purely financial credit ratings with their average correlation coefficient of 0.99 could not be starker.[111] Yet political pluralism explains only part of the divergences: The study goes on to decompose the considerable variance into the conceptualization of ESG and the measurement of the relevant attributes.[112] As to the former, it considers the attributes included in the various ratings, e.g., whether anti-competitive practices are covered ("scope"). A second aspect of conceptualization is the "weights" with which these categories enter the aggregate rating. "Measurement" then captures the variance in the assessment of categories, which can reflect the use of different indicators, variances in subjective judgment, or poor data collection.[113] It turns out that "measurement" explains well over half of the divergences, "scope" about one third and "weights" tend to be negligible.[114] Given the importance of measurement, one might conjecture that ESG ratings suffer from a lack of reliable firm-specific information. Another recent study, however, finds that ratings disagreement has increased over time and is, in fact, associated with more (!) extensive ESG disclosures of firms.[115] It appears that assessing even individual ESG elements involves a large amount of subjective judgment, either by the individual evaluator or in the respective guidelines of the ratings provider.[116] The discretionary nature of

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110 A correlation coefficient of 1 (–1) would imply perfect positive (negative) linear dependency. The study is based on 924 firms for which all six ratings were available in 2014; the results were confirmed in 2017 without the (discontinued) KLD rating. Berg, Kölbel & Rigobon, *supra* at 1321–23. An often-cited earlier study is Aaron K. Chatterji et al., *Do Ratings of Firms Converge? Implications for Managers, Investors and Strategy Researchers*, 37 Strategic Management Journal 1597 (2016).

111 Berg, Kölbel & Rigobon, *supra* at 1320.

112 *Cf.* Chatterji et al., *supra* at 1599–1601 (introducing the terms "theorization" and "commensurability").

113 For instance, Sustainalytics and Refinitiv revealed a correlation coefficient of only 0.59 for the straightforward factual question whether the roles of CEO and chairperson are separated in a given firm, Berg, Kölbel & Rigobon, *supra* at 1330.

114 The averages across all ratings are 56% ("measurement"), 38% ("scope") and 6% ("weights"), Berg, Kölbel & Rigobon, *supra* at 1337. An outlier is MSCI (with 36%, –4% and 68%, respectively) due to its firm-specific "exposure scores" that other ratings lack, *cf.* MSCI, *supra* at 21.

115 Christensen, Serafeim & Sikochi, *supra* at 157–162 (using ratings from MSCI, ASSET4 and Sustainalytics for firms from 69 countries 2004–2016).

116 *Cf.* Christensen, Serafeim & Sikochi, *supra* at 148–9, 151–2 (discussing why more information could lead to less disagreement).

ESG ratings also shows in constant changes that providers apply even retroactively.[117]

The empirical evidence is consistent with the notion that different ESG ratings represent varied visions of what constitutes social performance. Much of the dispersion, however, seems to reflect the difficulty of measuring an identical, agreed-upon concept of social performance, based on one and the same objective function. Instead of representing divergent political views, ratings providers could be aiming at the same target but be prone to large errors. In fact, this would be the only explanation for ratings diffusion if providers credibly claimed to serve purely financial investors and, therefore, to measure only financially material social performance.

2. Benefits of a standard

While different ESG ratings could in principle represent alternative political priorities, giving prosocial investors individual choice comes at a price: it sacrifices some of the limited power to affect firm behavior. Just like financial investors, impact investors use ESG ratings as a cost-efficient guide to selecting or excluding securities from a vast array of candidate issuers. Yet because impact investing aims to change relative prices and capital costs in securities markets, the success of any given strategy depends on its total share in the market. Adopting a strategy becomes more effective as others target the same firms by under- or over-weighting them.[118] This marks a key difference to democratic voting: Once a majority has formed, the decision wields the undivided power of the respective political body. By contrast, prosocial investors splinter their limited firepower if they fail to coordinate on the

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117 *See supra* notes 43 and 44 and accompanying text.

118 Investors recognize this requirement, *see* Eurosif, *Eurosif Report 2021, Fostering Investor Impact* 22 (2021) (calling investors to act "[i]n order for clear market signals to materialise and influence the reallocation of capital" and going on to deplore the "variety of methodologies" and "divergent evaluations" of ESG ratings). There is an analogy to conventional credit ratings: Arguably, they too support coordination among investors if funding decisions are strategic complements, that is, if one investor's lending is viable only if others lend at the same (low) rates, *see* Arnoud W. A. Boot, Todd T. Milbourn & Anjolein Schmeits, *Credit Ratings as Coordination Mechanisms*, 19 Rev. Fin. Stud. 81 (2006); Kaushik Basu & Haokun Sun, *The power and influence of rating agencies with insights into their misuse*, 109 Econ. Modelling 105,763 (2022).

same target firms and securities. Setting aside their disagreement and uniting on a common platform would sharpen their ability to create price differences. Converging on common criteria—such as from a standardized ESG rating—can also help to monitor mutual promises between prosocial investors to follow an impact strategy despite the risk-return sacrifices it requires.[119]

A second coordination dimension is between investors and firms. Affecting securities prices is only a means to incentivizing real investment in social performance. To this end, the firm and its managers must be assured of a lasting premium on their cost of capital. Investors need to maintain a higher market valuation after the firm has met their demands, instead of reverting to a purely financial investment strategy.[120] A shared measure of what counts as improvement in the eyes of investors makes the social premium more predictable and, importantly, also more dependable. Incentives are stronger if agents can be confident which outcomes and characteristics will be rewarded. Adopting and promulgating a common standard reinforces the price signal that impact investors want to convey.[121]

3. The if and how of standardization

The benefits of coordination militate for standardizing ESG ratings by coalescing on a single rating or by making existing ratings more uniform. Whether it can be achieved is a different matter. A thumbnail sketch of the relevant incentives portends a bumpy road. Rational investors that seek actual impact should weight slippage from their individual preferences against the ability to effect real change. To which degree this trade-off sways them towards a single standard depends on the intensity of their preferences and the loss in impact from fragmentation. What can be said is that each investor considers only the achievement of her own political goals, not

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119 An example could be the yearly assessments of signatory asset managers by the Principles of Responsible Investment Association. The scores remain confidential but assessments are meant to be discussed with client investors, *see* PRI, *How investors are assessed on their reporting*, https://web.archive.org/web/20230509093724/https://www.unpri.org/reporting-and-assessment/how-investors-are-assessed-on-their-reporting/3066.article.

120 *See* Broccardo, Hart & Zingales, *supra* at 3131–32.

121 The flip side is that a single standard could measure social performance only imperfectly (even if investors agreed universally on the objective function). Because firms tend to maximize measured, not actual, social performance, multiple ratings with different errors could improve incentives, *see* Chaigneau & Sahuguet, *supra* at 17–20.

those of other prosocial investors—not even insofar as they intersect.[122] The externality points to under-standardization. Also, the standardization benefit only affects investors' prosocial ambitions. Their strategic sophistication could be even more limited where they fend for the common good instead of their own private benefit.

Turning to the opposite market side, the providers of ESG ratings should be interested in differentiating their products to distance themselves from competing raters and relax pressure on fees. Viewed through this lens, the staggering disparity between the low correlation of ESG ratings and the almost perfect alignment of credit ratings could echo the revenue models of investor-pays and issuer-pays.[123] An even better explanation for the almost perfect agreement among credit ratings lies in the strong and unanimous demand of financial investors for coordination in regard to a firm's creditworthiness.[124] Be this as it may, as long as many ESG ratings providers vie for investors with divergent political preferences, they will strive to invent new reasons to diverge, such as to accommodate alternative political views or to measure social performance more accurately. A potential remedy is restraining competition through agreements or mergers. But antitrust concerns are not easily brushed aside: Notwithstanding the benefits to prosocial investors and their political aspirations, allowing a monopolization of the ESG ratings industry would diminish innovation in measuring the social performance of firms and would vest a private actor with considerable quasi-regulatory power.

The latter consideration points to a policy issue to be addressed if indeed an ESG rating standard were to emerge. By directing a large swath of capital in the market, the provider of the standard rating would exert much stronger pressure on firms than

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122 A similar observation has been made for "voting choice", *cf. supra* note 109 and accompanying text: By insisting on making their own voting choices instead of delegating the decision to the asset manager, investors could fail to internalize the benefit to other investors from a more informed voting decision, *see* Malenko & Malenko, *supra* at 10–16.

123 Note, however, that credit rating agencies introduced the issuer-pays model only in the 1970s, *supra* note 8.

124 For the coordination demand, *supra* note 118. Relatedly, different explanations have been given for the oligopoly in the credit rating industry, *see* Schroeter, *supra* at 386–7. Schroeter himself points to investors' need to reduce informational complexity but this only explains why each investor would selects a single rating (or a few ratings), not why she would seek to rely on the same ratings as others.

the current multitude of divergent indicators. This magnifies the implications of any deficiencies and raises the stakes in devising the optimal rating. The standard setter becomes a collective decision-making body—a kind of government—for the prosocial investors that follow its directions. Much like a government, it not only has to avoid consequential mistakes but is also charged with aggregating the preferences of its constituent investors. As the above discussion of the objective function for prosocial investing has highlighted, the political discretion of a unique ESG rating provider would be broad—much broader than for other private standard setters in fields like accounting or technology. If such a mandate should be given to a private actor at all, it inevitably requires a formalized governance structure and procedures ensuring public accountability.

VII. Conclusion

The chapter's journey through the landscape of ESG ratings began with the observation that measurement presupposes an idea of the measured. As an analytical statement, this is a truism. However, it need not reflect the practical approach taken by business people, finance professionals, and policy makers. Instead of first defining a coherent concept of "ESG" and deducing a measurement method from it, developing specific metrics can be a way to explore and ultimately spell out the underlying concept. It falls upon the analyst to inquire whether the inductive process has been tracing a coherent underlying concept—whether the measurement measures anything. As it turned out, ESG ratings lack a clearly defined concept that they are supposed to measure. In particular, it remains in the dark whether they aspire to provide financial information or guidance for prosocial impact. Both of these goals reflect different and to some degree contradictory concepts of relevant "ESG" characteristics and outcomes.

The inconsistency is hardly unexpected. It mirrors a business strategy of preying on investors' wishful thinking that "doing good" and "doing well" are fully aligned—and that only short-sighted and greedy finance professionals have failed to notice. For the financial industry, nurturing this illusion obfuscates performance measures and allows to sustain higher profit margins. The vagueness of ESG also plays into the hands of politicians. It offers the opportunity to engage in symbolic activity by

safeguarding investors against the unpopular financial industry and its penchant for "greenwashing." Keeping ESG ambiguous also allows political groups to piggyback their particular agenda on concerns with broader support, such as by tying social-justice demands to sustainability in the narrower sense of respecting planetary boundaries. Lastly, policy makers may honestly hope that ESG investment relaxes the enormous pressure on governments to regulate externalities, especially in meeting the epochal challenge of ending carbon emissions.

The amalgamation of business and political interests makes it unlikely that a regulation of ESG ratings would embrace the main policy claim of the chapter—that ESG ratings providers should define and disclose the purpose of their ratings for investors. For ESG ratings that self-identify has guides to prosocial impact investment, the chapter has highlighted the ensuing difficulties of aggregating political preferences and translating them into investment impact. The ambiguities and challenges of ESG ratings are miniature images of the general problems facing the ESG movement. They will have to be overcome for ESG to produce real-world benefits, other than filling the pockets of asset managers, advisers, and auditors as well as buying time for politicians. It is not a daring prediction that "E," "S," and "G" issues will continue to haunt corporations, capital markets, and market economies. Whether "ESG" is here to stay seems less certain.

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