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# ESG Ratings: A Blind Spot for U.S. Securities Regulation

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# ESG Ratings: A Blind Spot for U.S. Securities Regulation

## Cover Page Footnote

J.D., University of California, Berkeley; B.A., M.A., Stanford University. The author is a senior associate at a large New York-based law firm, resident in the Tokyo office. His practice focuses on securities law and capital markets transactions, as well as financial regulatory matters.

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# ESG Ratings: A Blind Spot for U.S. Securities Regulation

*Alexander Coley*[*]

*Abstract:*

*Providers of "Environmental, Social, and Governance" (ESG) ratings have emerged as prominent informational intermediaries in the sustainable finance ecosystem. The key players are familiar names such as Moody's, Morningstar, MSCI and S&P. In recent years, investors, financial markets observers and academics have raised serious doubts about the value and integrity of ESG ratings, pointing to lack of reliability and comparability and risks of conflicts of interest and abuse, including the potential for "greenwashing."*

*ESG ratings are now in the crosshairs of financial regulators, particularly, in Europe. However, the regulatory discourse has failed to contend with risks arising from the use of ESG ratings by companies (issuers) in their public disclosure – for example, to advertise their ESG bona fides on earnings calls, in road show materials for securities offerings, or even committing to the maintenance, or improvement, of ESG ratings in promises to investors. Drawing on use cases of green bonds and other sustainable finance instruments, the paper argues that although ESG ratings have become deeply intertwined in the securities offering process, they are effectively insulated from securities law liability.*

*To make this argument, the paper highlights a structural similarity to the SEC's attempt to regulate the use of credit ratings in the wake of the global financial crisis – an effort which has been criticized as toothless. If the treatment of credit ratings under U.S. securities law is any guide, there is little reason to expect that ESG ratings will serve as the basis for liability, no matter how much importance investors attach to them. This conclusion has broader ramifications for understanding the contours of Section 11 liability for third-party experts. More immediately, the paper should inform ongoing efforts by the SEC and other financial regulators to map out and address new sources of risks building in the sustainable finance market.*

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## INTRODUCTION

What do Tesla, Berkshire Hathaway, Johnson & Johnson, and Chevron have in common? In May 2022, each company was a core component of the benchmark S&P 500 index, but was disqualified from inclusion in a sister index, the S&P 500 "ESG Elite," due to substandard ESG scores.[1] Tesla's exclusion from the ranks of the ESG Elite drew the ire of CEO Elon Musk. In a barrage of tweets, Elon Musk railed against the perceived culprit—the ESG ratings industry—calling ESG a "scam" and taking special umbrage in the fact that ExxonMobil replaced Tesla's spot in the index.[2]

ESG ratings have become a ubiquitous feature of the sustainable finance ecosystem.[3] Broadly speaking, ESG ratings refer to third-party assessments or opinions about the sustainability performance of an entity or financial product.[4] ESG ratings exist within a wider field of sustainability-related products and services, comprising "data aggregation, ratings, rankings, screening/weighting services, research, benchmarks, voting advisory, controversy reports and financial product assessments."[5] In view of the

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[1] Margaret Dorn, *The (Re)Balancing Act of the S&P 500 ESG Index*, S&P DOW JONES INDICES (May 17, 2022), https://www.indexologyblog.com/2022/05/17/the-rebalancing-act-of-the-sp-500-esg-index/ (ESG refers to "environmental, social, and governance"); *see* Amanda M. Rose, *A Response to Calls for SEC-Mandated ESG Disclosure*, 98 WASH. U. L. REV. 1821, 1822–23 (2021) (summarizing the "dizzyingly broad array" of topics falling under the umbrella of the ESG acronym).

[2] @elonmusk, TWITTER (May 18, 2022, 11:09 AM), https://twitter.com/elonmusk/status/1526958110023245829; *see* Tom Lyon, *How a Sustainability Index Can Keep Exxon but Drop Tesla – and 3 Ways to Fix ESG Ratings to Meet Investors' Expectations*, THE CONVERSATION (May 24, 2022), https://theconversation.com/how-a-sustainability-index-can-keep-exxon-but-drop-tesla-and-3-ways-to-fix-esg-ratings-to-meet-investors-expectations-183705.

[3] *See* Dorn, *supra* note 1 (determining to exclude Tesla and others from the ESG Elite index was based on what S&P calls its "DJI ESG Scores," which are proprietary scores that result from a "bottom-up research process that aggregates underlying company ESG data to score levels."); *S&P Global to Acquire the ESG Ratings Business from RobecoSAM*, S&P GLOBAL (Nov. 21, 2019), https://press.spglobal.com/2019-11-21-S-P-Global-to-Acquire-the-ESG-Ratings-Business-from-RobecoSAM (as discussed below, products referred to as ESG "scores" or "ratings" often overlap and can be interchangeable. In S&P's case, their ESG scoring business is the product of an acquisition of well-known ESG ratings provider, RobecoSAM, in 2019).

[4] EUR. SEC. MKTS. AUTH., CALL FOR EVIDENCE, ON MARKET CHARACTERISTICS FOR ESG RATING PROVIDERS IN THE EU 5 (2022) (providing the following definition: "ESG ratings refer the broad spectrum of ratings products that are marketed as providing an opinion regarding an entity, a financial instrument or a product, a company's ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment that are issued using a defined ranking system of rating categories, whether or not these are explicitly labelled as 'ESG ratings.'"); *see* Alison Plaut, *What Is an ESG Rating?*, MOTLEY FOOL (Oct. 24, 2022), https://www.fool.com/investing/stock-market/types-of-stocks/esg-investing/esg-rating/ (primer on ESG ratings aimed at retail investors).

[5] EUR. COMM'N, STUDY ON SUSTAINABILITY-RELATED RATINGS, DATA AND RESEARCH 15 (2020) [hereinafter EU STUDY].

seismic shift towards ESG-focused investment strategies in recent years,[6] the emergence of a robust industry of intermediary service providers, including ESG ratings providers, is a natural market response.

Due to the vast proliferation of products and vendors in the market, it is not easy or always possible to identify what is distinctive about an ESG rating compared to an ESG score or ranking. The lines between these products blur and the terms are often used interchangeably. A recent report by IOSCO, the international organization of national securities regulators, attempts to distill the essence of ESG ratings as follows: "ESG scores usually result from quantitative analysis whereas ESG ratings are produced using both quantitative models and qualitative analysis and are accompanied by analyst reports to explain the ratings. On that basis, ratings may therefore incorporate analytical judgment or opinion."[7] The key for purposes of this paper is that ESG ratings embody an element of analysis or judgment.

This model of third-party intermediaries carving up the landscape of corporate issuers into tiers based on analysis of particular attributes—in this case, sustainability performance—invites an obvious comparison to credit ratings. It should come as no surprise that several of the major ESG ratings providers are affiliated with traditional credit rating agencies (i.e., S&P and Moody's). And just as credit rating agencies were the subject of significant controversy in the aftermath of the financial crisis of 2008-09,[8] ESG ratings providers have attracted a legion of critics. Academic studies reveal persistent patterns of divergence in ESG ratings assigned by the different providers,[9] while a range of commentators have drawn attention to methodological flaws or intuitively absurd results reached by ESG ratings companies.[10] Speaking in her personal capacity, SEC Commissioner Hester

6 J.P. MORGAN ASSET MGMT., LONG-TERM CAPITAL MARKET ASSUMPTIONS 25 (2022) (showing data on capital flows into sustainable investing strategies).

7 INT'L ORG. OF SEC. COMM'NS, ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) RATINGS AND DATA PRODUCTS PROVIDERS, FINAL REPORT 10 (2021), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf [hereinafter IOSCO REPORT].

8 FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT xxv (2011) (finding that "the failures of the credit rating agencies were key enablers of the financial meltdown."); Frank Partnoy, *What's (Still) Wrong with Credit Ratings?*, 92 WASH. L. REV. 1407, 1412–13 (2017) [hereinafter Partnoy (2017)] (documenting the post-crisis controversy over credit ratings).

9 Florian Berg, Julian F. Köelbel & Roberto Rigobon, *Aggregate Confusion: The Divergence of ESG Ratings* (2022), https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=3438533; 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 (2022), https://doi.org/10.2308/TAR-2019-0506.

10 *See, e.g.*, Hans Taparia, *The World May Be Better Off Without ESG Investing*, STAN. SOC. INNOVATION REV. (July 14, 2021), https://ssir.org/articles/entry/the_world_may_be_better_off_without_esg_investing; Andrés Gil, *Europe's Regulatory Playbook for ESG Rating Providers*, FINREG BLOG (Apr. 13, 2021), https://sites.law.duke.edu/thefinregblog/2021/04/13/europes-regulatory-playbook-for-esg-rating-providers; Rose, *supra* note 1, at 1825–26; Jill E. Fisch, *Making Sustainability Disclosure Sustainable*,

Peirce, called into question the entire enterprise of ESG advisory service providers.[11] In the financial press, coverage of ESG ratings and their discontents has become routine.[12]

Thus, while his rhetoric was inflammatory, Musk's disdain for ESG ratings is not a fringe viewpoint. A common source of criticism are ratings outcomes that are at odds with intuitions about what a model ESG citizen ought to look like. As Taparia noted, among other provocative examples, tech giants such as Alphabet, Amazon and Facebook "often get high ESG ratings because they are predictably low producers of greenhouse gas emissions. But few would consider them to be good corporate citizens."[13] In a similar vein, a recent article documented ratings upgrades across many of the largest financial institutions for environmental reasons, "even though they continue to lend billions of dollars to fossil-fuel companies."[14]

The growing frustration with the ESG ratings enterprise by market participants and commentators has not escaped the attention of regulators.[15] In November 2021, IOSCO issued a report containing recommendations for its constituent members on how to regulate ESG ratings providers in their jurisdictions. The U.K., the European Union and several national regulators within Europe, and Japan have all issued statements regarding their intention to bring ESG ratings providers within the regulatory fold. In the U.S., the SEC has issued public statements critical of ESG ratings as well.

This article is sympathetic to these calls for regulatory oversight. However, the approaches being floated are too narrow, because they fail to contend with a major source of risks: those stemming from the use of ESG ratings by the rated companies themselves. Companies are increasingly integrating ESG ratings into their direct sales pitches to investors. Indeed, public companies often feature ESG ratings in their investor relations efforts: disclosing ratings on corporate websites, in proxy statements[16] and

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107 GEO. L.J. 923, 949–50 (2019).

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

[12] *See, e.g.*, Cam Simpson, Akshat Rathi & Saijel Kishan, *The ESG Mirage*, BLOOMBERG (Dec. 10, 2021), https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line; James Mackintosh, *Is Tesla or Exxon More Sustainable? It Depends Whom You Ask*, WALL ST. J. (Sept. 17, 2018), https://www.wsj.com/articles/is-tesla-or-exxon-more-sustainable-it-depends-whom-you-ask-1537199931.

[13] Taparia, *supra* note 10.

[14] *Banks Get ESG Upgrades Despite Lending Billions for Fossil Fuels,* AM. BANKER (Feb. 7, 2022, 1:14 PM), https://www.americanbanker.com/articles/banks-get-esg-upgrades-despite-lending-billions-for-fossil-fuels.

[15] *See infra* Part I.B (overviewing responses from regulators).

[16] Some companies have begun to incorporate ESG ratings as a criterion for determining executive compensation. This could be viewed as companies making a noble commitment to sustainability – i.e., "putting their money where their mouth is." More cynically, it may just

sustainability reports, or featuring ratings in earnings press releases and slide show decks for investor meetings[17] – the logical next step is to provide ratings updates on earnings calls.[18] Because most of the public controversy over ESG ratings has focused on their "downstream" uses – i.e., in the marketing of ESG-themed investment products (mutual funds, ETFs) [19] or the construction of indexes like the ESG Elite – there has been less attention paid to the manifold uses of ESG ratings by issuers. This paper contributes to the literature by turning the focus on how ESG ratings interact with the primary securities offering process – specifically in the context of "sustainable finance instruments," a term I use for a range of ESG-themed securities, from green bonds to more exotic products like sustainability-linked bonds and sustainable IPOs.[20]

Someone casually familiar with the U.S. securities laws might assume that if an investor purchases securities on the basis of a company's ESG rating, liability could theoretically attach—say, if it turns out the ESG rating

be a reflection of the severe pressure that public companies are under from influential institutional investors. While not the primary focus of this article, the concerns raised here about the integrity of ESG ratings apply to the use of ESG ratings as a proxy for sustainability progress in setting executive pay.

[17] *See* MSCI ESG RESEARCH, *MSCI ESG General FAQS for Corporate Issuers* 8 (Feb. 2023), https://www.msci.com/documents/1296102/10259127/FAQ-For-Corporate-Issuers.pdf/ad19208c-d32c-7a7e-f90a-d48870b4d897 (explaining that issuers can seek permission to promote their ESG rating in "annual report[s], sustainability report[s], investor presentations, issuer website, etc.").

[18] Although the practice has not taken root in a systematized way, commentators are calling for increased integration of ESG strategy and performance into the quarterly earnings call. *See* Kevin Eckerle et al., *ESG and the Earnings Call: Communicating Sustainable Value Creation Quarter by Quarter* (May 27, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3607921. There are indications that issuers are increasingly mentioning ESG issues in their earnings calls. Tim Human, *Telling your ESG Story Beyond the Sustainability Report: ESG on the Earnings Call*, IR MAG. (Oct. 4, 2021), https://www.irmagazine.com/esg/telling-your-esg-story-beyond-sustainability-report-esg-earnings-call (discussing data showing that more 30 percent of S&P 500 companies cited ESG during their first-quarter earnings call in 2021). As this practice develops and becomes *de rigeur*, issuers would likely be tempted to incorporate third-party data such as ESG ratings into their updates and discussions with analysts.

[19] *See, e.g.*, Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Mutual Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393, 443 (2021); Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36,654 (proposed June 17, 2022) [hereinafter ESG Fund Disclosure Proposal] (proposing standardized reporting requirements for ESG-focused funds and investment advisers); *see id.* at 199-200 (recognizing the widespread use of ratings and other products from third-party ESG providers by ESG funds and advisers and discussing uses of third-party ESG providers by ESG funds and advisers in current practice).

[20] To be clear, by "sustainable finance instruments," I am specifically referring to financial instruments issued by companies or financial institutions in their capital raising efforts, as opposed to investment products such as ESG-themed funds or ETFs. This is a significant distinction. The latter have received most of the attention in the public eye (presumably since retail investors have the most direct interaction with these products).

was overly rosy, or made without a reasonable foundation, or presented in a duplicitous light. This paper casts doubt on the idea that securities law liability can effectively police the use of ESG ratings. The problem is that there is no clear basis on which to assign liability for misleading ESG ratings—either to the company (for including the ESG ratings in its disclosure) or the ESG ratings providers (for deficient or misleading analysis). This is because ESG ratings occupy an awkward status from the standpoint of U.S. securities law. They are third-party produced opinions—arguably with some resemblance to analyst ratings for equity securities or mutual fund ratings.[21] But ESG ratings are not merely a subscription-based service offered by a third-party provider to customers (like asset managers or analysts). They are better analogized to credit ratings, which are material information for investors yet are not required to be disclosed in the issuer's registration statement under SEC rules. This has created an anomalous market equilibrium whereby credit rating agencies are effectively insulated from Section 11 liability as experts. In the absence of a clear change in regulatory direction from the SEC, market participants can—and do—assume that ESG ratings will be treated similarly as credit ratings and conform market practices accordingly. If ESG ratings are as flawed and susceptible to misinterpretation as critics claim, this is a harmful result for investor protection.

The broad takeaway is that ESG ratings, like credit ratings, exist within a conceptual gap in the fabric of U.S. securities regulation. They are outside of the sphere of effective securities regulation, but without any obvious justification. One aim of this paper is to prompt dialogue on the adequacy of the current oversight regime for external ratings providers of all stripes—whether traditional credit ratings agencies or their newer sustainability-focused affiliates. In theory, regulators' jobs should be simplified by the fact that traditional credit rating agencies and ESG ratings providers increasingly share the same corporate roof.[22] The job is easier said than done, because ratings agencies are slippery regulatory targets.

The paper proceeds as follows. Part I provides a brief summary of the ESG ratings industry and surveys recent statements from regulators worldwide on the need for oversight. Part II.A develops the argument that the use of ESG ratings in securities offerings is an underappreciated source of risks that U.S. securities law is ill-equipped to handle. Using green bonds

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[21] There is a standard view of ratings products as opinions provided by trusted intermediaries which serve an economically valuable purpose by eliminating inefficient efforts of individual users. Partnoy—who disagrees with the characterization—describes this view in the context of credit ratings: "[C]redit ratings are simply opinions, not unlike a restaurant star rating from Michelin. Credit ratings respond to investors' demand for information about risks associated with fixed income investments." Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 630 (1999) [hereinafter Partnoy (1999)].

[22] *See infra* Part II.A.

as the primary case study, it explains how ESG ratings have become intertwined in sustainable finance offerings and how this exacerbates conflicts of interest and investor confusion. Part II.B drills down on the key regulatory precedent—the efforts to reform credit rating agencies (specifically, the NRSROs[23]) in the wake of the global financial crisis — arguing that it does not portend an effective regulatory response from the SEC. Although a skeptic could argue that the risks to investor protection are overblown, Part II.C presents two case studies to test the limits of this view: sustainability-linked bonds and Allbirds' pioneering "sustainable IPO" in 2021. Part III assesses competing modes of regulation for financial gatekeepers such as ESG ratings providers, and discusses the doctrinal limitations on using U.S. securities law liability to regulate third-party opinions. Despite these constraints, however, the paper offers reasons for cautious optimism and leaves a modest suggestion for the SEC. Part IV concludes.

## I. MARKET AND REGULATORY BACKGROUND

### *A. Development of the ESG Ratings Industry*

The pace of growth in sustainable investing has been extraordinary. According to a recent report by the Global Sustainable Investment Alliance, aggregate sustainable investment in five major markets reached $35.3 trillion at the start of 2020, showing a 15% increase since 2018.[24] Bloomberg estimates that ESG assets may hit $53 trillion by 2025, amounting to a third of global AUM.[25] As an indicator of retail investor interest, ESG-themed ETF inflows in 2020 (through 3Q) were about $49 billion, accounting for 24% of total fund inflows, and Bloomberg estimates that total inflows into ESG ETFs may reach $1 trillion globally over the next five years.[26] In the debt markets, green, social and sustainable debt issuance has experienced explosive growth in recent years, surpassing $2 trillion in cumulative volume at the end of 2020.[27] Bloomberg estimates that total issuance volume could

[23] *See* Partnoy (1999), *supra* note 21, at 690-98 (describing the origins of the NRSRO system and the subsequent ballooning of regulations that referenced the NRSROs, which had the effect of endowing the NRSROs with an entrenched oligopoly in the ratings business); *See* Partnoy (2017), *supra* note 8, at 1419-23 (explaining how under Dodd-Frank, Congress sought to reduce market reliance on the NRSROs by directing the SEC to remove references to NRSROs in the agency's rules); *see* Removal of References to Credit Ratings from Regulation M, 87 Fed. Reg. 18312 (proposed Mar. 30, 2022) (to be codified at 17 C.F.R. pts. 240, 242) (showing that the SEC's undertaking to remove references to NRSROs continues to this day).

[24] GLOB. SUSTAINABLE INV. ALL., GLOBAL SUSTAINABLE INVESTMENT REVIEW 2020 5 (2021).

[25] Adeline Diab & Gina Martin Adams, *ESG Assets May Hit $53 Trillion by 2025, a Third of Global AUM*, BLOOMBERG INTEL. (Feb. 23, 2021), https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/.

[26] *Id.*

[27] *Id.*

swell to $11 trillion by 2025.[28]

Against this backdrop, ESG ratings and data providers have assumed a prominent intermediary role in within the sustainable investing landscape. As described in the IOSCO Report, as "investors become more sensitive to the potential financial risks posed by climate change and the potential impact of other ESG considerations, such considerations are becoming increasingly significant in investment decision making."[29] This has fed an "increasing reliance" by investors on ESG ratings and data products, which provide a suite of services to help asset managers and investors "assess the sustainability track record of companies in which they invest."[30]

According to the EU Study published in November 2020, studies estimate there to be 10 to 15 major sustainability-related rating and data providers, while a KPMG report from 2020 estimates approximately 160 providers worldwide.[31] One prominent market survey found more than 600 ESG ratings and rankings globally as of 2018.[32] However, the industry has been on a conspicuous trend toward consolidation.[33]

This paper is primarily concerned with the group of companies that produce opinionated ESG ratings – i.e., ratings that embody some level of analysis and judgment – rather than the aggregators of ESG data. This group includes major providers such as Sustainalytics (owned by Morningstar), MSCI (the leading index/benchmark operator), ISS ESG (affiliated with ISS, the shareholder advisory giant), S&P Global, and Moody's ESG Solutions (formerly Vigeo Eiris). [34] These are the main players who stand in the front of the pack after the recent surge of acquisition and consolidation.[35] It should

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[28] *Id.*

[29] IOSCO REPORT, *supra* note 7, at 3.

[30] *Id.*; *see* ESG Fund Disclosure Proposal, *supra* note 19, at 200-01 (discussing how institutional investors and other market participants, namely investment advisers and fund managers, use ESG ratings).

[31] EU STUDY, *supra* note 5, at 15–16.

[32] Christina Wong & Erika Petroy, *Rate the Raters 2020*, SUSTAINABILITY INST., https://www.sustainability.com/thinking/rate-the-raters-2020/.

[33] IOSCO REPORT, *supra* note 7, at 7 ("The global market for ESG ratings and data products is concentrated around a small number of providers with a global presence, alongside a larger number of providers with a more regional focus or offering more specialized services."); EU STUDY, *supra* note 5, at 7-8. *See* Anna Hirai & Andrew Brady, *Managing ESG Data and Rating Risk*, HARV. L. SCH. F. CORP. GOVERNANCE (July 28, 2021), https://corpgov.law.harvard.edu/2021/07/28/managing-esg-data-and-rating-risk (listing notable examples of industry consolidation among ESG rating providers).

[34] Manuela Huck-Wettstein, *ESG Ratings and Rankings: Why They Matter and How to Get Started*, SUSTAINSERV (Dec. 7, 2020), https://sustainserv.com/en/insights/esg-ratings-and-rankings-why-they-matter-and-how-to-get-started/.

[35] *See* Declan Harty & Maria Tor, *Consolidation Among ESG Data Providers Continues Amid COVID-19 Pandemic*, S&P GLOBAL (Apr. 29, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/consolidation-among-esg-data-providers-continues-amid-covid-19-pandemic-58306410 ("It does seem to be moving toward an oligopoly.").

not be surprising that each of these ratings entities is part of an institutional network that is a household name in the financial markets and investment ecosystem.

*B. Calls for Regulatory Oversight of ESG Ratings*

As documented in the Introduction, as the influence and power of ESG ratings providers has expanded, a slew of critics and skeptical voices has emerged as a counterweight. In just the past year, ESG ratings have drawn significant attention from policy-makers and regulators. IOSCO published a final report in November 2021 containing 10 recommendations to global securities regulators on the appropriate nature and scope of regulation of the ESG ratings and data industry.[36] In Europe, the UK Financial Conduct Authority (FCA)[37] and the European Securities Market Authority (ESMA)[38] are following IOSCO's lead and have commenced processes for implementing regulatory oversight in their respective jurisdictions. In August 2022, the European Commission issued a consultation seeking public comment on the state of the ESG ratings market with a view toward possible EU intervention, while in March 2023 the U.K. Exchequer released its own consultation on a proposal to bring ESG ratings providers within the U.K. regulatory perimeter.[39] In Japan, the umbrella financial supervisor, announced in June 2021 that it would establish a "Code of Conduct" for the ESG ratings industry aimed at addressing conflicts of interest and moral hazard risk.[40] In the U.S., the Office of Credit Ratings, the SEC division created by Dodd-Frank to oversee the credit rating industry, discussed in its 2022 Staff Report the conflict of interest risks stemming from the rating

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[36] IOSCO REPORT, *supra* note 7.

[37] FIN. CONDUCT AUTH., ENHANCING CLIMATE-RELATED DISCLOSURES BY STANDARD LISTED COMPANIES AND SEEKING VIEWS ON ESG TOPICS IN CAPITAL MARKETS (2021) [hereinafter UK FCA POLICY STATEMENT]; FIN. CONDUCT AUTH., ENHANCING CLIMATE-RELATED DISCLOSURES BY ASSET MANAGERS, LIFE INSURERS AND FCA-REGULATED PENSION PROVIDERS 12 (2021).

[38] EUR. SEC. MKTS. AUTH., RESPONSE TO PUBLIC CONSULTATION: EC CONSULTATION ON A RENEWED SUSTAINABLE FINANCE STRATEGY (2020) (notifying the European Commission of ESMA's view that "the unregulated nature of ESG ratings and data assessments pose[s] a potential risk to investor protection," and ESMA's undertaking of a public consultation to gather further information); EUR. SEC. MKTS. AUTH., CALL FOR EVIDENCE, ON MARKET CHARACTERISTICS FOR ESG RATING PROVIDERS IN THE EU 5 (2022) (issuing a request for evidence from stakeholders intended to help develop an understanding of the characteristics of ESG ratings providers operating in Europe).

[39] EUR. COMM'N, TARGETED CONSULTATION ON THE FUNCTIONING OF THE ESG RATINGS MARKET IN THE EUROPEAN UNION AND ON THE CONSIDERATION OF ESG FACTORS IN CREDIT RATINGS 4 (2022); HM TREASURY, FUTURE REGULATORY REGIME FOR ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) RATINGS PROVIDERS 13 (2023).

[40] FIN. SERVS. AGENCY, BUILDING A FINANCIAL SYSTEM THAT SUPPORTS A SUSTAINABLE SOCIETY 16 (2021); *see also* FIN. SERVS. AGENCY, THE CODE OF CONDUCT FOR ESG EVALUATION AND DATA PROVIDERS 17 (2022) (Code of Conduct adopted in December 2022).

agencies' entry into ESG-related businesses.[41] In its recently proposed rule for mandatory climate disclosure, the SEC also acknowledged concerns with ESG ratings, citing multiple academic studies.[42]

This paper will not recite the concerns and criticisms raised by regulators in detail. As the first major statement on ESG ratings, the joint white paper of French and Dutch securities regulators (the "AMF/AFM Paper") is representative.[43] The AMF/AFM Paper focuses on the lack of transparency and comparability of methodologies of ESG ratings providers as a potential source of misallocation of capital, greenwashing,[44] harm to investors, and conflicts of interest, while also highlighting risks from growing dependence on a limited number of unregulated providers. While affirming the importance of "sustainability-related data, analysis and services in the financial system," it calls for mandatory regulation of ESG data and services providers, including ESG ratings companies.[45] The IOSCO Report and other regulators have echoed these concerns, particularly with respect to the lack of transparency and comparability.[46] As an indication of the extent of the problem, private sector solutions have emerged as a second-order measure to help customers understand the bewildering array of products and rating systems. For example, a specialty consulting firm, Framework ESG, pitches its ability to help clients discern a clear signal from the "ESG noise" created by the 600 ESG rating schemes published globally.[47]

Like the AMF/AFM Paper, most of the commentary around ESG ratings has taken for granted that ESG ratings are a valuable feature of the investing landscape. Scholars at MIT established a center whose mission is to "improve the quality of ESG measurement and decision making in the financial sector."[48] From this perspective, the basic problem identified with ESG

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[41] OFFICE OF CREDIT RATINGS, SEC, STAFF REPORT ON NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATIONS 8 (2022).

[42] The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (proposed Apr. 11 2022) [hereinafter SEC Climate Disclosure Proposal].

[43] AUTORITÉ DES MARCHÉS FINANCIERS & AUTORITEIT FINANCIËLE MARKTEN, POSITION PAPER: CALL FOR A EUROPEAN REGULATION FOR THE PROVISION OF ESG DATA, RATINGS, AND RELATED SERVICES (2020) [hereinafter AMF/AFM PAPER].

[44] INT'L ORG. OF SEC. COMM'NS, SUSTAINABLE FINANCE AND THE ROLE OF SECURITIES REGULATORS AND IOSCO 3 (2020) (defining greenwashing as "practices aimed to mislead investors or to give them a false impression about how well an investment is aligned with its sustainability goals").

[45] AMF/AFM PAPER, *supra* note 43, at 2, 4–5.

[46] Steven Maijoor, *Letter to Commissioner in Charge of Financial Services, Financial Stability and Capital Markets Union, European Commission* (Jan. 28, 2021); UK FCA POLICY STATEMENT, *supra* note 37, at 36 (calling attention to "hardwiring" of ratings into investment processes and issues with multiplicity of ESG rating provider questionnaires); FIN. SERVS. AGENCY (2021), *supra* note 40, at 16.

[47] FrameworkESG, *Making Sense of ESG Ratings and Rankings* (2021), https://frameworkesg.com/wp-content/uploads/2021/10/FWESG_RatingsRankings2021.pdf.

[48] *The Aggregate Confusion Project*, MIT SLOAN SUSTAINABILITY INITIATIVE, https://mitsloan.mit.edu/sustainability-initiative/aggregate-confusion-project ("[A]mbiguity

ratings is one of quality – in the current environment, there is a lack of consistency and comparability that diminishes their usefulness and could lead to investor confusion.[49] Likewise, the general tenor of the discussion in the statements issued by IOSCO and the financial regulators is an instinct to impose order on a messy situation – as opposed to, say, a call to prohibit or curtail the activities of ESG ratings providers. The baseline assumption is that a robust marketplace for ESG ratings is a net societal benefit.[50] By putting "guardrails" around the ESG ratings industry, the goal is to induce more reliable and valuable products for investors.[51]

By contrast, the issue of liability and accountability for ESG ratings has received little attention from regulators, including the European regulators who have dominated the policy discussion.[52] But to the extent that investors develop increasing reliance on ESG ratings in evaluating a company's securities, it is intuitive to ask how liability should be apportioned in cases that go wrong. In the U.S. securities regulation context, a company's disclosure of its ESG ratings should be subject to the securities laws' anti-fraud and investor protection framework. If a company's ESG ratings have

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around ESG ratings creates acute challenges for investors trying to achieve both financial and social return.").

[49] HM TREASURY, GREENING FINANCE: A ROADMAP TO SUSTAINABLE INVESTING 17 (2021) ("ESG ratings are becoming increasingly important to the investment process. However, different ESG ratings agencies provide opinions on different aspects of sustainability performance and their assessments may not always be comparable. . . . It is important that providers deliver ESG data and ratings transparently, and that they have strong governance and management of conflicts of interest.").

[50] *See* Partnoy (1999), *supra* note 21, at 630-35; *see* Partnoy (2017), *supra* note 8, at 1407-08 (reviewing the literature on credit rating agencies' role as reputational or informational intermediaries).

[51] For a characteristic take on the importance of harmonization and transparency in improving the value of ESG ratings to the market, *see* PC Chakravarti, *The Ratings Game – How to Improve Environmental, Social and Governance Scoring*, ACCENTURE (Jan. 5, 2021), https://www.accenture.com/sg-en/blogs/southeast-asia-blog/the-ratings-game-how-to-improve-environmental-social-and-governance-scoring; *see also* ESG Fund Disclosure Proposal, *supra* note 19, at 188-90 (raising concerns about inconsistent disclosure of ESG information and lack of standardization, and citing academic studies purporting to show the negative impacts to consumers therefrom); *but see* Curtis et al., *supra* note 19, at 443 (contending that ESG labeled investment funds should not be singled out for special regulation).. Regardless of which side has the better argument, this paper is concerned with a different class of risks altogether: risks from the use of ESG ratings by rated companies and the integration of ESG ratings providers in the securities offering process—not with the ability of ESG funds to deliver relatively high returns.

[52] *See generally* Sabin Center for Climate Change Law, *Global Climate Change Litigation*, GLOBAL CLIMATE CHANGE LITIGATION DATABASE (2023), http://climatecasechart.com/non-us-climate-change-litigation/ (concluding that the proper vehicle for enforcement seems to be the European consumer protection laws, rather than securities laws); *but see* Laurence Fletcher & Joshua Oliver, *Green Investing: The Risk of a New Mis-selling Scandal* (Feb. 19, 2022), https://www.ft.com/content/ae78c05a-0481-4774-8f9b-d3f02e4f2c6f (discussing the prospect of legal liability for misleading investors in European contexts).

been determined on a flawed basis or are presented in a misrepresentative light, and the company discloses those ESG ratings to investors, that raises basic securities law concerns. In theory, any public disclosure of ESG ratings exposes a company to baseline Rule 10b-5 liability.[53] When issuers use ESG ratings in connection with securities offerings, this should implicate not only baseline Rule 10b-5 liability concerns but also 1933 Act liability, which holds issuers and other offering participants to a stricter standard.[54] However, despite the strong intuition that U.S. securities law principles should apply, the next Part will argue that ESG ratings are unlikely to be an effective target of U.S. securities regulation, thereby exposing a regulatory blind spot.

## II. U.S. SECURITIES LAW CONSIDERATIONS

Offerings of sustainable finance instruments, such as green bonds, present enticing opportunities for companies to advertise their ESG performance, for which ESG ratings are a convenient proxy. Using green bonds as the primary case study, the first section of this Part documents how ESG ratings have become integrated into sustainable finance offerings and how this exacerbates conflicts of interest and investor confusion. Yet despite the clear risks from a U.S. securities law perspective, this paper argues there is no clear basis on which to assign liability for misleading ESG ratings. The problem is that U.S. securities law, despite its broad ambit, is ill-equipped to impose accountability on third-party ratings providers. Support for this conclusion is presented in the second section of this Part, which examines a key regulatory precedent—the SEC's failed attempts to enhance credit rating-related disclosure in 2009 and the broader NRSRO reform efforts under Dodd-Frank. In the resulting market practice, credit rating agencies are effectively insulated from Section 11 liability as experts. It is reasonable to conclude that ESG ratings providers would be similarly protected, which leaves aggrieved plaintiffs without practical recourse. Skeptics may concede that ESG ratings, as a product, suffer flaws such as incomparability or unreliability but dismiss the investor protection concern—for example, by disputing that a green bond investor would be materially harmed by a misleading ESG rating. To emphasize the potentially broad scope of harms, the third section of this Part presents special cases in which ESG ratings play a more central role in the structure of the security: sustainability-linked bonds and the first "sustainable IPO."

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[53] *See* SEC Climate Disclosure Proposal, *supra* note 42, at n. 49 (reminding companies of the expansive reach of Rule 10b-5 liability, perhaps due to the proliferation of climate-related corporate disclosure); *see also* Rose, *supra* note 1, at 1847 (establishing that inclusion of disclosure in a company's SEC filings ratchets up the securities liability exposure).

[54] *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 381-82 (1983) (distinguishing the stringent liability under Section 11 for "parties who play a direct role in a registered offering" from the catchall antifraud provision under Section 10(b), which has a wider application but imposes a heavier burden on plaintiffs—most notably, to prove *scienter*).

*A. Use of ESG Ratings in Green Bond Offerings*

To appreciate the risks to investors from the entanglement of ESG ratings in sustainable finance offerings, it is important to have a grounding in the structure and market practice of these transactions at a fairly high level of detail. Using green bonds as a prototypical example, this section provides a primer on the structure of sustainable debt offerings, including the key roles played by third-party providers.

Sustainable finance instruments encompass a range of securities, including green, social, and sustainability bonds, sustainability-linked debt, and, most recently, even the sustainable IPO.[55] The most traditional form of sustainable finance instruments are green bonds, which "enable capital-raising and investment for new and existing projects with environmental benefits."[56] In the classical iteration, the company promises to allocate the proceeds from its sale of bonds to purportedly green projects—e.g., funding for renewable power projects or investing in energy efficient technologies such as electric vehicles.[57] The distinctive feature is the company's promise to allocate proceeds to certain uses; hence, green bonds are often referred to as "use of proceeds" bonds.[58]

The market for green and other sustainable finance bonds has grown exponentially in recent years.[59] Europe has maintained the largest share of total issuance volume, although issuance in the United States and APAC has

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[55] *See* Melissa Chase, *Simplifying Sustainable Finance – Explaining Green Bonds, Green Loans, Sustainability-Linked Loans and Bonds and More*, SUSTAINALYTICS (Nov. 5, 2021), https://www.sustainalytics.com/esg-research/resource/corporate-esg-blog/simplifying-sustainable-finance-green-loans-vs-green-bonds-vs-sustainability-linked-loan-and-more (noting that sustainable finance also encompasses loan products in addition to debt securities). The Allbirds IPO in 2021 heralded the expansion of sustainable finance into equity securities. See *infra* Part II.C.

[56] INT'L CAPITAL MKT. ASS'N, *Green Bond Principles (GBP),* https://www.icmagroup.org/sustainable-finance/the-principles-guidelines-and-handbooks/green-bond-principles-gbp/.

[57] For an introduction to green bonds, including their history and basis of their appeal to investors, *see, e.g.,* Luke Trompeter, *Green ~~Greed~~ Is Good: How Green Bonds Cultivated into Wall Street's Environmental Paradox*, 17 SUSTAINABLE DEV. L. & POL. 4, 5-6 (2017); Stephen K. Park, *Investors as Regulators: Green Bonds and the Governance Challenges of the Sustainable Finance Revolution*, 54 STAN. J. INT'L L. 1, 8-17 (2018); Cristina M. Banahan, *The Bond Villains of Green Investment: Why an Unregulated Securities Market Needs Government to Lay Down the Law*, 43 VERMONT L. REV. 841, 844-48 (2019).

[58] *See* Chase, *supra* note 55; *see also* INT'L CAPITAL MKT. ASS'N, GREEN BOND PRINCIPLES: VOLUNTARY PROCESS GUIDELINES FOR ISSUING GREEN BONDS 8 (June 2021), https://www.icmagroup.org/assets/documents/Sustainable-finance/2021-updates/Green-Bond-Principles-June-2021-140621.pdf [hereinafter GREEN BOND PRINCIPLES] (listing several other variants of green bonds besides the standard use of proceeds green bond).

[59] Caroline Flammer, *Corporate Green Bonds*, 142 J. FIN. ECON. 499, 499-500 (2021) (describing the recent "boom" in corporate green bonds). For five-year trend data on issuance volume, see CLIMATE BONDS INITIATIVE, SUSTAINABLE DEBT MARKET SUMMARY H1 2021 1 (Sept. 2021), https://www.climatebonds.net/files/reports/cbi_susdebtsum_h12021_02b.pdf.

surged.[60] Sustainable bonds are currently unregulated by the European Union and the United States, but have not been free from calls for regulatory intervention.[61] Some jurisdictions, notably China, have already implemented a substantive regulatory scheme.[62] In 2021, the European Commission released a proposal to introduce a "voluntary" standard to regulate European green bonds, although there are legislative calls in Europe to adopt a mandatory approach.[63]

Although regulatory initiatives have taken hold in some jurisdictions, the green bond market, since its infancy, has been characterized by privately ordered solutions to potential market defects and abusive practices.[64] In particular, industry-led codes of conduct, such as the Green Bond Principles, serve as a common baseline against which a particular company's green bond can be evaluated, both in terms of its green credentials and to enable meaningful comparisons against other companies.

Consider the structure of a typical use of proceeds green bond. According to the Green Bond Principles, issuers are expected to publish a so-called "green bond framework," which is a document explaining how the issuer will apply the proceeds of its green bonds in a way that aligns with core components of the Green Bond Principles.[65] This is meant to signal to investors that the issuer is following a trusted set of industry best practices, providing a measure of comfort that investors' money will be allocated to environmentally-beneficial projects.[66]

Of course, in the absence of a credible threat of sanctions, a company would have the incentive to exaggerate the putative benefits or merits of its green bond framework. In other words, talk is cheap—and susceptible to self-serving behavior. A private innovation in the green bond market addresses

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[60] *See* Salima Lamdouar et al., *Assessing ESG-Labeled Bonds*, HARV. L. SCH. F. CORP. GOVERNANCE (May 6, 2022), https://corpgov.law.harvard.edu/2022/05/06/assessing-esg-labeled-bonds/.

[61] *See, e.g.*, Trompeter, *supra* note 57, at 9-11 (calling for greater regulation of, and accountability for, green bonds); Chris Flood, *Fears Rise over 'Greenwash' Bonds*, FIN. TIMES (Mar. 21, 2022) (discussing proponents of regulating the green bond industry in Europe to address greenwashing), https://www.ft.com/content/178449a7-8897-4359-b23a-e85524c3e227.

[62] Taotao Yue, *China's Burgeoning Green Bond Market: Developments, Characteristics, and Outlook*, SUSTAINALYTICS (Feb. 28, 2022), https://www.sustainalytics.com/esg-research/resource/corporate-esg-blog/china-burgeoning-green-bond-market-developments-characteristics-outlook.

[63] *See* Amy Geddes et al., *The EU Green Bond Standard: Will Compulsion Fragment the Market?*, HERBERT SMITH FREEHILLS (Feb. 3, 2022), https://www.herbertsmithfreehills.com/insight/the-eu-green-bond-standard-will-compulsion-fragment-the-market.

[64] *See* Park, *supra* note 57, at 6 (documenting how industry-led principles, guidelines and codes of conduct emerged to impose order on the unregulated green bond market).

[65] GREEN BOND PRINCIPLES, *supra* note 58, at 7.

[66] Other standards besides the Green Bond Principles do exist, e.g., CLIMATE BONDS INITIATIVE, CLIMATE BONDS STANDARD VERSION 3.0 (2019), https://www.climatebonds.net/files/files/climate-bonds-standard-v3-20191210.pdf.

this second-order credibility problem. This is the set of third-party solutions referred to as "external verification" and related consulting services, which serve as independent vetting mechanisms. The centerpiece of external verification is the "Second Party Opinion," whereby third-party sustainability experts are paid to evaluate a company's green bond framework to confirm alignment with the applicable industry-wide principles, such as the Green Bond Principles.[67] Issuing a green bond without a Second Party Opinion is understood to be unfeasible from a marketing standpoint.[68]

So far, none of this discussion has implicated ESG ratings at all. Strictly speaking, all that is necessary for a company to execute a use of proceeds green bond offering is (1) the company's green bond framework (specifying green projects to which the bond proceeds may be allocated) and (2) a Second Party Opinion (to confirm that the company's green bond framework is credible when weighed against industry-approved standards).[69] As a result, a use of proceeds bond is at once narrow and broad. It is narrowly concerned with the allocation of bond proceeds to specified uses. But it is a form of financing that is, in theory, broadly available, in that it does not depend on the issuer's maintenance or achievement of any particular ESG rating or score. There is nothing inherent in the structure of a green bond that would prevent a "dirty" company (as measured by its poor environmental ratings) from successfully issuing a green bond, nor even from obtaining a Second Party Opinion.[70] This is a critical point to emphasize, because it will help to illuminate the problems when ESG ratings become entangled with green bonds in practice.

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[67] ICMA maintains a database of sustainable finance bond issues, which includes links to publicly available Second Party Opinions. INT'L CAPITAL MKT. ASS'N, *Sustainable Bonds Database*, https://www.icmagroup.org/sustainable-finance/sustainable-bonds-database/#HomeContent.

[68] *See* Flammer, *supra* note 59, at 514 (suggesting that market response to a green bond is "stronger for green bonds that are certified by independent third parties and first-time issuers," which is consistent with market participants' (i.e., issuers and their investment bankers) preference for obtaining reputable external verification); *see also* Toan Huynh et al., *Beyond the Shades: The Impact of Credit Rating and Greenness on the Green Bond Premium* 59 (Working Paper, Feb. 2022) (finding significant evidence of a green bond premium, including evidence that the green bond premium is significantly greater for bonds that undergo external review, such as Second Party Opinions).

[69] After the initial issuance, a key component of a green bond is ongoing reporting on the allocation of bond proceeds to actual projects (the "eligible projects" enumerated in the framework). Issuers will often hire an external reviewer to perform regular (e.g., annual) assessments of the allocation process over the life of the bond to ensure compliance with the green bond framework. Annual reviews are typically conducted by the provider who gave the Second Party Opinion.

[70] *See infra* Part II.A.2.a for a discussion of how there appear to be strong market forces that make it difficult for a "dirty" company to issue a green bond.

1. Conflicts of Interest

Conflicts of interest afflict the green bond issuance structure and the market for external verification. Potential conflicts arise on at least two levels. The first level, which is well-established in the literature, is due to the "issuer pays" business model of the Second Party Opinion providers.[71] On this theory, since Second Party Opinion providers are hired and paid by the very companies they are rating, the opinion providers may be induced to lower their rating standards to win business.

A second layer is the conflict of interest arising from the dual role played by ESG service providers in providing both external verification services (such as Second Party Opinions) *and* ESG ratings to green bond issuers. As it turns out, several major providers of external verifications happen to be owned by the major ESG ratings companies.[72] While the market began as a fragmented and entrepreneurial ecosystem, where standalone Second Party Opinion providers or ESG ratings companies were niche providers operating independently of the incumbent conglomerates, the steady trend of consolidation in the sustainability industry, described in Part I.A., has predictably increased overlap among service providers.

Conflicts arise because the same company that, *qua* ratings provider, purports to be an independent source of analysis and opinion about an issuer's ESG performance may be hired and paid fees by the same issuer to provide a Second Party Opinion for a green bond framework.[73] Thus, an ESG ratings provider, in the hopes of securing external verification business from a green bond issuer, may be tempted to show favoritism in scoring, ranking, and rating the issuer — the same dynamic that gave rise to credit rating shopping.[74] Although ESG ratings providers claim to maintain strict internal

[71] *But see* UK FCA POLICY STATEMENT, *supra* note 37, at 35 (noting that the ESG ratings business typically uses a subscription model, which is supposed to mitigate conflicts of interest as compared to credit ratings, which are an "issuer pays" business model); *see* Banahan, *supra* note 57, at 852-53 (suggesting that such optimism is unfounded).

[72] Sustainalytics, Moody's, and ISS ESG are three names of major providers that, whether directly or through affiliates, are highly active in both green bond external verification and ESG ratings.

[73] While a standalone ESG ratings business may rely on a "subscriber pays" model, with end-users (asset managers, institutional investors) paying fees in exchange for ratings reports and research, that simple description no longer holds for the integrated sustainability service providers. Sustainable finance offerings introduce an "issuer pays" model back into the equation. Issuers hire sustainability experts to perform external verification, including Second Party Opinions and other related consulting services, which are essential to conducting a sustainable finance offering.

[74] *See, e.g.*, Carrie Guo, Note, *Credit Rating Agency Reform: A Review of Dodd-Frank Section 933(B)'s Effect (or Lack Thereof) Since Enactment*, 2016 COLUM. BUS. L. REV. 184, 192 (discussing the rating shopping phenomenon in the credit rating market); Banahan, *supra* note 57, 852-53 (highlighting similarities in conflicts of interest arising from incentive structures of green bond external verification and credit ratings businesses); *see also* Frank Partnoy, *How And Why Credit Rating Agencies Are Not Like Other Gatekeepers*, *in* FINANCIAL GATEKEEPERS: CAN THEY PROTECT INVESTORS? 59, 70 (Yasuyuki Fuchita & Robert E. Litan

policies to prevent conflicts of interest,[75] there is an obvious potential for abuse: pressure for an ESG ratings provider to expand its external verification business could distort its otherwise independent assessment of the issuer's ESG rating. This dynamic invites comparisons to the credit rating industry in the lead-up to the financial crisis.[76]

If this seems merely theoretical, look no further than Sustainalytics's own website. There is a section dedicated to ESG ratings solutions *for companies* (i.e. issuers), which advertises, among others, the following use case under the caption "Investor Relations": "Leverage your company's ESG Risk Rating to support capital raising activities such as the issuance of green, social, or sustainability bonds."[77] Elsewhere, in a summary of sustainable finance instruments, Sustainalytics observes: "For instance, some companies have highlighted their ESG performance (e.g., Sustainalytics's ESG Risk Ratings) at their bond issuance roadshows to demonstrate their management of key ESG issues."[78]

This sales pitch from Sustainalytics's website should send a shiver down the spine of any U.S. securities lawyer. It is concerning because of the way it implicates the *issuer's* role in advertising its ESG ratings in the context of a securities offering. There has been scant discussion in the regulatory discourse about how ESG ratings providers and issuers can actively collaborate to promote the issuer's ESG *bona fides*. The Sustainalytics sales pitch also undercuts the primary reason for optimism about ESG ratings, which is that the "subscriber pays" model minimizes conflicts of interest.[79] Although ESG ratings data may be "subscriber pays" for investors, here Sustainalytics is offering to license the use of a rating to the rated company

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eds., 2006) (discussing conflicts of interest arising from ancillary services provided by credit rating agencies) [hereinafter Partnoy (2006)].

[75] *See, e.g.*, EU STUDY, *supra* note 5, at 68-69 (reviewing survey responses on conflict of interest policies at major ESG ratings providers).

[76] *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 8, at 206-212 (using Moody's in the pre-crisis era as a case study to describe how imperative it is to increase market share compromised integrity of the ratings); *see, e.g.,* Partnoy (2006), *supra* note 74, at 68-73 (showing the long pedigree of the claim that conflicts of interests are pervasive within the credit rating agency). *see* Dragon Yongjun Tang, Jiali Yan & Yaqiong Yao, *The Determinants of ESG Ratings: Rater Ownership Matters* (July 18, 2021), https://portal.northernfinanceassociation.org/viewp.php?n=2240017640#:~:text=The%20most%20prominent%20new%20metrics,%E2%80%9D%2C%20receive%20higher%20ESG%20ratings (revealing evidence of the sensitivity of ESG ratings to conflicts of interest by showing how ESG ratings providers show favoritism in ratings to companies within their own larger corporate group – so-called "sister firms").

[77] *ESG Risk Ratings*, SUSTAINALYTICS, https://www.sustainalytics.com/corporate-solutions/esg-risk-ratings.

[78] *Id.*

[79] *See, e.g.*, UK FCA POLICY STATEMENT, *supra* note 37, at 38 (contrasting policy issues and underlying problems of credit rating agencies versus ESG rating providers, noting that "investor pays" models reduces—but does not eliminate—the potential for conflicts of interest).

itself — i.e., "issuer pays."[80] And the primary use case for such rating is to market the company's securities.

It is important to reiterate that there is no requirement under any set of green (or social or sustainability) bond principles, such as the ICMA principles, for an issuer to "leverage" its ESG ratings for purposes of a green bond offering (as Sustainalytics suggests). As explained above, a use of proceeds bond is narrowly concerned with the allocation of bond proceeds to specified uses, and does not depend on the issuer's maintenance or achievement of any particular ESG rating or score. Furthermore, as will be discussed in greater detail in the next section, the logical link between an ESG rating and a particular green (or social or sustainability) bond may be extremely attenuated, even to the point of being misleading.

Yet Sustainalytics clearly believes that there is a business opportunity for an integrated offering of ESG ratings and external verification. Although Sustainalytics, along with every ESG ratings provider, will maintain it has a strict internal policy to mitigate conflicts of interest, the financial incentives create a justifiable concern. To illustrate, suppose that Company A has received a less-than-stellar ESG rating from Provider X due to a poor social ("S") score, but due to differences in methodologies, it received a better overall ESG rating from Provider Y. If Company A is considering a green bond — the proceeds of which are solely allocated to, say, investments in electric vehicle technology — then it may be inclined to hire Provider Y for the Second Party Opinion and external verification services, since it can then "highlight its ESG performance at its bond issuance roadshow (to use Sustainalytics's words). Of course, in this case, Provider X might then be incented to revise its "S" rating of Company A if that would allow it to win the Second Party Opinion mandate for the green bond.[81]

Not surprisingly, Morningstar, the parent company of Sustainalytics and one of the major providers of ESG ratings, appears sensitive to the poor optics. In 2021, it newly added the following language to its 10-K risk factors: "An issuer pay model also applies to Sustainalytics' Sustainable Finance Solutions business unit products and services. These payments may create the perception that our credit ratings and research are not independently determined or reliable."[82]

The potential for conflicts of interest in ESG ratings has not gone unnoticed by regulators either. IOSCO and regulators in the U.K., Europe, and Japan have observed the potential for bias to creep into ESG ratings due

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[80] *See* IOSCO REPORT, *supra* note 7, at 18 ("[if] the incentive or financial benefit for an issuer to be the subject of an ESG ratings or data product were to increase, this would increase the financial benefit or incentive for an issuer to pay for the ESG ratings or data product.").

[81] One could predict an upwards rating creep for companies that are likely to need Second Party Opinion and external verification services.

[82] Morningstar, Inc., Annual Report (Form 10-K) (Feb. 26, 2021), https://www.sec.gov/ix?doc=/Archives/edgar/data/1289419/000128941921000039/morn-20201231.htm.

to the incentives of ratings providers to win external verification business.[83] From a U.S. perspective, the issue should be straightforward. The U.S. securities laws are, at base, concerned with full and fair disclosure.[84] Sustainable finance offerings provide a context where there is tremendous pressure by issuers to disclose ESG ratings to the market. If the integrity of those ESG ratings is compromised due to conflicts of interest (or the appearance thereof), that is squarely within the harms that U.S. securities law purports to address.

2. Investor Confusion Risk

The previous section focused on conflicts of interest in green bond offerings arising from the dual role played by ESG ratings companies as providers of both ESG ratings and Second Party Opinions services. Implicit in that argument is the importance (real or perceived) of ESG ratings to the green bond offering process. A confluence of factors has driven the mainstreaming of ESG ratings in the green bond market: (1) on the "supply-side," the business motive of sustainability service providers to cross-sell ESG ratings to green bond issuers, (2) on the "demand-side," investors clamoring for exposure to green bond issuers with high ESG ratings, and (3) issuers willing to oblige these constituencies.

This section focuses on the demand-side of the equation. Investors in sustainable finance instruments such as green bonds crave ESG ratings and the veneer of authority they provide. Issuers are happy to oblige. But the underlying flaws and unreliability of ESG ratings remain unaddressed, and offering documents sent to investors are not accompanied by meaningful protective disclosure.

*a. Temptation to Use ESG Ratings in Issuer Disclosure*

The unrestrained use of ESG ratings in securities offerings creates conditions that are ripe for investor confusion. Again, green bonds are an ideal case study for illustrating this phenomenon, because they create incentives to market ESG ratings as part of the offering process. The structuring and marketing of sustainable finance instruments such as green bonds invariably encourage, or even require, issuers to sell investors on their ESG bona fides (for which ESG ratings are a convenient proxy). This pressure is precisely what Sustainalytics is seeking to capitalize on in its sales

[83] IOSCO REPORT, *supra* note 7, at 33; UK FCA POLICY STATEMENT, *supra* note 37, at 36; AMF/AFM PAPER, *supra* note 43, at 2; FIN. SERVS. AGENCY (2021), *supra* note 40, at 16 ("When objective criteria for evaluation standards are not disclosed, there are cases of conflict of interests when, for example, a rating agency provides both external corporate or green bond evaluation and paid consulting services for the same company.").

[84] *See* Gary Gensler, *Statement on Proposed Mandatory Climate Risk Disclosures*, SEC (Mar. 21, 2022), https://www.sec.gov/news/statement/gensler-climate-disclosure-20220321 (describing the "core bargain" underlying the adoption of the securities laws in the 1930s).

pitch to companies.[85]

As explained in the previous section, there is no necessary link between a company's ESG rating and its green (or social or sustainability) bond framework. Issuing a green bond bears no necessary relationship to a company's environmental ("E") score or rating from a third-party ESG ratings provider. At least in theory, issuing a use of proceeds bond does not require the issuer feature its ESG ratings at all, much less be an ESG star performer. In other words, a company with a horrible track record of environmental damage could issue a green bond because a green bond is simply a promise to allocate proceeds to certain prescribed uses — and nothing more.[86] The disconnect is even more apparent when we remember that ESG scores are an aggregate of three separate pillars (E, S, and G).[87] It is hard to imagine why a company would need to tout its social "S" rating in the course of marketing a green bond to investors.

Despite the narrow character of the green bond structure, investors are increasingly emphasizing that their investment decisions go beyond a narrow focus on the issuer's ability to satisfy its obligations under the green bond framework, but look to the issuer's ESG performance on the whole. [88] The natural result of this investor demand is increasing pressure on companies to promote their ESG credentials, which means disclosing and promoting positive ESG ratings. The timing and manner of that disclosure can vary— e.g., a company might showcase its ESG ratings directly in the roadshow presentation for a green bond, or it may choose to transmit the information

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[85] *Supra* Part II.A.1.

[86] Indeed, companies often issue green bonds as just a single "tranche" of a larger debt offering. Only the green tranche is subject to constraints on the use of proceeds; the money raised in the other tranches could be used freely by the company for non-green uses.

[87] *See* Jay Clayton, Former SEC Chair, *Remarks at Meeting of the Asset Management Advisory Committee*, SEC (May 27, 2020), https://www.sec.gov/news/public-statement/clayton-amac-opening-2020-05-27 ("[W]hile I believe that in many cases one or more "E" issues, "S" issues, or "G" issues are material to an investment decision, I have not seen circumstances where combining an analysis of E, S and G together, across a broad range of companies, for example with a "rating" or "score," particularly a single rating or score, would facilitate meaningful investment analysis that was not significantly over-inclusive and imprecise.").

[88] *See, e.g.*, Louise Bowman, *ESG: Green Bonds Have a Chicken and Egg Problem* (June 19, 2019), https://www.euromoney.com/article/b1fxdsf5kpjxlg/esg-green-bonds-have-a-chicken-and-egg-problem (citing multiple investors who stress importance, and even necessity, of a strong ESG rating for the issuer in assessing a green bond investment); Tommy Stubbington & Billy Nauman, *Investors Probe ESG Credentials of Bond Sellers on 'Greenwashing' Fears*, FIN. TIMES (Oct. 28, 2020), https://www.ft.com/content/1bcbad16-f69e-47db-82fa-0419d674bb53 (quoting a portfolio manager saying "We don't buy a bond because it's green, but because the company is"); *see also* ASIAN DEVELOPMENT BANK, PROMOTING GREEN LOCAL CURRENCY BONDS FOR INFRASTRUCTURE DEVELOPMENT IN ASEAN+3 35 (Apr. 2018) ("Investors with responsible investment mandates have indicated that they are less likely to buy green bonds issued by companies with low ESG ratings"); Flammer, *supra* note 59, at 506 (finding that green bond issuers have higher environmental and ESG ratings).

outside the offering context (posting ESG ratings on its website or including them in quarterly earnings releases) — but the end result is dissemination to potential investors.

Companies, seeking to appease the demands of investors, are thus under pressure to disclose ESG ratings as part of their sales pitch for the bonds. An outsized source of this pressure comes from the largest asset managers, such as BlackRock, and institutional investors (e.g., CalPERS), who have emerged as the most vocal lobbyists for mandatory climate and sustainability-related disclosures.[89] In a market environment where ESG considerations are now paramount, asset managers or large institutional investors may have mandates to invest only in companies that maintain a certain ESG rating level. If an asset manager seeks to construct a product that can be marketed on the strength of its high ESG ratings, then it has a direct interest in ensuring that its portfolio investments are amenable to being rated — even if that rating is only tenuously related to the green bond itself.

*b. Problems with ESG Ratings Increase Investor Risks*

The reason that U.S. securities lawyers will cringe at the idea of an issuer leveraging or highlighting its ESG ratings in a green bond offering—or in any other public disclosure—is straightforward. If, for all the reasons enumerated above, ESG ratings are as problematic as critics and regulators claim, then they are precisely *not* the type of information that issuers should lean on to sell their securities to investors. That is, ESG ratings are the product of unregulated third-parties whose methodologies are criticized as opaque, inconsistent, and unreliable.

The problem is aggravated in the green bond context. Although asset managers and institutional investors are presumably best positioned to understand how green bonds work and why ESG ratings bear no relationship to them, it is far less likely that retail investors, who may be interested in investing in baskets of sustainable finance products (green bond ETFs, etc.), would understand this unintuitive reality.[90] They may make the reasonable assumption that any company issuing a "green" or "sustainable" bond is, as the name suggests, in fact "deserving" of those labels in a more intuitive sense. It is common sense to assume that a company issuing green bonds — indeed, those who have received a third-party stamp of approval in the form

[89] *See* Lawrence A. Cunningham et al., Proposal on Climate-Related Disclosures for Investors 2-7 (Apr. 25, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20126528-287180.pdf. (cautioning the SEC against substituting "investor demand" from this vocal and self-interested segment of investors for the traditional concerns of securities regulation, namely the protection of retail investors).

[90] *See, e.g.*, iShares USD Green Bond ETF, ISHARES BY BLACKROCK, https://www.ishares.com/us/products/305296/ishares-usd-green-bond-etf. (explaining that retail investors are unlikely to be buying green bonds directly, but can get exposure to green bonds through bond funds and ETFs).

of a Second Party Opinion — would rate highly as a "green" company.[91] Furthermore, echoing concerns of former SEC Chair Clayton, the multi-dimensionality of an ESG rating (a single metric that is meant to capture three distinct pillars) is likely to compound confusion except in the hands of the most sophisticated users.

The proliferation of methodologies and lack of convergence between ratings providers promises to further aggravate the investor confusion risk. To take a hypothetical example of a "worst case" scenario, imagine a public company is preparing to issue green bonds for the first time, and is soliciting quotes from a set of external verification providers for a Second Party Opinion on its green bond framework. As a public company, the issuer will have already received ESG ratings from the major providers (indeed, it may have developed positive relationships with certain ESG ratings providers through the questionnaire and engagement process), but consistent with observed trends, there is a high divergence in the ratings. After reviewing its options, the issuer chooses the Second Party Opinion provider whose ESG ratings affiliate happened to assign it the highest ESG rating.[92]

This hypothetical, which is stylized but not farfetched, illustrates the headache and potential danger for investors. Should investors be deemed to have evaluated and accepted the risk of the ESG ratings that were not featured by the issuer in its marketing efforts? ESG ratings are widely available, if not free to the public. Large investors will invariably have access through their own subscriptions with the ESG ratings providers. Increasingly, the ratings providers are making their ESG ratings freely available to the public as well.[93]

Should it matter whether or not the company affirmatively disclosed its ESG ratings? What if the Second Party Opinion contained reference to the company's ESG ratings?[94] What if, during the road show for the offerings, the issuer or underwriters orally convey to investors that the issuer obtained a glowing ESG rating (without mentioning the affiliation to the Second Party Opinion provider), and they fail to mention the less flattering ratings from other providers? Does it matter if such other ratings are easily accessible online? Or if those ratings are locked behind a paywall? There are any

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[91] This dovetails with the SEC's traditional concern about misleading fund names. *See* Press Release, SEC, *SEC Proposes Rule Changes to Prevent Misleading or Deceptive Fund Names* (May 25, 2022), https://www.sec.gov/news/press-release/2022-91 (targeting funds with ESG-themed names in a proposal to modernize the Names Rule).

[92] It would be a valuable empirical project to study whether there are discernible traces of bias or favoritism in the ratings of ESG ratings providers that do not perform external verification services for green bonds versus the full-service providers that do both ratings and external verification.

[93] *See* IOSCO REPORT, *supra* note 7, at 18.

[94] Second Party Opinions vary widely in form and content. Some providers do not intermingle green bond verification services like Second Party Opinions with ESG ratings assigned by affiliates.

number of permutations one can imagine.

In a perfectly transparent world, investors may have the perspicacity to evaluate and weigh the full range of ESG ratings published by different providers, equipped with knowledge about each provider's idiosyncratic methodologies and purposes. Of course, the reality is far messier. In the absence of any clear rules of the road for disclosure, the use of ESG ratings is likely to be more *ad hoc* and susceptible to self-serving behavior (either by the issuer, underwriters, or the third-party ESG provider itself). Anecdotally, in some jurisdictions, such as Europe, there is a more relaxed attitude towards disclosing ESG ratings, whereas in the U.S. there appears to be a trend towards building separation between offering materials (like the prospectus and road show materials) and ESG ratings as a risk mitigation technique. But in neither case is there is a consensus about what supplemental information should be given to investors to help them understand ESG ratings in context, and who should be responsible if the ratings do not reflect reality. [95]

Complicating the picture further is the specialist or expert nature of the third-party ESG service providers. From the nascency of the federal securities laws, Congress recognized the potential for abuse or investor confusion if statements of purported experts were left unregulated. In the Securities Act of 1933, Congress made special dispensation under Section 7 and Section 11 to protect investors from undue and harmful reliance on statements of purported experts.[96] There would have been plenty of real-world examples from the pre-Depression era of fraudulent practices for Congress to draw on.[97]

A primary characteristic of green bonds is the imprimatur of experts: most notably in the form of the Second Party Opinion provider. Indeed, the external verifier is often described in the prospectus having "recognized expertise" in matters of sustainability.[98] Likewise, if ESG ratings are used in the marketing of the green bonds, investors are susceptible to take these as the word of experts.[99] Indeed, the SEC acknowledged in its climate

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[95] *See infra* Part II.B. The SEC tried (unsuccessfully) to solve a similar problem in the context of credit ratings. In 2009, the SEC proposed to provide investors with appropriate context for understanding the import and limitations of credit ratings used in a securities offering through robust disclosure requirements.

[96] *See* William W. Barker, *SEC Registration of Public Offerings Under the Securities Act of 1933*, 52 BUS. LAW. 65, 89 (1996) ("Permitting the use of named sources without consent permits undue emphasis to be placed on the authoritative nature of the source rather than the information. To protect against these risks, Congress determined that authoritative sources were not to be named in the registration statement unless written consents were filed.").

[97] SARAH L. QUINN, AMERICAN BONDS: HOW CREDIT MARKETS SHAPED A NATION 115-16 (2019) (describing fraudulent practice in pre-Depression mortgage bond markets, including inflated and misrepresented property valuations from appraisers).

[98] *See, e.g.*, American Express Company, Prospectus Supplement, at S-16 (Apr. 28, 2022), https://www.sec.gov/Archives/edgar/data/4962/000110465922053630/tm2213423-2_424b2.htm#sEXP.

[99] In light of the pervasive problems with ESG ratings, one might assume that institutional

disclosure proposed rule that ESG ratings are "relied upon, in particular, by unsophisticated investors for the value of institutional certification."[100] Although green bond investing has traditionally been the province of institutional investors, as sustainable finance continues to expand into the retail investor marketplace (even if indirectly, through funds and ETFs), investor confusion concerns should take on a higher valence for the SEC.

### *B. The Regulatory Blind Spot: Drawing on the Parallel to Credit Ratings*

The previous section explained how ESG ratings have assumed an important role in green bond offerings. Due to (1) conflict of interest risks inherent to the ESG rating provider business model and (2) potential investor confusion about the meaning and import of ESG ratings, it argued that ESG ratings raise concerns about investor protection, which are aggravated in the context of securities offerings.

The first reaction of someone casually familiar with U.S. securities law might be that there is no *prima facie* reason to think the system is unequipped to handle fraud or misuse of ESG ratings in company disclosure.[101] After all, under securities law first principles, what would stop a suitably aggrieved investor-plaintiff from bringing a securities fraud claim against the issuer for the misleading use of an ESG rating, or even against the ESG ratings provider itself?

This section will suggest that optimism is unfounded. The structure of the problem is a constellation of three claims: ESG ratings are simultaneously (1) viewed as important by investors, (2) widely criticized as unreliable, difficult to understand, and subject to conflicts of interest and (3) despite being used in the context of investment decisions in securities offerings, they are third-party opinions that are effectively shielded from liability.

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investors should take no stock in ESG ratings at all – and therefore could not be said to seriously *rely* on the ratings (a "no harm, no foul" principle). A cynical view is that institutional investors, despite being fully aware of the endemic problems with ESG ratings, view the imprimatur of expert certification as a handy option on a potential lawsuit if the investment doesn't pan out. A more moderate view is simply that institutional investors, who are making decisions pursuant to strict internal controls, will always prefer the imprimatur of expertise even if, in a more honest mood, they would place little weight on the expert's opinion.

[100] SEC Climate Disclosure Proposal, *supra* note 42, at 348.

[101] *See, e.g.*, Firm Memoranda, Quinn Emanuel Urquhart & Sullivan, LLP, *Greenwashing Claims on the Rise: Avoiding Dirty Laundry* (Mar. 22, 2021), https://www.quinnemanuel.com/the-firm/publications/greenwashing-claims-on-the-rise-avoiding-dirty-laundry/ (detailing the growing list of ESG-related litigation, including both public enforcement (at state and federal levels) and private suits based on securities law claims); *see also* Press Release, SEC, *SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations* (May 23, 2022), https://www.sec.gov/news/press-release/2022-86 (announcing a successful enforcement action against an investment adviser affiliate of BNY Mellon on charges of misleading ESG-related fund disclosures).

To get a handle on (3), there is a natural regulatory precedent to draw on. There is a striking similarity to the structure of the problem with credit ratings in securities offerings, as identified by the SEC in the aftermath of the global financial crisis, which led the SEC to propose credit ratings disclosure rules to enhance investor protection and reign in profligate use of credit ratings in securities offerings. However, as this section will recount, the SEC's ambitions were not realized. Instead, after a series of extraordinary political and regulatory events, a market equilibrium emerged that left the NRSROs effectively insulated from liability, while credit ratings were allowed to feature in the marketing of securities but without the protective disclosure that the SEC had first proposed. Thus, if the treatment of credit ratings under U.S. securities law is any guide, there is little reason to think that ESG ratings might serve as a functional hook for liability, no matter how much importance investors attach to them.

1. Recapping the SEC's Ill-fated Credit Ratings Disclosure Proposal

In October 2009, prior to the passage of the Dodd-Frank Act, the SEC released a proposal for a credit ratings disclosure rule ("Credit Ratings Disclosure").[102] In the proposal, the SEC expressed concern that "credit ratings appear to be a major factor in the investment decision for investors and play a key role in marketing and pricing of the securities, investors may not have access to sufficient information about credit ratings."[103] The proposed rule would have required issuers to disclose in the registration statement information about credit ratings used in connection with a securities offering.[104] The express purpose of the rule was to provide investors with information to "place the credit rating in an appropriate context" and also allow investors to understand potential conflicts of interest affecting the credit rating.[105] The proposed rule represented the latest iteration in a complex back-and-forth within the SEC's own rulemaking history as to the proper way to incorporate credit ratings within a disclosure regime for issuers.[106]

What is notable about Credit Ratings Disclosure is that the SEC's

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[102] *See* Credit Ratings Disclosure, 74 Fed. Reg. 53085, 53086 (proposed Oct. 15, 2009) [hereinafter Credit Ratings Disclosure].

[103] *Id.*

[104] *Id.* at 53087; *see also id.* at 53089 (proposing to mandate disclosure in the registration statement regarding the credit rating agency providing the rating and its ratings methodology, a description of any scope limitations or contingencies in the rating and, in order to highlight conflicts of interest, disclosure of the source of payment for the credit rating and if any non-rating services have been provided by the agency or its affiliates); *id.* at 53109 (proposing to require disclosure when any of the issuer, selling security holders, underwriters, or other member of a selling group uses a credit rating in a registered offering).

[105] *Id.* at 53086-87.

[106] *Id.* at 53087-89 (summarizing the agency's shifting stance with respect to ratings disclosure since 1981).

diagnosis of the problems with the use of credit ratings in securities offerings is strikingly similar to the problems raised in this paper with respect to ESG ratings. The proposed rule identified three main concerns:

● *Investor reliance.* In spite of their risks and flaws, credit ratings are undeniably important to investors and to the marketing and pricing of securities.[107] Much as it may wish investors would substitute reliance on credit ratings with individuated analysis based on the four corners of a registration statement, the SEC acknowledged the "reality that credit ratings are important to investors" – a fact that informed its approach to the proposed rules.[108]

● *Investor confusion*. The SEC observed that "the information conveyed by ratings has become increasingly less comparable across types of securities."[109] The financial crisis also revealed that investors may have fundamentally misunderstood the meaning of, or limits inherent in, credit ratings – perhaps seduced by the simple comfort of a "AAA" rating.[110]

● *Conflicts of interest and rating shopping*. In a theme of perennial interest in gatekeeper regulation,[111] the SEC expressed concerns with "the potential conflicts of interest faced by credit rating agencies and how these conflicts may impact ratings,"[112] including conflicts that arise where credit rating agencies also provide issuers with non-ratings services, such as consulting services.[113]

Each of these concerns has a familiar ring from the criticisms recited against ESG ratings above. But the Credit Ratings Disclosure proposal is especially interesting because it is focused on the securities offering process itself: "We have proposed to require disclosure regarding credit ratings if the registrant, a selling security holder, underwriter or any member of a selling group uses a credit rating in connection with a registered offering."[114]

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[107] *Id.* at 53086 ("[E]ven though credit ratings appear to be a major factor in the investment decision for investors and play a key role in marketing and pricing of the securities, investors may not have access to sufficient information about credit ratings.").

[108] *Id.* at 53087 (confronting this tension by stating "[w]e understand that investors will continue to use credit ratings in making investment decisions; therefore, we are proposing disclosure requirements we believe will provide investors with additional meaningful information that they can use to make those decisions. We acknowledge the risk that requiring disclosure of credit ratings could emphasize their significance and draw attention away from other, more important information about the registrant and its securities."); *see* KATHARINA PISTOR, THE CODE OF CAPITAL: HOW THE LAW CREATES WEALTH AND INEQUALITY 80 (2019) (noting that offering documents for the complex structured debt products that precipitated the subprime mortgage crisis may have contained adequate risk disclosure, but investors simply relied on credit ratings from the NRSROs).

[109] Credit Ratings Disclosure, *supra* note 102, at 53086.

[110] *Id.* at 53086-87.

[111] *See supra* notes 74-76 and accompanying text.

[112] Credit Ratings Disclosure, *supra* note 102, at 53087.

[113] *Id.* at 53104.

[114] *Id.* at 53090.

Clearly, the success of the rule would depend on what it means for a credit rating to be "used" in an offering. In order to forestall attempts by issuers and offering participants to sidestep the disclosure requirement, the SEC clarified in the proposal that "use" of a credit rating should be interpreted broadly, e.g., to include oral and written selling efforts by the issuer and underwriters, and it warned that "[a] registrant would not be able to avoid providing the proposed disclosure by using a rating only in oral selling efforts and not including it in written communications related to an offering, by not 'volunteering' the information about the credit rating except upon request or by referring an investor to a website that discloses the credit rating."[115] The SEC's proposal was thus deliberately crafted to preempt "form over substance" interpretations by market participants of the proposed rule.

Credit Ratings Disclosure stands in contrast to measures, like those ultimately adopted under Dodd-Frank, that focus on oversight-based solutions instead of policing the direct points of contact where credit ratings and investors meet: in the offering and sale of securities.[116] In other words, the Credit Ratings Disclosure proposal focused on the types of risk that, as this paper has argued, have been neglected in the current public debate over ESG ratings.

2. Credit Rating Agency Reform, Continued: Dodd-Frank

Credit Ratings Disclosure was part of a two-pronged attack from the SEC aimed at investor protection and increased accountability from the credit rating agencies. On the same day as Credit Ratings Disclosure, the SEC also issued a concept release proposing the rescission of Rule 436(g) under the Securities Act,[117] which would have the effect of "exposing NRSROs to liability as experts under Section 11 of the Securities Act when credit ratings they provide are included or incorporated by reference into a Securities Act registration statement or prospectus."[118] In theory, the idea was to impose accountability on NRSROs by bringing them within the sphere of Section 11 experts – along with other gatekeepers who participate in SEC registered securities offerings, like underwriters and accountants. Under the Securities Act offering framework, written consent must be filed with the registration statement if an expert is "named as having prepared or certified a report or valuation for use in connection with the registration statement."[119]

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[115] *Id.* at 53090. *See infra* Part II.B.3 for an examination of similar methods that offering participants use in practice to advertise ESG ratings without disclosing them in the prospectus.

[116] *See infra* Part III.A for a discussion of these competing modes of gatekeeper regulation.

[117] Concept Release on Possible Rescission of Rule 436(g) under the Securities Act of 1933, Securities Act Release No. 9071, Exchange Act Release No. 60798, Investment Company Act Release No. 28943, 74 Fed. Reg. 53114 (proposed Oct. 15, 2009) [hereinafter Concept Release].

[118] Danielle Carbone, *The Impact of the Dodd-Frank Act's Credit Rating Agency Reform on Public Companies*, 24 INSIGHTS 19, 19 (2010).

[119] 15 U.S.C. § 77g(a)(1).

Taken together, these two proposals were a shot against the bow of the NRSROs. Credit Ratings Disclosure would have effectively mandated disclosure of credit ratings in the registration statement. Nullification of Rule 436(g) meant that the consent of NRSROs would be required in order to disclose the ratings. And without the safe harbor of Rule 436(g), the NRSROs would finally be exposed as potential Section 11 defendants.

Ultimately, however, the SEC's version of credit ratings reform never materialized, as neither of the twin rule proposals was finalized. The events that unfurled this heady post-crisis period a fascinating case study in the realpolitik of financial industry regulation. First, Congress took matters into its own hands, passing credit rating reform through Title IX, Subtitle C, "Improvements to the Regulation of Credit Rating Agencies" of the Dodd-Frank Act.[120] Among this broad package of reforms, Section 939G had the effect of accomplishing part of what the SEC had originally aimed to do by directing the rescission of Rule 436(g), thereby eliminating the exemption from Section 11 liability previously enjoyed by the NRSROs.[121]

However, as Carbone and Partnoy have documented, Congress's foray into credit rating agency reform was ultimately neutered. The NRSROs took a defiant stand, announcing that they were "unwilling to provide consents to issuers."[122] Drawing on a time-tested playbook, the NRSROs marshalled First Amendment arguments on their behalf, claiming it would constitutionally infringe speech rights to be forced to "consent" to being named in the registration statement.[123] When the rescission of Rule 436(g)

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[120] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 931-939H, 124 Stat. 1376, 187290 (2010) [hereinafter Dodd-Frank Act]. In fact, credit rating agencies had been in the crosshairs of lawmakers and regulators even prior to the global financial crisis. EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS 3-182 (12th ed. 2017) (establishing that rating agency reform was part of the package of reforms enacted under Sarbanes-Oxley in the wake of the Enron scandal, which was prior to the global financial crisis of 2008).

[121] Dodd-Frank Act, *supra* note 120, at § 939B; *see* Partnoy (2017), *supra* note 8, at 1434-36; *see also* Carbone, *supra* note 118, at 19.

[122] Carbone, *supra* note 118, at 19. By unilaterally refusing to give consent, the NRSROs were effectively holding the debt markets hostage, since it was not feasible for issuers to execute deals without being able to disclose the credit rating of the securities being offered due to the written consent requirement under Section 7 of the Securities Act. *See* Barker, *supra* note 96, at 89.

[123] *See* PISTOR, *supra* note 108, at 87. For an example of the NRSRO lobbying effort in action, *see, e.g.,* Laurence H. Tribe & Thomas C. Goldstein, Comment on Concept Release on Possible Rescission of Rule 436(g) Under the Securities Act of 1933 and Credit Ratings Disclosure (Dec. 14, 2009), https://www.sec.gov/comments/s7-24-09/s72409-13.pdf (arguing that the SEC's proposed rules in the Credit Ratings Disclosure and Concept Release would violate the First Amendment). *See* Marilyn Blumberg Cane et al., *Below Investment Grade and Above the Law: A Past, Present and Future Look at the Accountability of Credit Rating Agencies*, 17 FORDHAM J. CORP. & FIN. L. 1063, 1104-07 (2012) (surveying the history of NRSROs' claims to First Amendment protection for credit ratings); Partnoy (2006), *supra* note 74, at 84-89 (critically examining the NRSROs' argument that their core business is financial publishing and therefore that their ratings enjoy broad First Amendment protection).

came into effect, the NRSROs followed through and the debt markets froze up, requiring the SEC to take emergency action to restore market functioning.[124] Even with Rule 436(g) formally off the books, the NRSROs still succeeded in deflecting a paradigm shift that would have imposed expert liability under Section 11. As a result, it is impossible to force the NRSROs to "consent" to being named in the registration statement and subject to Section 11 liability.

When the dust settled, a new market equilibrium was reached. To extinguish lingering uncertainty within the debt markets, the SEC Staff issued compliance and disclosure interpretations (C&DIs) clarifying that the consent of a rating agency would not be required if credit ratings are included in Rule 433 free writing prospectuses (most commonly in the form of term sheets) or press releases that comply with Rule 134.[125] Under this new status quo, disclosure of credit ratings would not be required in the registration statement (and thus, no consent of NRSROs would be needed), while the SEC explicitly endorsed the use of credit ratings in term sheets that fall outside the Section 11 liability perimeter.

In effect, this state of affairs recapitulates the problematic dynamic that the SEC sought to address in its Credit Ratings Disclosure proposal: a "form over substance" approach, whereby offering participants (issuers and underwriters) could seek to mitigate their own liability by omitting credit ratings from the registration statement and prospectus, while continuing to use credit ratings in their direct marketing efforts to investors[126] – e.g., in road show materials and, as explicitly endorsed by the SEC in its C&DIs, in the term sheet and Rule 134 press release. The SEC's compelling logic in the Credit Ratings Disclosure proposal about the importance of providing investors with sufficient information to understand credit ratings in context was never brought to fruition. Instead, issuers and underwriters can continue their routine use of credit ratings to market securities (without any requirement to disclose ratings in the registration statement) while the NRSROs continue to sidestep Section 11 expert liability altogether. Reliance

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[124] Carbone, *supra* note 118, at 19-20. *See also* Cane et al., *supra* note 123, at 1067-71 (documenting criticisms of the SEC for capitulating to the NRSROs' intransigence).

[125] SEC, Securities Act Rules, Compliance and Disclosure Interpretations, Question 233.06 (July 27, 2010), https://www.sec.gov/corpfin/securities-act-rules. *See* Carbone, *supra* note 118, at 21 (pointing out this "anomalous result"). The treatment of credit rating disclosure in press releases and term sheets is perplexing. These are perhaps the most salient piece of offering documentation available to investors, and yet the SEC was willing to provide free rein to issuers to continue marketing off credit ratings, while specifically removing the Section 11 liability threat for offering participants and the NRSROs. Also conspicuously absent is the SEC's reasoning from the Credit Ratings Disclosure proposal about the importance of providing investors with necessary information to place a credit rating in proper context and to understand latent conflicts of interest. When credit ratings appear in a press release or term sheet, they are presented as isolated data points, divorced of any analysis, qualifications, or context.

[126] *See supra* Part II.B.1.

on credit ratings remains deeply ingrained,[127] even as the SEC, to this day, dutifully carries out its Dodd-Frank Act mandate to eliminate references to credit ratings from the agency's own rules – a Congressional mandate expressly intended "[t]o reduce the reliance on ratings."[128]

Although Dodd-Frank Title IX did not attempt a robust overhaul of credit ratings-related disclosure akin to the SEC's ill-fated Credit Ratings Disclosure, it is important to mention that Congress did not entirely ignore disclosure liability as part of its package of reforms. Under Section 933(b) of the Dodd-Frank Act, Congress lowered the pleading standard for bringing private securities law class actions against the NRSROs directly.[129] However, as Guo demonstrates, the evidence that Section 933(b) has had the expected effects is scant.[130]

Instead, the primary vehicle for credit rating agency reform under Dodd-Frank came through the "oversight" channel, including the creation of a new Office of Credit Ratings (OCR) within the SEC to specialize in monitoring the NRSROs,[131] as well as substantive measures to prevent conflicts of interest, improve corporate governance, and enhance transparency of methodologies.[132] Of course, included in the SEC's regulatory toolkit is an enforcement power, allowing it to investigate and pursue enforcement action against NRSROs for a wide range of violations, including for certain conflicts of interest.[133] To date, however, enforcement against the NRSROs has been rare. In May 2020, the SEC announced the first enforcement action against an NRSRO for violation of Rule 17g-5(c)(8)(i), which aims at deterring undue influence of sales and marketing efforts on the ratings process—resulting in a $3.5 million settlement.[134] While Rule 17g-5 and other similar provisions are laudable and surely promote better governance practices on the margins, the overall impact on NRSRO incentives no doubt pales compared to what Congress had intended through direct liability-

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[127] *See, e.g.*, Partnoy (2017), *supra* note 8, at 1423-27.

[128] Removal of References to Credit Ratings from Regulation M, *supra* note 23, at 18313 n.1.

[129] *See* Guo, *supra* note 74, at 186.

[130] *Id.* at 208-09.

[131] SEC, About the Office of Credit Ratings (last modified Feb. 1, 2022), https://www.sec.gov/ocr/Article/ocr-about.html; *see* Partnoy (2017), *supra* note 8, at 1413, 1428-29; *see also* Gil, *supra* note 10 (explaining how the European credit agency reform, culminating in the CRA Regulation, shares features with the Dodd-Frank oversight regime, including with respect to governance, oversight, and conflicts of interest).

[132] *See* Cane et al., *supra* note 123, at 1113-16 (summarizing the SEC's implementation of the NRSRO oversight mandate under Dodd-Frank).

[133] *See* 15 U.S.C. § 78o-7(c)-(d) (provisions of Dodd-Frank setting out the SEC's enforcement authority over NRSROs).

[134] *See* King & Spalding LLP, *Morningstar's SEC Settlement Underscores Importance of Avoiding Conflicts of Interest* (June 5, 2020), https://www.kslaw.com/news-and-insights/morningstars-sec-settlement-underscores-importance-of-avoiding-conflicts-of-interest.

enhancement measures such as the rescission of Rule 436(g).

3. Status Quo for ESG Ratings: No Teeth to SEC's Accountability Approach

The SEC's proposal in Credit Ratings Disclosure was premised on an inconvenient, but stubborn fact: credit ratings – despite their flaws – are unquestionably material to investors. And yet, as the previous subsection documented, neither the SEC nor Congress was able to effectively use disclosure requirements as a hook for holding the credit ratings agencies accountable. As a result, a practice in U.S. securities offerings has persisted where (1) all market participants acknowledge that credit ratings are material information to investors, (2) issuers and underwriters use credit ratings to market securities to investors, but (3) the only formal disclosure of credit ratings is limited to term sheets and press releases that are insulated from Section 11 liability.

Applying the lessons of the SEC's ill-fated credit rating reform, there is little reason to expect a different result with ESG ratings.[135] ESG ratings are a newer instantiation of the dilemma that the SEC tried to address in Credit Ratings Disclosure. As described in the previous section, ESG ratings have become increasingly important to investors in green bond and sustainable finance offerings [136] – in spite of manifest conflicts of interest and well-documented problems with reliability and methodological cohesion. In turn, there is a correlative enthusiasm from issuers to proactively market their ESG ratings to investors. Yet, under the status quo, there is no affirmative requirement under SEC rules for a company to disclose its ESG ratings, much less to provide contextual detail. That means the issuer can simply omit to include ESG ratings in the formal offering document (i.e., the registration statement filed with the SEC and the prospectus included therein), narrowing the liability profile for offering participants and keeping ESG ratings providers out of the SEC's crosshairs.

In practice, issuers need not even bother putting their ESG ratings in marketing materials distributed to investors, much less in a registration statement subject to Section 11 liability. The reason is simply that ESG ratings are already accessible. Issuers can rest assured that investors—and certainly the sophisticated institutional investors—have ready access to ESG ratings and reports as part of their research subscriptions with the ESG ratings

[135] Regulators have often acknowledged the temptation to analogize ESG ratings providers to traditional credit rating agencies, although there is variation in views about the wisdom of this approach. *See* UK FCA POLICY STATEMENT, *supra* note 37, at 37-39 (comparing and contrasting policy issues raised by credit rating agencies versus ESG rating providers); AMF/AFM PAPER, *supra* note 43, at 6 (arguing that ESG ratings should be regulated under a new, ad hoc framework rather than extending the existing CRA regulatory regime). Gil asserts that "[t]he EU will likely draw from their previous work on CRA reform and benchmark reform in proposing standards to regulate ESG rating providers." Gil, *supra* note 10.

[136] *See supra* Part II.A.2.

providers.[137] Indeed, there is a trend of ESG ratings providers expanding free access to their ESG ratings databases, although full research reports still require paid subscriptions.[138] Public companies often post their ESG ratings (and other sustainability-related accolades) on their own websites, providing a centralized hub of data that is mere clicks away for an interested investor. The issuer is still able to effectively "use" ESG ratings because it knows that the ratings can be costlessly transmitted to investors outside of the formal prospectus. For example, in oral conversations during a roadshow, a company can casually guide investors to the sustainability section of its website, or simply tell them to look up its ratings from the applicable providers.

This is precisely the dynamic that the SEC attempted to preclude in Credit Ratings Disclosure. There, the SEC endorsed a holistic view of when a credit rating is "used" in connection with a securities offering: e.g., to include "oral and written selling efforts of the registrant and other members of the selling group."[139] In recognition of the various channels through which issuers and underwriters can convey credit rating information to investors, the SEC disavowed a "form over substance" approach that would allow issuers to easily sidestep disclosure requirements – e.g., by conveying ratings orally or by pointing investors to a URL at which the ratings can be found.[140] Ironically, these are the same techniques that companies and underwriters currently use in sustainable finance offerings to segregate ESG ratings from the "formal" offering materials, thereby avoiding uncomfortable questions about who will take responsibility for the work product of a third-party ESG ratings provider.

As far as their purpose and nature are concerned, ESG ratings and credit ratings are very different products.[141] But there are uncanny parallels in the structure of the problem of how these ratings can be addressed in the context of securities offerings. If the regulatory experience of credit ratings in the aftermath of the global financial crisis is any indication, the conclusion is that ESG ratings will likely exist in a regulatory blind spot within the U.S. securities law framework. The ambitious investor protection-focused

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[137] *See* IOSCO REPORT, *supra* note 7, at 13-14, 18 (discussing availability of ESG ratings based on subscription model and also increasing trend of free access); *see also id.* at 24 (indicating the broad usage of ESG ratings products by members of the investment and asset management community, implying widespread availability of ESG ratings). Importantly, this finding does not appear to extend to retail and other non-institutional investors. It is unclear to what extent ESG ratings and reports are practically available for investors without large budgets to spend on research subscriptions. If it is true that ESG ratings and reports are readily available for large institutional investors but practically out of reach for retail investors, then all the more reason for the SEC to be concerned about information asymmetries arising from the unregulated dissemination of ESG rating disclosure to investors.

[138] *Id.* at 18.

[139] Credit Ratings Disclosure, *supra* note 102, at 53090.

[140] *See supra* Part II.B.1.

[141] *See* AMF/AFM PAPER, *supra* note 43, at 6-7.

disclosure regulation that the SEC proposed in 2009 did not materialize. And even with a Congressional thumb on the scale, the idea of subjecting NRSROs to Section 11 liability through the written consent requirement appears to have been intractable.[142] Given that the same handful of financial service providers who own the NRSROs has now extended its influence over the ESG ratings market, there is little reason to expect that the regulatory outcome will be different.

*C. Analyzing Special Cases: Is the Accountability Concern Overblown?*

A skeptic might be willing to accept that ESG ratings, like credit ratings, are unlikely to serve as a basis for Section 11 expert liability, but nonetheless remain unperturbed about the practical consequences. The argument is that ESG ratings can have only limited practical utility in a green bond offering and therefore, no matter how egregious the rating or the means by which it was marketed to investors, could not give rise to a material misstatement or omission under the securities laws in the first place.

According to this view, despite outward claims from green bond investors about the importance of the issuer's ESG credentials (as reflected in third-party ESG ratings) to their investment decisions, a court would be unlikely to credit this self-serving argument and would dismiss the idea that the ESG rating was part of the offering materials – after all, the issuer likely took pains to insulate its ESG ratings from the registration statement and prospectus used in the offering.

In some sense, this is an argument premised on the market's acknowledgment that ESG ratings are too unreliable to be taken seriously. Especially in a green bond offering, which are typically marketed to institutional investors,[143] it would be difficult to make the case that such sophisticated investors would take an issuer's ESG ratings at face value (given the widely known problems with ESG ratings) and rely upon those disclosures as the basis for an investment decision.

Although the conflict of interest inherent in the dual role played by external verifier and ESG ratings provider remains, some may conclude that regulatory oversight of ESG ratings providers would be sufficient to mitigate this risk. Indeed, the SEC appears to have gotten comfortable with this approach in the domain of credit ratings, relying on regulatory oversight of the NRSROs through its Office of Credit Ratings rather than the direct liability approach it attempted in 2009.[144] For these skeptics, the regulatory

[142] By contrast, the SEC recently proposed a new attestation requirement for greenhouse gas emissions data in its climate-related disclosure rule, which would presumably bring attestation providers within the scope of Section 11. *See* SEC Climate Disclosure Proposal *supra* note 42, at 254-55.

[143] Retail investors may get exposure to green bonds through bond funds and ETFs. *See, e.g.*, iShares USD Green Bond ETF, *supra* note 90.

[144] Of course, the SEC's ability to regulate NRSROs flows from Congressional grants of authority, such as Dodd-Frank. It is unclear whether the SEC would be able to promulgate

proposals out of Europe get to the heart of the matter – imposing oversight on ESG ratings providers as a means to ensure implementation of policies and procedures, ultimately leading to higher quality and more user-friendly ratings for investors.[145]

In other words, a skeptic might feel there is no special U.S. securities law concern raised by green bonds or other similar instruments. Nevertheless, even if one is not convinced that any special regulatory dispensation or attention is needed for these "vanilla" products, the same considerations do not apply for more exotic types of sustainable finance instruments. The following case studies are intended to test the limits of the hands-off approach.

1. Sustainability-Linked Bonds

Sustainability-linked bonds are a type of financial instrument that put greater pressure on the claim that ESG ratings are not material to investors. As defined by ICMA, "Sustainability-linked bonds are any type of bond instrument for which the financial and/or structural characteristics can vary depending on whether the issuer achieves predefined Sustainability/ESG objectives."[146] Typically, this means the issuer is contractually bound to pay stepped-up interest to bondholders if it fails to meet certain sustainability-related goals which are memorialized in the bond documentation.[147] This is in contrast to use of proceeds bonds, which, as noted above, provide no contractual recourse for bondholders if the issuer flouts its promise to direct bond proceeds in the promised manner and thus rely heavily on reputational levers.[148]

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oversight rules for ESG ratings providers in the absence of clear Congressional authorization.

[145] For a formal expression of this kind of view, see *infra* note 220 and accompanying text, discussing the so-called "Brussels Effect."

[146] INT'L CAPITAL MKT. ASS'N, SUSTAINABILITY-LINKED BOND PRINCIPLES: VOLUNTARY PROCESS GUIDELINES 2 (June 2020), https://www.icmagroup.org/assets/documents/Regulatory/Green-Bonds/June-2020/Sustainability-Linked-Bond-Principles-June-2020-171120.pdf.

[147] *Id.* at 5. For an overview of the main components of a sustainability-linked bond offering and recent market trends, *see* Gibson Dunn & Crutcher LLP, *Sustainability-Linked Loans and Sustainability-Linked Bonds – Trends and Perspectives* (July 29, 2021), at 7, https://www.gibsondunn.com/wp-content/uploads/2021/08/WebcastSlides-Sustainability-Linked-Loans-and-Sustainability-Linked-Bonds-%E2%80%93-Trends-and-Perspectives-29-JULY-2021.pdf; White & Case LLP, *Sustainability-linked Bonds: The New Face of Transition Finance* (Aug. 14, 2020), https://www.whitecase.com/publications/alert/sustainability-linked-bonds-the-new-face-transition-finance.

[148] This does not entail that sustainability-linked bonds are inherently more effective than classic green bonds (or other use of proceed bond variants). In fact, skeptics have suggested that traditional green bonds are subject to greater scrutiny and monitoring, whereas sustainability-linked bonds are a vehicle for less scrupulous issuers to fink without taking on meaningful financial risk. *See* Joe Rennison, *Investors Scrutinize Green Claims in $80bn Sustainability Bond Market*, FIN. TIMES (Nov. 16, 2021), https://www.ft.com/content/89fbcd50-8eac-4092-a24d-ae863c051058 (suggesting that sustainability-linked

Typical examples of sustainability metrics in a sustainability-linked bond include progress by the issuer in reducing carbon emissions, increasing share of renewable energy consumption or production, or phasing out single-use plastics. But in addition to these more objective measures of sustainability progress, sustainability-linked bonds permit explicit "hardwiring" of ESG ratings into the payment terms of the bond. Under the ICMA guidelines, an issuer can use ESG ratings as a key performance indicator (KPI) in its sustainability-linked bond framework.[149] So, for example, the coupon payment amount on the bonds would be contingent on the issuer maintaining (or improving) its third-party ESG ratings.

In practice, the use of ESG ratings in the terms of sustainability-linked bonds has not caught on widely.[150] Investors are already primed to be skeptical toward sustainability-linked bonds,[151] so it is not surprising that ESG ratings are seen as nonstarters for issuers, especially given that their expected financial return depends on an unreliable metric. The ICMA principles require KPIs to be, among others, "measurable or quantifiable on a consistent methodological basis," which seems out of reach given the current unregulated state of ESG ratings.[152]

Time will tell if ESG ratings ever gain acceptance from investors as a credible KPI. An optimistic view is that unreliability in ESG ratings is simply a function of the current mess in underlying sustainability data disclosed by issuers. Through initiatives such as the SEC's Climate Disclosure Rule, eventually issuers will be in the habit of disclosing comparable and reliable data that third-party ESG ratings providers can aggregate and synthesize to produce quality information for end-users. In effect, no more "garbage in, garbage out." According to this optimistic view, benefits of greater credibility at the issuer disclosure level would accrue to sustainability-linked bonds as well.[153]

In the meantime, however, ESG ratings have already permeated the

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bonds "lack the more rigorous criteria placed on green bonds" and that step-up interest penalties are "relatively small").

[149] INT'L CAP. MKT. ASS'N, SUSTAINABILITY-LINKED BOND PRINCIPLES: RELATED QUESTIONS 6 (Feb. 2021), https://www.icmagroup.org/assets/documents/Sustainable-finance/Sustainability-Linked-Bond-Principles-Related-questions-February-2021-170221v3.pdf (confirming that a third-party ESG rating can serve as KPI for a sustainability-linked bond).

[150] *See* Matthew Dunlap, *Green and Sustainability-Linked Bonds Come of Age*, REORG (Sept. 15, 2021), https://reorg.com/european-high-yield-esg-related-bond-market (finding that companies rarely link their KPIs to external ESG ratings); Jacqueline Poh, *Borrowers Take Hybrid ESG Approach Even as Precise Goals Favored*, BLOOMBERG (Nov. 30, 2021), https://www.bloomberg.com/news/articles/2021-11-30/borrowers-take-hybrid-esg-approach-even-as-precise-goals-favored (finding that 6% of sustainability-linked debt issued in 2021 was tied to ESG ratings).

[151] *See* David J. Miller et al., *Sustainability-linked Bonds*, OIL & GAS INV. 75 (Oct. 2021), https://www.lw.com/thoughtLeadership/sustainability-linked-bonds-oil-and-gas-investor.

[152] INT'L CAP. MKT. ASS'N, *supra* note 146, at 3.

[153] *See infra* Part III.B.

sustainability-linked bond market in subtler ways. Even if ESG ratings are not used as KPIs, the role of ESG ratings is more pronounced in the external verification process for sustainability-linked bonds as compared to traditional use of proceeds green bonds. While both types of bonds require an external verifier to deliver a Second Party Opinion, external verifiers are afforded a greater degree of judgment and discretion in the case of sustainability-linked bonds. In contrast to traditional green bonds, which are focused on green impact from specific projects, sustainability-linked bonds turn the spotlight on the issuer itself—i.e., the issuer's own sustainability performance, as measured by externally verifiable criteria and milestones. For this reason, there is a greater nexus between sustainability-linked bonds and ESG ratings, which, of course, purport to function as a proxy for a company's ESG performance. Indeed, the ICMA principles for sustainability-linked bonds are designed in a way that encourages a greater role for external verifiers. They contain a concept of "ambitiousness" of the sustainability performance targets selected by the issuer, and also call for a holistic assessment of whether the targets are consistent with the issuer's sustainability strategy. External verifiers, in carrying out their assignment to review the bond framework according to the ICMA principles, are susceptible to analyzing an issuer's ESG performance by simply relying on their company's own proprietary ESG ratings.

From a business standpoint, it is natural that external verifiers would leverage their own proprietary ESG ratings in their work product; this is just "cross-selling" in action. But providers are increasingly conscious of perceived conflicts of interest.[154] The conflict of interest risk with sustainability-linked bonds is particularly acute. Compared to green bonds, there is an even greater risk of conflicts of interest and inducement to "shop" for ratings, since the company's interest payment burden is on the line.

Stepping back, in a typical green bond offering, I have suggested it is at least plausible to view ESG ratings as not seriously material to an investment decision, despite the self-serving claims of investors.[155] With sustainability-linked bonds, the Second Party Opinion has a more direct bearing on the material terms of the securities, such as the interest payment amount. And that, in turn, is part of the financial business deal struck between the issuer and investors. Perhaps reflective of the acute potential risks, the SEC mused with requiring disclosure for sustainability-linked bonds in its recent climate disclosure proposed rule.[156] However, unless the SEC undertakes a major shift in its post-Dodd-Frank attitude towards third-party ratings, it is unlikely that Section 11 liability will attach to ESG ratings providers themselves.

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[154] *See* Morningstar 10-K, *supra* note 82.

[155] *See id.* at 44.

[156] *See* SEC Climate Disclosure Proposal, *supra* note 42, at 89 ("[s]hould we require disclosure of key performance metrics tied to such financing instruments?").

2. Allbirds' "Sustainable IPO"

The discussion thus far has focused on sustainability-themed debt instruments. As others have documented, the sustainable finance movement began in the ultra-safe province of sovereign and suprasovereign debt markets, and has more recently expanded to corporate issuers.[157] Corporate issuers in the sustainable debt market are public companies, meaning they are subject to ongoing reporting obligations and stock exchanges, and generally commit to sharing information with public shareholders and other groups of stakeholders. Since their inception, third-party ESG ratings providers have depended on the public availability of information about companies as the basis for their ratings.[158] In theory, this gives the ESG ratings providers a veneer of independence from the companies they rate. In this model, the ESG consulting firms are disinterested third-parties who apply proprietary analytical techniques to information sourced from the public domain. While ESG ratings providers supplement their analysis with questionnaires sent to issuers, this practice has traditionally been limited to public companies (for whom responding to a questionnaire is fair game as a "stakeholder relations" matter).[159]

But these presuppositions must be revisited now that the sustainable finance movement has expanded to a more speculative realm: the initial public offering. In 2021, the footwear and clothing company Allbirds made waves as a pioneering example of a sustainability-focused IPO.[160] The Allbirds IPO was notable on multiple grounds: first, it was a public offering by a Public Benefit Corporation (PBC), meaning it is required under its constitutive documents to promote a specific public benefit—in Allbirds' case, environmental conservation.[161] Second, Allbirds adopted a formal

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[157] *See, e.g.*, Park, *supra* note 57, at 14-16.

[158] *See* IOSCO REPORT, *supra* note 7, at 11 (noting that ratings providers rely on public disclosures, among other information, for their analysis).

[159] *See id.* (noting that coverage of private companies is less systematic, and would typically require a "mandate from an investor or lender").

[160] Jason Halper et al., *"Sustainable" Companies Face Increased Pressure*, HARV. L. SCH. F. CORP. GOVERNANCE (Dec. 26, 2021), https://corpgov.law.harvard.edu/2021/12/26/sustainable-companies-face-increased-pressure (describing that Allbirds had to significantly retract or moderate many of its more ambitious sustainability-related claims following legal challenges and objections from the SEC); Nicholas Megaw et al., *Allbirds Dropped 'Sustainable' Claim from IPO After SEC Objection*, FIN. TIMES (Nov. 7, 2021), https://www.ft.com/content/efbbaa8d-0c62-421e-96b0-5b010c339d33 (explaining that the SEC was particularly hostile to claims that the offering be described as a "sustainable IPO," which implies a new type of offering).

[161] Allbirds, Inc., Registration Statement (Form S-1), at 15 (Oct. 25, 2021), https://www.sec.gov/Archives/edgar/data/1653909/000162828021020401/allbirdss-1a4.htm [hereinafter "Allbirds S-1"]. *See* Jill E. Fisch & Steven Davidoff Solomon, *The "Value" of a Public Benefit Corporation*, *in* RESEARCH HANDBOOK ON CORPORATE PURPOSE AND PERSONHOOD 4-5 (Elizabeth Pollman & Robert B. Thompson eds., 2021) (explaining that benefit corporations permit companies and their boards to reject economic stockholder value as the corporation's exclusive objective in favor of some form of stakeholder or societal

framework, called its "sustainability principles and objectives framework," to articulate clear standards for sustainability performance that are visible to investors and stakeholders and subject to independent external verification (in the mode of green bonds).[162] Judged based on the messaging in the S-1, Allbirds' sustainability commitments were central to the marketing of the IPO itself.[163]

For purposes of our discussion, the Allbirds IPO sheds light on—or perhaps forces re-examination of basic assumptions about—the role and treatment of third-party ESG ratings providers under the U.S. securities laws.[164] In particular, the S-1 incorporated three examples of certifications from third-party sustainability providers:

(1) *B Corp Certification*. Allbirds elected to have its "social and environmental performance, accountability, and transparency" assessed by an independent non-profit, B Lab, Inc. B Lab provides certification scores on a 200-point scale that is updated every three years.[165]

(2) *ESG Risk Rating*. Allbirds disclosed its ESG rating from Sustainalytics (an "ESG Risk Rating"), including that its score placed it in the top 10% of companies assessed by Sustainalytics, both in the footwear industry and overall.[166]

(3) *SPO Framework Assessment*. Allbirds hired ISS ESG, one of the major sustainability and ESG ratings providers, to "assess and evaluate [its] performance against the SPO Framework."[167]

The reason Allbirds is an instructive case study is that, as an initial public offering, the S-1 registration statement was subject to SEC Staff review and comment. This contrasts with green bond and other debt securities offerings, which are typically issued by large seasoned issuers and undergo no SEC staff review process.[168] Green bonds are also frequently issued in transactions exempt from registration pursuant to Rule 144A and/or

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value).

[162] *See* Allbirds S-1, *supra* note 161, at 151-54.

[163] *See id.* at 1 ("[w]e aim to reverse climate change through better business by empowering people to make better, more conscious decisions for themselves as well as the planet"); *see id.* at 5-7 (weaving sustainability into the Company's self-image, as described in the section "Why We've Been Successful So Far").

[164] For a more comprehensive discussion of the notable legal aspects of the Allbirds IPO and other IPOs by sustainability-focused companies generally, see Halper et al., *supra* note 160.

[165] Allbirds S-1, *supra* note 161, at 134-35.

[166] *Id.* at 150.

[167] *Id.* at 153.

[168] The SEC Division of Corporation Finance's stated policy is to "selectively review transactional filings," but as a policy matter does not disclose criteria used to identify companies and filings for review. SEC, Div. Corp. Fin., *Filing Review Process*, https://www.sec.gov/divisions/corpfin/cffilingreview. In practice, bonds are typically issued off shelf registration statements, meaning that individual issuances (takedowns) of securities do not require a declaration of effectiveness from the SEC.

Regulation S – all outside the purview of SEC Staff review. Allbirds therefore provides a lens into the SEC Staff's thinking on a critical question for this paper: namely, to what extent are the opinions and evaluations of third-party sustainability providers treated as statements of "experts" within the meaning of Section 7 and Section 11 of the Securities Act? In comments on the registration statement, the SEC Staff instructed the issuer to provide the written consent of B Lab to being named in the S-1.[169] Although Allbirds pushed back on this request multiple times,[170] the Staff did not relent, citing that Allbirds' board of directors "will utilize the Company's impact score and assessment from B Lab, among other factors."[171] In the final instance, B Labs provided its written consent to be named as an expert, thereby accepting potential liability under Section 11.[172]

By contrast, the Staff did not question Allbirds' use of the Sustainalytics ESG Risk Rating in the registration statement.[173] The difference in treatment is puzzling from a securities law standpoint. The SEC's stated reasoning for requiring the B Lab consent was that B Lab's "impact score and assessments" are used by the Allbirds board of directors. This seems to rest on a notion that the B Labs certification is a part of the company's ongoing bargain with investors, which elevates it beyond a mere recitation of information in the public domain. But the Sustainalytics ESG Risk Rating is described by

[169] SEC, Comment Letter re: Allbirds, Inc. Draft Registration Statement on Form S-1, at 3 (July 13, 2021), https://www.sec.gov/Archives/edgar/data/1653909/000000000021008654/filename1.pdf; SEC, Comment Letter re: Allbirds, Inc. Amendment No. 1 to Draft Registration Statement on Form S-1, at 1 (Aug. 4, 2021), https://www.sec.gov/Archives/edgar/data/1653909/000000000021009573/filename1.pdf.

[170] *See, e.g.*, Cooley LLP, Response Letter re: Allbirds, Inc. Draft Registration Statement on Form S-1 (July 23, 2021), https://www.sec.gov/Archives/edgar/data/1653909/000162827921000468/filename1.htm (arguing that the "the consent requirements of Rule 436 are generally directed at circumstances in which an issuer has engaged a third-party expert or counsel to prepare a valuation, opinion, or other report specifically for use in connection with a registration statement. The Company's certification process and designation as a 'Certified B Corporation' was independent of and not entered into in connection with a registration statement.").

[171] *See* Cooley LLP, Response Letter re: Allbirds, Inc. Amendment No. 2 to Draft Registration Statement on Form S-1 (Aug 31, 2021), https://www.sec.gov/Archives/edgar/data/1653909/000162828021017825/filename1.htm.

[172] B Lab Company, Consent of B Lab Company (Exhibit 99.1) (Aug. 29, 2021), https://www.sec.gov/Archives/edgar/data/1653909/000162828021017824/exhibit991-sx1.htm. A survey of other comment letters reveals similar requests by SEC Staff to provide written consents. But in contrast to the Allbirds example, in the other cases, the companies amended subsequent drafts of the S-1 to eliminate references to the B Lab certification. *See, e.g.*, Latham & Watkins LLP, Response Letter re: Warby Parker Inc. Registration Statement on Form S-1 (Sept. 9, 2021), https://www.sec.gov/Archives/edgar/data/1504776/000162828021018318/filename1.htm.

[173] *See* Allbirds S-1, *supra* note 161, at 150 ("Information contained on, or that can be accessed through, this website is not incorporated by reference in this prospectus, and you should not consider information on this website to be part of this prospectus."). It is uncertain whether a court would be inclined to agree with this assertion.

Allbirds in similar terms. In the S-1, it is discussed in the same section as the B Lab certification (under the heading "Governance"), implying that it is also utilized by the board of directors as a basis for decision-making.[174] In its ongoing reporting, Allbirds features the Sustainalytics ESG Risk Rating on the sustainability portion of its website, in a section titled "Governance" that also discusses the B Lab certification.[175]

Can the difference in treatment between these two types of third-party evaluation be reconciled? Based on Barker's historical analysis, the policy behind the consent requirement in the Securities Act is to protect investors from undue or misguided reliance on the putative authority of sources used in the registration statement.[176] As *Huddleston* illustrates, the Securities Act imposes a higher standard of liability on parties who "play a direct role in a registered offering" – hence, for third-parties who are otherwise disconnected from the offering, it only makes sense to impose potential liability if their consent is obtained. From this standpoint, one may fairly conclude that by focusing solely on the B Lab certification, the SEC Staff overlooked the Sustainalytics and ISS ESG contributions to Allbirds' sustainability messaging in the registration statement. Each of these external ratings and verifications is featured prominently throughout the registration statement. The providers are described as a "globally recognized independent ESG assessment provider" (Sustainalytics) and "an internationally recognized independent third party with expertise in ESG and analysis" (ISS ESG), respectively.[177]

Ultimately, there may be no principled distinction between the B Lab certification and the other third-party ESG-related evaluations in the Allbirds S-1. A cynical interpretation might be that the SEC Staff views the major third-party ratings companies such as Sustanalytics and ISS ESG as a losing battle. After the post-Dodd Frank impasse over credit rating consents, ESG ratings may also be seen as untouchable – a reasonable conclusion given that the ESG ratings providers are now part of the same conglomerates that aggressively lobbied against credit ratings reform in 2009-10. By contrast, the SEC may have seen B Lab as a less prickly target. B Lab was founded for the sole purpose of promoting its sustainable IPO framework – an act that it could materially further by cooperating with the SEC.[178] Likewise, given the tremendous expectations surrounding the sustainability features of the IPO (touted, at least in the popular press, as the first sustainable IPO), Allbirds would have had strong incentives to convince B Lab to provide its

[174] *See id.* at 148-50.

[175] ALLBIRDS, ESG OVERVIEW, https://ir.allbirds.com/esg-overview.

[176] *See* Barker, *supra* note 96.

[177] Allbirds S-1, *supra* note 161, at 150, 153.

[178] From a long-term perspective, there is reason to be skeptical that third-party ESG players will be more receptive to provide written consents. If the recent trend of consolidation in the ESG ratings provider industry is any indication, new entrants are quickly swallowed up by larger incumbents, which does not bode well for disruptive innovation.

consent.

The Allbirds IPO is a noteworthy chapter in our study because it because it fully embraced the importance of third-party verification of the company's sustainability performance, plans and governance framework – to the point of disclosing certifications, ratings and assessments of multiple ESG service providers in a registration statement filed with the SEC.[179] In this sense, this is the outcome of a collective judgment from the deal team – the issuer, underwriters, and their advisors – that the third-party ESG-related certifications and evaluations constitute material information to investors (the omission of which would be actionable), and therefore fall squarely within the Section 11 liability perimeter. But if the SEC Staff's selective treatment of third-party material in Allbirds is any indication, large ESG ratings providers can continue to operate without fear of triggering the Section 7 consent requirement.

## III. SEARCHING FOR SOLUTIONS

ESG ratings have become indispensable to the securities offering process for a diverse range of sustainable finance instruments, despite manifest conflicts of interest and investor protection risks. The previous Part hypothesized the existence of a regulatory blind spot, whereby ESG ratings providers are insulated from Section 11 liability, while issuers can openly leverage their ESG ratings in investor relations and marketing efforts – and, in some cases (e.g., sustainability-linked bonds, sustainable IPOs) – use ESG ratings to structure the terms of their securities. This Part expands on claim that U.S. securities law is unable to create a credible threat of liability for ESG ratings providers, while considering the space of possible alternative regulatory interventions.

### *A. Gatekeeper Regulation: The Liability Enhancement Channel and its Flaws*

If the argument of this paper is correct, it is unlikely that the U.S. securities offering liability regime will provide accountability for ESG ratings providers in particular cases – i.e., where investors in specific offerings of green bonds and other sustainable finance instruments allege harms under the antifraud provisions of the U.S securities laws. This is despite the fact that, among the major world financial centers, the U.S. is known for its comparatively robust securities law enforcement regime,[180] as

[179] This marks a striking difference from green bond practice. As described above in Part II.B, the prevailing practice is to avoid disclosure of third-party ratings and even information about the Second Party Opinion to the extent possible. This takes after the accepted approach to credit ratings, where the idea of seeking a written consent from an NRSROs in order to include a rating in the prospectus would be inconceivable.

[180] *See* John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 245 (2007) (establishing the relative intensity of securities enforcement in the

typified by the controversial private securities class action.[181] Consistent with its tripartite mission, including the "prevention of fraud," U.S. courts and the SEC have promoted a strong enforcement culture under the U.S. securities laws, which is reinforced through private litigation and regulatory enforcement by the SEC's Division of Enforcement.[182]

Drawing on theories of financial regulation of gatekeepers, perhaps it is not surprising that a liability-focused approach to ESG ratings regulation is likely to be ineffectual.[183] In Coffee's influential typology, the main strategies available to securities regulators can be grouped into four categories, of which "liability-enhancing rules" is one.[184] Writing in the aftermath of Enron and the passage of Sarbanes-Oxley, Coffee observes that "although enhancing liability rules is probably the most obvious and traditional response to scandals, this was also the one strategy that business interests effectively resisted during the enactment of Sarbanes-Oxley."[185] Credit rating reform exhibited a similar dynamic: entrenched gatekeeper interests also foiled attempts to enhance liability for NRSROs in the wake of the financial crisis—even to the point of thwarting express Congressional intent.[186] As explained in Part II.B., there is a long history of credit rating agencies deploying First Amendment arguments to insulate themselves from securities law claims—reaching an apogee in the NRSROs' blanket refusal to obey Congressional intent in the rescission of Rule 436(g), which was robed in a First Amendment argument.[187] Once the SEC acceded to the

U.S., also differentiated by its vigorous system of private enforcement).

[181] *See* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1302-05 (2008) (outlining debates over the policy value of private securities class actions under Rule 10b-5).

[182] The SEC stands out from peer regulators in that one of its first actions to address financial risks from climate and ESG issues was to establish an enforcement task force. *See* SEC, *Spotlight on Enforcement Task Force Focused on Climate and ESG Issues,* https://www.sec.gov/spotlight/enforcement-task-force-focused-climate-esg-issues; SEC, Press Release, *SEC Announces Enforcement Task Force Focused on Climate and ESG Issues*, https://www.sec.gov/news/press-release/2021-42.

[183] *See, e.g.*, Partnoy (2017), *supra* note 8, at 1433.

[184] John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 305 (2004); *see also* Concept Release, *supra* note 117, at 53118 (suggesting that "[e]nhancing the accountability of NRSROs may help to address concerns about the quality of credit ratings" and "[a]n improvement in the quality of credit ratings should, consistent with the goals of the federal securities laws, better protect investors").

[185] Coffee, *supra* note 184 at 305; *see also id.* at 353 (observing that a strict liability rule would not be "politically acceptable to auditors, who represent a powerful political lobby").

[186] *See* Partnoy (2017), *supra* note 8, at 1433, 1435 (concluding that the degree of accountability for credit rating agencies remains low in the aftermath of Dodd-Frank).

[187] *See* Cane et al., *supra* note 123, at 1107-11 (surveying critiques of the argument that broad First Amendment protection should be afforded to credit ratings agencies); *see also* Concept Release, *supra* note 117, at 53117 (noting that NRSROs represent themselves as experts at analyzing credit and risk, and expressing doubt about the force of NRSROs' claims

NRSROs' view that, even with Rule 436(g) off the books, they cannot be forced to give consent to be named in the registration statement, the prospects for securities liability are slim. And if liability for credit ratings is out of reach, then *a fortiori* so for ESG ratings (since neither I nor, to my knowledge, any other commentator would suggest that ESG ratings are *more* material to investors – and therefore more deserving of regulatory or judicial solicitude – than credit ratings).

If third-party ESG ratings providers are effectively protected from securities law liability, could aggrieved investors seek recovery from issuers themselves? After all, an issuer is responsible for all of the statements in the registration statement and does not benefit from a due diligence defense under Section 11. Courts have addressed this question in the past with respect to credit ratings.[188] The difficulty is that when an issuer communicates a rating assigned to it by a third-party, the sense in which the statement is an actionable "misstatement" basically depends on whether it accurately reported the rating or not – not whether the underlying third-party opinion was objectively well-founded or reasonable.[189] Those are matters of judgment for the ratings provider, which cannot be imputed to the company.

The Supreme Court's 2015 securities law decision in *Omnicare* has interesting – and maybe counterintuitive – implications for third-party ratings. *Omnicare* addressed the scope of Section 11 liability for statements of opinion by the issuer in a registration statement. The Court's important contribution was to flesh out how omissions could render an opinion actionable. Specifically, "if a registration statement omits material facts about the issuer's *inquiry into or knowledge concerning a statement of opinion*, and if those facts conflict with what a reasonable investor would take from the statement itself, then § 11's omissions clause creates liability."[190] For an issuer, this represents is a genuine constraint. Although the issuer might think it can shield itself from liability by prefacing its

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that they are merely "providing opinions on risk").

[188] *See, e.g.*, J & R Marketing, SEP v. General Motors Corp., 549 F. 3d 384, 393 (6th Cir. 2008) ("GMAC's disclosure of its credit rating was merely a true statement of historical fact"); Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp., 632 F.3d 762, 774-76 (1st Cir. 2011) (acknowledging that liability can potentially extend to someone who accurately described an opinion, but rejecting this in the context of a company's reporting of its credit rating, even though the rating turned out to be mistaken; also noting that a majority of district courts that have considered the issue dismissed similar claims).

[189] The *Plumbers' Union* court explains: "The line is admittedly a fine one, but the ratings — inherently opinions and not warranties against error, . . . — were accurately reported by defendants and nothing more is required so long as the ratings were honestly made, had some basis, and did not omit critical information. That a high rating may be mistaken, a rater negligent in the model employed or the rating company interested in securing more business may be true, but it does not make the report of the rating false or misleading. If the purchaser wants absolute protection against errors of opinion, the answer is insurance rather than lawsuits." *Id* at 775-76.

[190] Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 575 U.S. 175, 189 (2015).

opinions with, "I believe" or "I think," the Court held that an opinion could be misleading if the issuer omitted context that would tend to undermine confidence in the opinion. The idea is that investors have reasonable expectations that a company's statements of opinion or belief will have some commercially grounded or customary basis. If there is no such basis, the company has an obligation to disclose the basis, however atypical, on which its opinions were actually formed.[191]

The problem is that, with credit ratings, the issuer is merely reporting the opinion of a third-party – an opinion that the issuer had no part in forming. Thus, any critical omissions that might render a credit rating, *qua* opinion, materially misleading would be omissions *by the credit rating agency* in preparing its ratings report. They are not omissions of the issuer, because when an issuer reports its credit ratings, it is not thereby adopting the ratings report in full or somehow incorporating it by reference into its SEC filings. The ratings report is not a prospectus by which securities are offered and sold to investors. So it would seem a bridge too far to penalize an issuer for the rating agency's failure to provide sufficient context in its ratings report to justify its opinion.

More generally, the use of third-party ratings by issuers outside of the securities offering context provides another layer of insulation from liability. Any communication is potentially subject to Rule 10b-5 liability, but the standard is *scienter*.[192] A company will not be found liable for a "material misstatement" under Rule 10b-5 for merely reporting the opinions of a third party.[193] Moreover, as Guo suggests, the efficacy of antifraud lawsuits (typified by Rule 10b-5 claims) has diminished over time.[194]

Within the U.S. securities law framework, some optimists may argue that existing incentive structures provide adequate protection against misleading or abusive practices by ESG ratings providers. The idea is that the incentives of offering participants are already aligned to steer issuers

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[191] To make this idea concrete, consider a company asserting in its SEC filings: "We believe the imposition of economic sanctions targeting Russia are unlikely to impact our cost of sales in the upcoming year." Without more, an investor might conclude this statement was made on the basis of an internal review of the company's inputs and supply chain, cross-checked against a database of active sanctions programs, and separately confirmed by external counsel with specialized knowledge of economic sanctions regulations. But if it turned out that the company's belief was based not on any such process, but merely an optimistic hope for a swift conclusion to an ongoing war, then failure to provide any context surrounding its (dangerously optimistic) opinion could be materially misleading.

[192] *See Huddleston*, *supra* note 54, at 381-382.

[193] In light of the conflict of interest risk discussed above, one could concoct scenarios of issuers conspiring with ESG ratings providers to boost their ratings in a manner that could meet the elements of a Rule 10b-5 claim. But policing is obviously impracticable; hence, for targeting gatekeepers, and why conflict of interest policies, internal controls, and oversight is the default posture. The question is whether these conflict of interest policies and other measures have bite.

[194] Guo, *supra* note 74, at 211.

away from over-reliance on ESG ratings in the offering context. Consider the role of underwriters, which are the paradigmatic gatekeepers under the securities laws.[195] Underwriters work with issuers to develop the marketing message for an offering, but they also take on risk for information conveyed to investors.[196] As direct participants in the offering, underwriters are subject to the same liability provisions as the issuer – with one crucial difference: unlike issuers, underwriters can take advantage of the so-called "due diligence defense."[197] The optimists might say that surely underwriters, in order to discharge their due diligence obligation to conduct a "reasonable investigation," would take steps to vet the reasonableness of ESG ratings that are being used in the marketing of an issuer's green bonds, sustainability-linked bonds or even an IPO.

But this returns us to the recurring problem with third-party ratings used in connection with securities offerings, which is that market participants can strategically exploit ambiguity in disclosure requirements to get the benefit of marketing the issuer's ESG ratings without incurring the most stringent forms of Securities Act liability. After the SEC gave up on Credit Ratings Disclosure, the "form over substance" approach was given tacit approval.[198] As shown in the previous Part, the simplest fix is to exclude ESG ratings from the formal offering documentation, relying instead on other channels to convey that information to investors.[199] Even if underwriters, as matter of prudence, strictly prohibit the issuer from referring to ESG ratings in formal presentations to investors, the issuer's ESG ratings are mere clicks away on the internet – a fact known to all offering participants.

The basic conceit is to create conceptual separation between the securities offering and the ESG rating, so that offering participants can reach a consensus understanding that the ESG rating is not part of the "disclosure package" delivered to investors. So long as the ESG ratings are excised from

[195] *See* In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 662 (S.D.N.Y. 2004) ("Congress recognized that underwriters occupied a unique position that enabled them to discover and compel disclosure of essential facts about the offering. Congress believed that subjecting underwriters to the liability provisions would provide the necessary incentive to ensure their careful investigation of the offering.") (internal quotations omitted).

[196] Underwriters face liability for a potentially wide universe of information – known in the jargon as the "disclosure package," which consists of the formal offering documents, any documents incorporated by reference therein, and documents used in the marketing process, such as road show presentations. Statements conveyed orally to investors (e.g., during a road show presentation) can also be actionable under the securities laws, but these raise obvious evidentiary difficulties in bringing claims. To protect themselves from liability, the underwriters build indemnification clauses into their underwriting agreements with issuers.

[197] *See WorldCom*, *supra* note 195 at 662-63. The formal "due diligence defense" is a statutory defense under Section 11, but practitioners understand that the same reasonable investigation would mitigate an underwriter's risk against claims under Section 12 or Rule 10b-5.

[198] *See supra* Part II.B.2.

[199] *See supra* Part II.B.3.

the registration statement and prospectus, the underwriters can rest easy about their own statutory liability exposure. But in the absence of a liability motive, this removes the underwriters' incentive to perform a reasonable investigation of ESG ratings in the first place. And so the ESG ratings providers can proceed business as usual. [200]

This market practice reflects a "form over substance" approach to the securities laws, which turns a blind eye to the centrality of ESG ratings to the offering process. A similar dynamic unfolded with credit ratings after the fallout from the rescission of Rule 436(g), where the SEC reversed course on its mission to enhance credit ratings disclosure—presumably out of deference to the NRSROs—and to the detriment of investors. With ESG ratings, an old pattern appears to be repeating itself.

### *B. Resolution Without (U.S.) Regulation?*

The previous section has suggested that liability enhancement is unlikely to be an effective channel for regulating ESG ratings in the United States. Globally, however, we are on the cusp of regulatory action. With European regulators on the leading edge, and IOSCO setting the agenda for regulators around the world, it is clear that ESG ratings providers are slated for regulation and oversight. Although the shape of future regulation is still to be determined, the direction of travel suggests that financial regulators are following a familiar playbook: industry codes of conduct,[201] transparency of methodologies, and conflict of interest policies, with major ESG ratings and data providers subject to registration and supervision requirements in the manner of credit rating agencies.[202] In parallel, European regulators are gearing up to expand oversight of green and sustainability bonds,[203] and have expressed awareness of the conceptual linkages between green bond and ESG ratings regulation.[204]

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[200] Issuers are always potentially subject to Rule 10b-5 liability for their public statements, even those that are not included in formal offering documents or even in regular SEC filings. But as explained in *Huddleston*, showing the requisite *scienter* is a tall order.

[201] *See, e.g.,* Adrienne Klasa, *Regulators Take Aim at ESG Ratings in Fight Against Greenwashing*, FIN. TIMES (May 28, 2022), https://www.ft.com/content/97dd3144-dadb-452f-9a65-088a841ad7b1 (reporting that MSCI, one of the largest providers in the ESG ratings space, advocates an industry-first approach: "We think starting with a code of conduct and developing a regulatory framework from there would make the most sense."); IOSCO REPORT, *supra* note 7, at 35 (suggesting that national regulators consider the development of voluntary standards or codes of conduct); FIN. SERVS. AGENCY (2021), *supra* note 40 (publicly announcing support for the approach recommended in the IOSCO REPORT).

[202] *See, e.g.*, Maijoor, *supra* note 46, at 3-4 (advocating for registration and supervision, methodological improvements, and conflict of interest requirements).

[203] *See* Geddes, *supra* note 63 (explaining how under the European Green Bond Standard proposal, ESMA would be granted expanded powers to oversee registration and supervision over external reviewers of sustainable bonds).

[204] In June 2022, the French AMF reiterated its call for Europe-wide regulation of ESG ratings, specifically urging that regulatory authority be located in ESMA due to the overlap

In the U.S., in the absence of a Congressional mandate, the prospect of direct regulatory action is much less clear. However, the SEC's recent rule proposals on ESG topics contain a faint outline of an argument for a more passive approach to ESG ratings regulation than this paper has generally advocated. This is the idea that the surfeit of problems affecting ESG ratings is a downstream consequence of inadequate and unreliable corporate disclosure of sustainability-related information.[205] For example, in the SEC Climate Disclosure Proposal, the SEC suggests that mandatory climate-related disclosure could reduce reliance on ESG ratings – since its proposed mandatory disclosures would allow investors to make meaningful comparisons of company ESG performance, whereas ESG ratings are notoriously neither standardized nor transparent.[206] In a different context, the SEC in the ESG Fund Disclosure Proposal suggests that disclosure requirements on ESG funds could remedy some of the pervasive conflicts of interest afflicting ESG ratings providers.[207]

Acting within its traditional remit of disclosure-based regulations, the SEC's rules would, in theory, address one of the trenchant criticisms of ESG ratings: the "lack of convergence" critique.[208] In a rather utopian picture, we can imagine an ecosystem where (1) corporate ESG disclosure rules (ideally harmonized across jurisdictions) elicit "decision-useful" information for investors and (2) ESG ratings serve a secondary role in interpreting and cataloguing the information disclosed by corporates, and provide value-add solely through the provision of proprietary opinions. Each ESG rating provider would, due to the pressures of a competitive marketplace, need to develop a niche that investors find valuable.

There is reason to be skeptical. For one, as Partnoy has argued

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with its role as supervisor of (1) credit ratings agencies and (2) assuming the European Green Bond Standard is implemented, green and sustainable bonds. *See* AUTORITÉ DES MARCHÉS, *The AMF Reiterates its Call for a European Regulation of ESG Data, Ratings, and Related Services* (June 2, 2022), https://amf-france.org/sites/default/files/pdf/69480/en/The_AMF_reiterates_its_call_for_a_European_regulation_of_ESG_data%2C_ratings%2C_and_related_services.pdf?1655336559.

[205] *See, e.g.*, 15 U.S.C. §77g (authorizing the SEC to require companies to disclose in the registration statement such information and documents "as the Commission may by rules or regulations require as being necessary or appropriate in the public interest or for the protection of investors").

[206] SEC Climate Disclosure Proposal, s*upra* note 42, at 336; *see also* ACCENTURE UK & INT'L REGUL. STRATEGY GRP., ESG RATINGS AND ESG DATA IN FINANCIAL SERVICES: A VIEW FROM PRACTITIONERS 5 (Feb. 2022), https://www.irsg.co.uk/assets/Reports/IRSG-Accenture-report-on-ESG-Ratings-and-ESG-Data-in-Financial-Services-FINAL-2.pdf. ("Over time, efforts to improve ESG disclosures – such as the development of the International Sustainability Reporting Standards, in conjunction with coordinated regional initiatives and implementations – should lead to systematic improvements in underlying ESG data that is available to the market and supports a higher level of consistency and robustness in ESG ratings products.").

[207] ESG Fund Disclosure Proposal, *supra* note 19, at 133, 151.

[208] *See, e.g.,* Berg et al., *supra* note 9.

persuasively, the market dynamic in the world of credit rating agencies has little to commend it.[209] Despite broad convergence in ratings by the leading NRSROs, these critical gatekeepers of the financial markets failed to detect the oncoming financial crisis. Although it is still early days for the ESG ratings enterprise, evidence already suggests that the predictive power of ESG ratings is limited.[210] It is doubtful that a further entrenchment of the market dominance of the major players in the ESG ratings and advisory business would tend to improve the utility of ratings. On Partnoy's view, the oligopoly enjoyed by major credit rating agencies has contributed to market distortion and inefficiencies, and has impaired the usefulness of credit ratings as a source of information.[211]

Can the consolidation trend in the sustainability services industry really be reversed? In the ESG Fund Disclosure Proposal, the SEC seems to think that disclosure requirements intended to shine a spotlight on conflicts of interest could have the effect of increasing competition. However, one is reminded of a similar context where even strict rules prohibiting conflicts of interest have not made a dent in an oligopolistic market dynamic: the SEC's enhanced auditor independence rules adopted under Sarbanes-Oxley in the wake of the Enron-era accounting scandals.[212] Under this regime, audit firms are subject to strict rules governing an accounting firm's ability to perform non-audit consulting services for an audit client, which, in theory, might deter conglomeration and encourage market entry for smaller niche providers. And yet the Big Four remains the Big Four. A similar observation could be made about the NRSROs even after the SEC ratcheted up its conflict of interest rules under Dodd-Frank.[213]

A popular characterization of the political economy of financial regulation is that it can only take place after crisis.[214] Certainly the major advances in U.S. securities law in the 21st Century were born out of crises: the accounting scandals of the early 2000s led to Sarbanes-Oxley and the financial crisis to Dodd-Frank, while the federal securities laws themselves were forged out of the devastation wrought by the 1929 stock market crash and the Great Depression.[215]

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[209] *See* Partnoy (1999), *supra* note 21, at 623-24; Partnoy (2017), *supra* note 8, at 1414, 1427.

[210] *See* George Serafeim & Aaron Yoon, *Stock Price Reactions to ESG News: The Role of ESG Ratings and Disagreement* (Harv. Bus. Sch. Working Paper, 21-079, 2021).

[211] *See* Partnoy (1999), *supra* note 21, at 623-24.

[212] *See* Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 8183, Exchange Act Release 47265, 68 Fed. Reg. 6006, 6006-07 (Feb. 5, 2003); Coffee, *supra* note 184, at 336.

[213] *See supra* Part II.B.2.

[214] *See, e.g.,* John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1020-21 (2012).

[215] *Id.*

The current wave of regulatory reform, centered around climate and sustainability concerns, is of a different nature. To be sure, the threat of crisis (in the form of climate change) is real – indeed, existential. But unlike previous crises that wracked financial markets, depleted retirement savings accounts, and catalyzed recessions, the current crisis is slow-burning and more susceptible to varying political interpretations.[216] As a result, the political conditions for legislative action in a hyper-partisan America are not ideal. Despite President Biden's avowed commitment to using a "whole-of-government approach" to tackle the climate crisis,[217] there are limits to the efficacy of Executive Branch action without the cooperation of Congress.[218] Even an aggressively activist SEC is limited to the confines of its statutory mandate. Thus, the political economic facts on the ground do not point to a grand reform along the lines of European models.[219]

Perhaps the current dysfunctional state of the ESG ratings does not require such strong medicine as comprehensive legislative reform. A combination of milder interventions would suffice. First, conditions may be ripe for a "Brussels Effect" phenomenon, whereby the U.S. and other less proactive jurisdictions can reap spillover benefits from more stringent regulation emanating from Europe.[220] Although Bradford explains that the Brussels Effect tends to be weak in cases of financial regulation due to the mobility of capital, that would not apply in the case of ESG ratings.[221] This is because the ESG ratings business is dominated by a handful of global financial services conglomerates, who are so entrenched in the European

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[216] Not to mention there is hardly agreement on how the "S" and "G" prongs of ESG contribute to the "E"-centric climate crisis, which aggravates the political messaging problems.

[217] *See* The White House, Fact Sheet: President Biden Takes Executive Actions to Tackle the Climate Crisis at Home and Abroad, Create Jobs, and Restore Scientific Integrity Across Federal Government (Jan. 27, 2021), https://www.whitehouse.gov/briefing-room/statements-releases/2021/01/27/fact-sheet-president-biden-takes-executive-actions-to-tackle-the-climate-crisis-at-home-and-abroad-create-jobs-and-restore-scientific-integrity-across-federal-government/.

[218] The SEC Climate Disclosure Rule has attracted fierce opposition by Republicans in Congress. *See* Kellie Lunney, *SEC Urged by Republican Senators to Drop Climate Disclosure Plan*, BLOOMBERG LAW (Apr. 5, 2022), https://news.bloomberglaw.com/environment-and-energy/sec-urged-by-republican-senators-to-drop-climate-disclosure-plan. *See, e.g.,* Pat Toomey et. al, Letter (June 15, 2022) ("[T]he SEC's proposed climate disclosure rule is just the latest example of a financial regulator hijacking the democratic process by straying into a contentious public policy issue wholly unrelated to its mission and expertise.").

[219] One might also predict that even in Europe, the outcome of any new rulemaking would tend to be, in the absence of a crisis that is salient for the broader polity, more heavily influenced by industry and other highly motivated interest groups – and therefore have a suboptimal bite. This is a straightforward application of the logic of collective action.

[220] *See* ANU BRADFORD, THE BRUSSELS EFFECT: HOW THE EUROPEAN UNION RULES THE WORLD 1-4 (2020) (referring to the phenomenon whereby the European Union is able to exercise unilateral rule-setting authority for the rest of the world, when certain conditions are met).

[221] *See id.* at 48-53.

market that they cannot afford to "exit" European regulation. Thus, if Europe successfully casts its supervisory net around the ESG ratings providers, it seems likely that any improvements to methodological practices, internal controls, and conflict of interest policies, etc. would apply across the firm's global operations—including in the United States. One of Bradford's insights about the Brussels Effect is that there would be no incentive for an ESG ratings firm to expend resources to bring its European operations up-to-snuff without applying the same improvements across the organization.

Second, we should not dismiss the SEC's own optimism out of hand. Even though it is unlikely to seek liability enhancement for ESG ratings providers in the model of Credit Ratings Disclosure and the repeal of Rule 436(g), there may be truth to the SEC's belief that company-level disclosures may improve the downstream work product of third-party intermediaries such as ESG ratings companies.[222] Likewise, the SEC has been proactive in the regulation of ESG funds, which are the primary contact point between ESG ratings and Main Street investors. Although neither of these rules would regulate the practices of ESG ratings providers themselves, they will arguably align the incentives of other market participants (i.e., issuers and underwriters) to demand better work product from the ESG ratings companies (e.g., if a fund is subject to strict disclosure requirements, it will exercise greater caution in relying on ESG ratings as the basis for its own decision-making and communications with investors), perhaps spurring competition and innovation among third-party ESG providers. In conjunction with Brussels Effect spillover benefits, this could be just enough to prevent the most egregious behavior or market failure.

### *C. Modest Proposals for Green Bond Reform*

In the final analysis, I remain skeptical that such optimism is warranted. The key contribution of this paper was to focus on unique risks arising from the securities offering context, using the example of credit rating agency reform as a guide. Despite earnest attempts by the SEC and even Congress to impose discipline on the NRSROs through liability-enhancing rules, these attempts did not come to fruition. The resulting equilibrium in U.S. capital markets practice amounts to a "form over substance" approach to credit ratings – despite their overt materiality to investors, all parties collectively agree that disclosure in the registration statement is unnecessary (thus dispensing with the awkward requirement to obtain consent from the obstreperous NRSROs), while the issuer and underwriters can happily convey the ratings to investors through other channels (e.g., term sheets). As this paper has explained, this same rationale has been applied to ESG ratings used in the marketing of sustainable finance instruments.[223] This does not

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[222] There is a major caveat – namely that the SEC's disclosure rules are limited to climate-related disclosure, which is a mere subset of all ESG concerns.

[223] With the notable and puzzling exception of Allbirds, where the issuer disclosed its ESG

instill great confidence in market participants' ability or incentive to self-police.

That does not, however, mean that all is lost. Even if the prospects for reform of ESG ratings are dim, there are low-cost, politically expedient routes the SEC could take. To see this, consider that in the world of securities regulation, U.S. securities law is hegemonic in some respects. Market gatekeepers (underwriters, accountants and internal and external lawyers) tend to treat the SEC Staff's proclamations as gospel – including a wide range of sources of informal guidance that do not rise to the level of formal rulemaking: compliance and disclosure interpretations (C&DIs), Staff interpretations on accounting and disclosure matters, the Staff's Financial Reporting Manual, as well as no-action letters and comment letters issued to specific companies. We have already seen one potent example of this phenomenon: when the NRSROs held debt markets hostage in 2010, it was the SEC's issuance of no-action letters and C&DIs that assured market participants and restored market functionality.[224] Amazingly, these informal sources of guidance were enough to overcome what was arguably express legislative direction to the contrary.

Today, there is almost a complete absence of regulatory authority or guidance addressing the uses of third-party ESG ratings in the securities offering process. Therefore, as this paper has argued, market participants can strategically exploit ambiguity to justify a path of least resistance. With ESG ratings, it is no great leap to analogize to the recent regulatory experience with credit ratings, whereby the SEC assented to the omission of credit ratings from the registration statement, to justify a similar approach (i.e., "form over substance") in the case of ESG ratings, despite being inwardly aware of their importance to investors and the swirl of controversy that follows them. To reverse this trend, the SEC Division of Corporation Finance, at a bare minimum, could issue informal guidance to market participants on sustainability-themed securities offerings such as green and sustainability-linked bonds. In particular, it could address the use of third-party intermediaries in the offering process and call attention to potential conflicts of interest. It could draw on the policy considerations that motivated its Credit Ratings Disclosure – such as the importance of providing investors with context about limitations on the usefulness of ESG ratings, or about conflicts of interest, but without undertaking a mandatory rulemaking.

Without purporting to implement substantive regulations, the Staff could nudge behavior in a positive direction. For example, a statement from the Staff raising concerns about conflicts of interest in the ESG ratings industry would imbue underwriters (and, consequently, lawyers giving 10b-5 opinions) with a felt responsibility to conduct due diligence on ESG ratings

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ratings in its S-1 (but did not obtain the provider's consent). *See supra* Part II.2.C.

[224] *See* Carbone, *supra* note 118, at 19-20; *see also* Cane et al., *supra* note 123, at 1067-71.

providers before proceeding with a transaction. Even slight changes in the day-to-day rhythm of capital markets transactions could, at the margins, induce ESG ratings companies to adapt practices and behavior to address the concerns of deal participants, without whom their external verification business would collapse.

From a political economy standpoint, the costs of informal guidance are low. SEC Commission action would not be required; disclosure guidance is issued by the Staff of the Division of Corporation Finance and does not undergo a formal rulemaking process. If the passage of time reveals the guidance to be inapt, it is easy to override or rescind. While the obvious rejoinder is that informal guidance suffers from a lack of political legitimacy, the Staff would merely be adding gloss to existing securities law principles. The incentive structure of repeat market players (underwriters, lawyers, and the third-party intermediaries themselves) would take care of the rest.

Allbirds itself was arguably a step in the right direction. Although SEC Staff comments on a draft S-1 are not formal proclamations of the Commission, they are now embedded in the fabric of existing securities regulation. By insisting on the B Lab consent, the Staff will likely have prompted market participants to view the Section 7 consent requirements in a more holistic light – which they will presumably carry forward into future deals.

The argument of this paper is not that informal SEC Staff guidance is the ideal prescription to what currently ails ESG ratings. But the lesson from our excursion into credit rating agency reform in 2009-10 is that there are significant obstacles to enacting more direct regulatory reforms. The optimistic spin is that a combination of minor, but feasible, interventions can produce meaningful improvements.

## IV. CONCLUSION

ESG ratings have attracted controversy in financial markets and caught the eyes of financial regulators the world over. This paper was motivated by a narrow and modest line of inquiry: how do the U.S. securities laws deal with ESG ratings – particularly when those ratings are used in offerings of green bonds and other sustainable finance instruments. But the paper only scratches the surface of a complex bundle of policy questions raised by ESG ratings and the explosive growth of the sustainability service industry (or the "climate industrial complex" in SEC Commissioner Peirce's memorable phrase). If Allbirds signaled the start of a trend of sustainable equity offerings, then these questions will become more pressing and relevant to Main Street investors.

The entire purpose of the sustainability movement in finance is to shed light on longer-term risks that are not traditionally captured by financial metrics. This view is encapsulated in guiding documents such as Larry Fink's

2020 Letter to CEOs.[225] Although ESG ratings providers each adopt idiosyncratic definitions of sustainability and the core meaning of ESG, the basic conceptual conceit behind sustainable investing is to raise awareness of, and to take steps to minimize, this source of negative externalities, thereby unlocking the "true" value of an investment.[226] But if ESG ratings are imprecisely calibrated to reflect companies' actual sustainability performance (or their exposure to long-term risks), then capital cannot be allocated in an optimal manner to address the underlying risks.

Skeptics may view the ESG movement as a passing trend, and thus be inclined to discount the value of expending regulatory energy on a narrow problem such as liability for ESG ratings. Indeed, corporate disclosure issues in U.S. securities law are largely characterized by a self-policing and self-correcting ecosystem – problems are sorted out through an iterative push-and-pull process among gatekeepers, including underwriters, auditors and lawyers, without the need for direct intervention by the SEC.

If ESG investing becomes the new normal, then intermediary businesses like the ESG ratings providers will consolidate their positions, carving out a permanent niche in the financial ecosystem. Regulators would be unwise to overlook this development. The global financial crisis exposed systemic risks attributable to another class of third-party intermediaries: the NRSROs. In that case, while regulators and Congress seized upon the opportunity to enact liability-enhancing rules, their efforts were neutered in what may fairly be characterized as a political lobbying effort. Today, the Gensler-led SEC has already staked out an aggressive position in regulating climate and ESG-related disclosure for issuers and funds – it should look closely at the role played by third-party intermediaries as well. Indeed, it is because ESG purports to address long-term risks that we cannot afford to casually dismiss the potential risks of ESG ratings misuse. Although credit ratings presented a more visceral example of what can go wrong if securities are misjudged on a massive scale (i.e., a widespread financial panic), the most compelling premise of ESG is that the risks are existential. If we recalibrate our perception of what is at stake when ESG ratings are misused on a wide scale, the problem becomes one that must be confronted sooner rather than later.

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[225] *See* BLACKROCK, *Larry Fink's 2020 Letter to CEOs: A Fundamental Reshaping of Finance*, https://www.blackrock.com/corporate/investor-relations/2020-larry-fink-ceo-letter ("[A] company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders.").

[226] There is also the view of ESG that sustainable investing is just about unlocking value. On this view, a company incorporating sustainability into its decision-making and internal controls will provide better returns to investors than one which does not.