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S&P to Apply Modeling to Address Missing Company Disclosures For ESG Ratings

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In August 2023, S&P Global announced that it would be changing its approach to its ESG Scores on corporate sustainability performance, citing inconsistent company disclosures. The **"S&P Global ESG Scores Methodology"** is an industry-specific relative score (on a scale of zero to 100) designed to measure a company's performance and management around ESG-related risks, opportunities and impacts.

The primary source of information underlying the Global ESG Scores is S&P Global's Corporate Sustainability Assessment (CSA), which evaluates the sustainability practices of more than 13,000 companies in 62 industries worldwide using industry-specific questionnaires. Participating companies complete the annual CSA by providing data and supporting evidence, including internal documentation. More than 3,000 firms participated in the 2022 CSA.

Before the recent change in methodology, to assess companies that did not participate in the CSA, S&P itself completed the CSA questionnaire using publicly available information, assigning the minimum possible value of zero to questions where the relevant data was not publicly available. Noting limitations associated with this approach, S&P developed modeling designed to emulate the performance-based scoring that could have been applied if reported data were available, although modeling cannot be applied to the more than 40% of the CSA questions that require companies to disclose information publicly in order to score any points.

Taking the Temperature: As S&P notes in its statement announcing the changes to its methodology, sustainability metrics are increasingly a focus for both industry and investors, and more companies are willing (and able) to provide ESG-related information

(as evidenced by the more than 3,000 companies that participated in the most recent CSA). As a result, there continues to be a proliferation of ratings providers. However, there is continuing concern that ESG ratings providers are not consistent in the methodologies that they apply and as a result, the ratings are potentially misleading for investors, as we have highlighted.

Regulators also have taken notice. The UK's financial regulator, the Financial Conduct Authority (FCA), is evaluating the ESG ratings market with a view to bringing ratings within its regulatory purview. The FCA also published a draft code of conduct for ESG ratings providers earlier this year. Also earlier this year, the European Commission adopted a proposed regulation, which was based on 2021 recommendations from the International Organization of Securities Commissioners, aimed at promoting operational integrity and increased transparency in the ESG ratings market through organizational principles and clear rules addressing conflicts of interest. Ratings providers would be authorized and supervised by the European Securities and Markets Authority. The regulation "provides requirements on disclosures around" ratings methodologies and objectives, and "introduces principle-based organizational requirements on" the activities of ratings providers. In July 2023, the Securities and Exchange Board of India formalized regulations governing ESG ratings providers, as we discussed in connection with its consultation on the issue.

A key consideration for ratings is consistency. For example, in May this year, MSCI also announced a change to its ESG Rating Methodology, which resulted in downgrades to 31,000 of the funds rated by MSCI. Methodological changes that have such significant impacts on ratings are likely to amplify calls for regulation, particularly as ratings methodologies remain unclear, the sources of information supporting scores varies, and scores diverge among different providers.