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ESG Ratings: Considerations in Advance of Proxy Season

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As companies prepare for the 2023 proxy season, their ESG performance, as evaluated and rated by various third-party ratings providers, is a key focus. With the growing importance of ESG to institutional investors, specialized funds and the general investing public, ESG ratings are an increasingly important investor relations concern. While such ratings may influence investor decision-making throughout the year, for many companies and boards, ESG matters take on heightened importance in advance of annual meetings and related shareholder engagement efforts. As a result, in the lead up to proxy season, many companies contemplate ratings improvement strategies, including proxy statement and other disclosure updates, policy adoptions and governance changes. With the ever-growing variety and complexity of ratings, however, developing effective strategies can be a challenge. Objectives and methodologies vary greatly among ratings providers, and there is often limited comparability (or even significant conflict) between different scores, leaving many companies confounded as to where to begin. Below, we've highlighted a few key considerations and action items to assist companies in taking steps toward improving their ESG ratings ahead of the upcoming proxy season.

Which ESG ratings apply to my company?

Whether your company is subject to a particular ESG rating is generally based on the company's index, size and market. For US-based companies, for example, ISS's Governance QualityScore applies to Russell 3000 and S&P 1500 issuers, and Sustainalytics' ESG Risk Ratings apply to large- and medium-cap issuers. Some ratings providers, including Moody's and Refinitiv, even provide ESG ratings for certain private companies.

To determine which ESG ratings apply to your company, we generally recommend reviewing your ISS and Glass Lewis proxy reports to determine which ESG ratings are included therein, engaging your investors to determine which ESG ratings they use that apply to your company, and reaching out to the ratings providers themselves. In many cases, particularly if your company is in the Russell 3000, ratings providers will proactively contact companies to verify the data underlying their ESG ratings, which often creates a meaningful opportunity to build a relationship upon which to facilitate timely and accurate updates to your rating.

Which ESG ratings will appear in my company's ISS and Glass Lewis proxy reports?

Companies may be particularly concerned with ESG ratings that appear in ISS and Glass Lewis proxy reports, due to their widespread visibility to investors and other stakeholders. The ESG ratings presented in these proxy reports, which are described further below, have no impact on either advisory firm's proxy voting recommendations, but given their prominence in these reports, they often receive marked attention from companies and investors alike. Moreover, even though these ESG ratings do not impact proxy voting recommendations, overlap can exist between the factors underlying the ESG ratings and the proxy voting guidelines linked to each advisory firm's proxy voting recommendations (e.g., a classified board may negatively impact a company's ISS Governance QualityScore and trigger negative recommendations against the company's director nominees). As a result, these ratings can be indicative of present or future ESG issues that could impact proxy voting recommendations. However, before taking steps to improve any ESG rating – including those presented in your proxy reports – we recommend engaging with your investors and other stakeholders to determine whether this particular rating is meaningful to them.

ISS

ISS includes two ESG ratings in its proxy reports – ISS Governance QualityScore and ISS Environmental and Social (E&S) Disclosure QualityScore – both of which are conspicuously placed at the top of proxy reports in bold and color. Companies are invited to review, verify and provide feedback on the data underlying their QualityScores using a complementary data verification tool accessed through **ISS Corporate Solutions' Governance Analytics platform**.

- **ISS Governance QualityScore** measures a company's corporate governance practices across four categories – board structure, compensation, shareholder rights, and audit and risk oversight – and their associated risks relative to the company's index or region. More than 260 factors are analyzed across the coverage universe (approximately 7,300+ companies in 30 markets, including constituents of the S&P 1500 and Russell 3000), of which up to 169 are used for any one company based on its region.
- **ISS E&S Disclosure QualityScore** measures the depth and extent of a company's disclosures regarding the company's understanding of its environmental and social risks, its preparedness to face and mitigate those risks, and its commitment to being held accountable for those risks, relative to peer companies within the company's industry group. More than 380 factors are analyzed across the coverage universe (approximately 5,300+ companies across 24 industry groups in the Americas, European and Australasia regions), of which around 240 are used for any one company based on its industry group. The specific factors under analysis generally reflect several leading disclosure standards and frameworks – including the Global Reporting Initiative (GRI), the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-Related Financial Disclosures (TCFD) – and the factors that are related to these standards are more heavily weighted than other factors.

Glass Lewis

Glass Lewis includes two third-party ESG ratings in its proxy reports – Sustainalytics' ESG Risk Ratings and Arabesque ESG Profile – each of which is placed in the middle of proxy reports. Sustainalytics (owned by Morningstar) sends a draft ESG Risk Ratings report to each company in the coverage universe (approximately 14,000+ companies, covering most major global indices) for feedback on an annual basis.

- **Sustainalytics' ESG Risk Ratings** measure the degree to which a company's economic value is at risk due to ESG factors or, more technically, the magnitude of the company's unmanaged ESG risks. A company's ESG Risk Rating is comprised of a quantitative score and a risk category, where the quantitative score represents the degree of unmanaged ESG risks and the risk category is determined based on such quantitative score. The five risk categories – negligible, low, medium, high and severe – are absolute, meaning that a life sciences company, for example, can be directly compared with an oil company or any other type of company.
- **Arabesque ESG Profile** measures a company's performance on financially material ESG issues and reputational risk across the United Nations Global Compact's core principles. The ESG score is intended to identify "sustainable companies that are better positioned to outperform over the long run" and is claimed to be computed using only "information that significantly helps explain future risk-adjusted performance," while the Global Compact score is intended to provide a "deeper understanding of reputational risk facing a company."

What is the audience for my company's ESG ratings?

Your ESG ratings improvement strategy should account for the fact that ESG ratings target a variety of audiences, including institutional investors, smaller investment funds and social impact investors, as well as the public. Many companies are initially most focused on ESG ratings that appear in their proxy reports or that otherwise have significant public visibility, such as Sustainalytics' ESG Risk Ratings that appear in Morningstar research reports and are shown free of charge on Yahoo Finance. Unsurprisingly, ESG ratings that may be viewed by large numbers of investors, customers, employees and journalists can easily become sources of concern for boards and management teams. Nonetheless, ESG ratings with the most visibility may not necessarily be the most impactful for all companies.

For example, for companies interested in attracting capital from social impact investors, ESG ratings that measure substantive ESG performance from a stakeholder materiality standpoint, such as the ISS Corporate Rating, may be particularly relevant. For companies focused on their inclusion in ESG indices and exchange-traded funds, the more relevant ESG ratings would be those from providers such as MSCI, S&P Global and FTSE Russell, whose ratings form the basis for ESG index construction. Hedge funds and asset managers also rely on a variety of ESG ratings, often including in-house ratings that may draw from multiple ratings or ESG datasets, such as Bloomberg and ESG Book. According to **a recent SquareWell study**, nearly all of the world's 50 largest asset managers use at least one ESG rating in their investment decisions, and more than half use at least four ESG ratings, with the most common being MSCI (92%), Sustainalytics (76%) and ISS (58%).

Given the complexity and the limited correlation of ESG scores across ratings, a one-size-fits-all approach to ESG ratings optimization is likely unavailable to most companies. Instead, before investing in ESG ratings improvement efforts, companies should assess their overall ESG goals and consider which ratings are most relevant to actualizing those goals. As part of such efforts, investor and stakeholder outreach can play a helpful role in assessing which ratings matter most to priority audiences. Often, such engagement reveals surprises, such as funds focused on more niche industry-specific ratings or in-house ratings drawing from data providers heavily reliant on artificial intelligence and alternative data.

What are my company's ESG ratings aiming to measure?

An effective ratings optimization strategy also requires understanding the significant variation in the subject matter ESG ratings are aiming to measure. While certain ESG ratings, such as Sustainalytics' ESG Risk Ratings, aim to measure ESG in a relatively comprehensive manner – including substantive risk related to environmental and social practices in a wide variety of areas, as well as disclosure and governance quality – many others take a narrower approach. For example, ISS QualityScores are focused almost exclusively on the quality of ESG disclosure and governance practices. For such ratings, ESG risks arising from a company's business model are significantly less relevant (if at all) compared to alignment with reporting and governance best practices. Even for ratings focused on substantive performance, there is a split between ratings that attempt to capture the full spectrum of ESG issues and those that focus on more limited subject matter, such as CDP scores, which exclusively measure climate reporting transparency, or industry-specific topics, such as the Good Pharma Scorecard, which is focused on life sciences trial data transparency.

Performance-focused ratings also are divided by different approaches to materiality. On the one hand, ESG ratings such as the ISS Corporate Rating focus on company ESG topics through a stakeholder impact lens, scoring companies based on how their businesses impact third parties, such as employees, vendors and supply chain workers, or how they more broadly impact the environment. Under such ratings, companies would receive negative scores if they have limited labor rights protections in their supplier agreements, have limited product recycling programs or have excessive water use or greenhouse gas (GHG) emissions, regardless of any concrete indication of financial risk arising from such performance. While such a scoring approach may align with popular conceptions of the function of ESG as a measure of good corporate citizenship, some of the most influential ratings for investment funds and ESG indices are defined by a narrower investor impact approach, which looks exclusively at ESG matters that may give rise to company financial risk.

MSCI, for example, **recently stated that its ESG ratings are designed "to measure a company's resilience to financially material [ESG] risks,"** and that they are not a "general measure of corporate 'goodness.'" A **recent Bloomberg study** noted the limited impact of excessive GHG emissions on MSCI scores. While this approach is quite similar to traditional Securities and Exchange Commission (SEC) understandings of materiality, **investor materiality ratings have attracted negative publicity**, reflecting **larger disagreements as to whether ESG ratings should reflect a broadening of the "purpose of the corporation"** or simply an attentiveness to business risks potentially elided by traditional financial reporting. This materiality split is also reflected in the differences between various ESG reporting frameworks and governmental regulations, with some adopting an investor materiality approach (e.g., the TCFD, the International Sustainability Standards Board (ISSB) and current or proposed SEC and UK reporting regulations) and others adopting a double-materiality approach (e.g., the GRI and **European Union Corporate Sustainability Reporting Directive regulations**).

How are my company's ESG ratings measured?

Although there are often **limited score correlations across ESG ratings**, many ratings providers employ a broadly similar industry-focused, "materiality mapping" approach to measuring ESG quality, whereby they identify which ESG factors are most material to particular industries and assign a relative weighting to each such factor for companies included in such industries. Nonetheless, there is significant variation among ratings providers in which ESG factors are selected for measurement, what sources are used to measure those factors and the weights that are assigned to those factors. Further, because a ratings provider's proprietary frameworks are generally industry-specific, high variance in scores can exist across industries within a given ESG rating even where two companies' practices are the same (e.g., if we assume a life sciences company and an oil and gas company have similarly robust human capital practices and disclosure, as well as similarly poor environmental risk management practices and disclosure, the life sciences company will generally have a higher ESG rating than the oil company, as human capital management is generally more heavily weighted for life sciences companies, and environmental risk management is generally more heavily weighted for oil companies).

Given the significant variance in methodologies across ratings providers and industries, adopting a generic "market best practices" ESG approach is generally an inefficient strategy for ratings improvement. From a ratings standpoint, prioritizing improved disclosure and policies on a particular ESG topic should be driven by a substantive understanding of how different topics are measured and weighted, rather than an abstract view of the importance of certain ESG actions. For example, companies with limited manufacturing operations often invest significant resources on environmental reporting, such as GHG emissions or water usage, only to discover that this has limited, if any, impact on their priority ratings. While many ratings providers publish limited information on methodology and weighting, companies can often gain valuable insights by engaging with ratings providers to request reports and undertake data verification exercises.

What data sources are used to establish my company's ESG ratings?

In measuring ESG quality, ratings providers draw upon a variety of data sources: company publications (e.g., SEC public filings, ESG reports and information posted on company websites), private data (e.g., company responses to solicited surveys) or alternative data (e.g., social media and governmental or nongovernmental datasets). Some ratings providers rely exclusively on company publications (e.g., ISS QualityScores) and others pull data from more than one bucket (e.g., ISS ESG Corporate Rating, Sustainalytics' ESG Risk Ratings, MSCI ESG Ratings and Moody's ESG assessments), generally to varying degrees (e.g., MSCI collects, on average, 45% of its data from alternative sources).

Even where ESG ratings do not include alternative data and rely exclusively on company disclosure, substantive scores inevitably are shaped by information and assumptions beyond company control, as ratings providers apply different questions and weightings to individual companies based on assumptions about topics material to their wider industry or individual business model. Understanding the data sources and the assumptions underlying ESG ratings should play an important role in establishing an ESG ratings improvement strategy. In addition to aligning ESG disclosures with subjects heavily weighted in key ratings' methodologies, companies should consider using disclosure to counteract or correct the impact of alternative data or industry assumptions, such as pointing to the lower relevance of certain risk areas to a company's business model. Along with directly engaging with ratings providers to discuss and correct mistaken assumptions about material topics and risks, we also recommend paying greater attention to ESG datasets and the role of alternative data. As with financial reporting, boards and management teams should not assume that company disclosure is the only game in town in driving ESG ratings and broader public and investor perceptions.

First steps

While companies are often frustrated by the baffling heterogeneity of the ESG universe, ESG reporting, at least, is becoming increasingly standardized due to efforts by government regulators (e.g., the SEC and European Commission) and standards boards (e.g., the ISSB) to create more uniform ESG disclosure requirements, in addition to partial market convergence around certain reporting standards, such as the TCFD framework for climate reporting. On the other hand, there is little indication that ESG ratings are undergoing a similar convergence and consolidation; instead, recent years have seen a constant flow of new ratings offerings and often increased opacity from ratings providers on scoring methodologies. As a result, companies hoping to adopt effective ESG ratings improvement strategies will need to take a proactive approach. Besides engaging with investors and other stakeholders to better understand which ESG ratings to prioritize, making sense of the scoring methodologies also generally requires a proactive approach, including engaging with ratings providers directly to request ratings reports, taking advantage of data verification opportunities, and working with outside advisers, such as ESG consultants and law firms.

After having identified key ESG ratings and established an understanding of their scoring methodologies, we suggest working with advisers to develop formal ratings improvement plans. Due to methodological factors discussed above, significant ratings improvement may be possible without fundamental changes to your company's business model, insofar as ratings are often driven more by the quality of disclosure and governance than by substantive environmental or social performance. As a result, you may often work with advisers to identify numerous low-pain areas for improvement, such as the public disclosure of already existing policies and actions, the formalization of policies and principles that align with existing company practice, or improved disclosure on topics that you either already track or can reasonably track with minimal additional investment.

Even where ratings improvement does not require significant operational changes, advanced planning remains critical, as designing and implementing improved ESG policies and disclosure practices (and related internal controls) often requires considerable lead time, not including the time required to have such changes reflected in updated ESG scores. As a result, starting as early as possible on your ESG ratings improvement strategy is strongly advised. Whether you are concerned with annual meetings, attracting ESG-focused capital, avoiding shareholder proposals or simply placating important investors, improvement on relevant ratings will almost always require several months (if not considerably more) of preparation. Even if ESG ratings are not an immediate investor concern (e.g., for many newly public companies) or if your company does not yet meet the criteria for coverage by some ratings (e.g., inclusion in the Russell 3000), these timing considerations mean that adopting a forward-looking ratings optimization plan may often be a wise approach.

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