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Investor protection in ESG ratings: A law and economics approach

Promotor: Prof. Dr. Veerle COLAERT
Supervisor: Arnaud VAN CAENEGEM
Corrector: Prof. Dr. Aleksandra KUCZERAWY

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Aline SOENEN
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Abstract

As Environmental, Social, and Governance (ESG) factors become increasingly central to investment decisions, ESG ratings have emerged as critical tools for assessing corporate sustainability. However, these ratings could introduce significant problems due to investors' reliance on third-party providers. This paper investigates the agency costs embedded in ESG ratings from a law and economics perspective, focusing on how these agency costs undermine investor protection. It evaluates the effectiveness of the ESG rating Regulation in addressing these concerns. This analysis applies a dual framework of transparency – operationalized as clarity and comparability – and integrity to assess whether agency costs are effectively addressed in terms of investor protection. The Kaldor Hicks concept will be used to define the effectiveness. The research evidences that while the Regulation improves clarity, it falls short on comparability and integrity. The paper concludes by proposing targeted regulatory enhancements to better align ESG rating practices with the EU's investor protection objectives.

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Introduction

1. TESLA VS. EXXONMOBIL - In 2022, Tesla, a leader in electric vehicle innovation, was removed from the S&P 500 ESGIndex while ExxonMobil, one of the largest integrated fuels, lubricants, and chemical companies in the world, remained on the list. This decision underscores the complexity and subjectivity of ESG ratings. Following the announcement, Elon Musk's critical response on Twitter amplified public scrutiny, leading to a wave of media coverage questioning the logic of excluding a company focused on sustainable transportation while retaining a major oil corporation.¹
2. SOFT LAW - As seen in the example above, ESG ratings have gained significant attention in the last years, driven by the increasing focus on sustainable business practices. Initially, sustainable business practices were primarily guided by soft law. Notably, the adaptation of the UN Guiding Principles on Business and Human Rights (UNPG) providing a framework for both states and companies to prevent, address, and remedy human right abuses in business operations.² Similarly, the OECD Guidelines for Multinational Enterprises on Responsible Business Conduct, originally adopted in 1976 and updated recently in June 2023, provide recommendations to guide multinational enterprises in making positive contributions to economic, environmental, and social progress while minimizing any adverse impacts from the operations, products, or services.³
3. TWO MILESTONES - In 2015, two important milestones were added to the sustainability agenda, with the adoption of the Sustainable Development Goals (SDGs)

¹ J. LYON, *How a sustainability index can keep Exxon but drop Tesla – and 3 ways to fix ESG ratings to meet investors' expectations*, Michigan Ross University, 26 May 2022, <https://michiganross.umich.edu/news/how-sustainability-index-can-keep-exxon-drop-tesla-and-3-ways-fix-esg-ratings-meet-investors>.

² UN Guiding Principles on Business and Human Rights (16 June 2011), United Nations HR/PUB/11/04 (2011); G. CROISANT and R. BARRETT, "The ESG megatrend: an introduction" in D. DE MEULEMEESTER (ed.), *ESG and International Arbitration. Beyond the Acronyms. Reports from the CEPANI Colloquium held on 17 November 2023*, Kluwer, 2023, 9; J. BONNITCHA and R. MCCORQUODALE, "The concept of 'Due Diligence' in the UN guiding Principles on Business and Human Rights: A Rejoinder to John Gerard Ruggie and John F. Sherman, III", *EJIL* 2017, Vol.28 No. 3, 899-900.

³ OECD Guidelines for Multinational Enterprises on Responsible Business Conduct, *OECD* (2023), OECD Publishing, Paris, 10-11 (2023); G. CROISANT and R. BARRETT, "The ESG megatrend: an introduction" in D. DE MEULEMEESTER (ed.), *ESG and International Arbitration. Beyond the Acronyms. Reports from the CEPANI Colloquium held on 17 November 2023*, Kluwer, 2023, 9-10.

and the Paris Climate Agreement. The SDGs, established by the UN General Assembly through its resolution “Transforming our world: the 2030 Agenda for Sustainable Development”, are 17 interlinked objectives, intended to function as a “shared *blueprint for peace and prosperity for people and the planet, now and into the future.*” The second important milestone was the adoption of the Paris Climate Agreement, which had a huge impact on the ‘E’ of ESG. Its goal is to pursue efforts “*to limit the temperature increase to 1.5°C above pre-industrial levels.*”⁴

4. THE NEED FOR A REGULATION - As ESG ratings became central to corporate and financial decision-making, the European Commission introduced in 2018 the Action Plan on Financing Sustainable Growth based on the recommendations of the High-Level Expert group on sustainable finance, which identified the need for regulating ESG rating activities. This led to the adoption of the Regulation on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities designed to improve the credibility and consistency of ESG assessments.⁵
5. ESG RATING AGENCIES - With all these new initiatives ESG ratings are increasingly coming in the spotlights. Policymakers, investors, and corporations are paying close attention to these ratings as they assess the sustainability and ethical impact of businesses worldwide. These developments have also inevitably led to the rise of ESG ratings agencies, as they become a key reference for companies, financial markets, and investors in terms of corporate sustainability assessments.⁶

⁴ G. CROISANT and R. BARRETT, “The ESG megatrend: an introduction” in D. DE MEULEMEESTER (ed.), *ESG and International Arbitration. Beyond the Acronyms. Reports from the CEPANI Colloquium held on 17 November 2023*, Kluwer, 2023, 10.

⁵ ESG rating Regulation; EU High-level expert group on sustainable finance, *Financing a sustainable European economy*, 2018, 5; European Commission, Renewed sustainable finance strategy and implementation of the action plan on financing sustainable growth, 8 March 2018, https://finance.ec.europa.eu/publications/renewed-sustainable-finance-strategy-and-implementation-action-plan-financing-sustainable-growth_en.

⁶ E. ESCRIG-OLMEDO, M.A. FERNANDEZ-IZQUIERDO, I. FERRERO-FERRERO, J.M. RIVERA-LIRIO, and M.J. MUNOZ-TORRES, “Rating the raters: Evaluating how ESG Rating Agencies Integrate Sustainability Principles”, *Sustainability* 2019, 1.

Problem Statement

6. AGENCY COSTS - In recent years, investors have increasingly sought to align their portfolios with sustainability goals, driving significant growth in sustainable finance. In 2025, the total value of global sustainable funds registered \$ 8.6 trillion. While the landscape remains complex, this overall upward trend in the sustainable finance market reflects sustained investor confidence and underscores the enduring resilience of sustainable investment strategies. However, conducting independent sustainability assessments is time-consuming and a resource-intensive process, often requiring access to extensive data and specialized analytical tools. According to Gargantini and Siri, there are compelling reasons to assume strong reliance of investors on Environmental, Social, and Governance (ESG) rating instead of conducting independent sustainability assessments, with as result to delegate their evaluation process.⁷ By outsourcing ESG assessments, investors incur various costs – both direct and indirect.⁸

Almost any contractual relationship in which one party (the “agent”) agrees to perform a task for another (the “principal”) may give rise to an agency problem. This arises because the agent typically possesses more information than the principal about relevant matters, making it difficult – and costly- for the principal to ensure that the agent fulfills the agreement exactly as promised. As a result, the agent may behave opportunistically: delivering a deficient performance or diverting benefits intended for the principal. This reduces the value of the agent’s performance, either directly or indirectly, as the principal may need to invest in expensive monitoring to safeguard their interests. The more complex the agent’s tasks and the greater their discretion, the higher these “agency costs” are likely to be.⁹ These costs can be linked to several challenges found in the literature.

⁷ M. GARGANTINI, and M. SIRI, “Information Intermediaries and Sustainability – ESG ratings and benchmarks in the European Union” in K. ALEXANDER, M. SIRI, AND M. GARGANTINI, (eds), *The Cambridge Handbook of EU Sustainable Finance: Regulation, Supervision and Governance*, Cambridge University Press, 2025, 17-20; Morningstar, *Global Sustainable Fund Flows: Q1 2025 in Review Record-high outflows amid new geopolitical challenges and an intensifying ESG backlash*, 2025, 1.

⁸ A. GIROUD and S. BONILLA-FERET, *World Investment Report 2024: Investment facilitation and digital government - Chapter 3: Sustainable Finance Trends*, 2025, 79.

⁹ R. KRAAKMAN e.a., *The anatomy of corporate law. A comparative and functional approach*, Oxford, OxfordPress, 2017, 22-23.

Renown legal scholars, such as Annunziata and Siri, or Chiu, have structurally analyzed the ESG rating Regulation and critically evaluated its consistency with other EU laws governing information intermediaries. An agency cost analysis of ESG ratings and an evaluation of investor protection is currently missing in the literature.¹⁰ This research will fill that gap.

7. REGULATION - Alongside these concerns, the rapid expansion of sustainable finance has led to an evolving regulatory landscape. In particular, the European Union has introduced several new regulations. The Regulation (EU) 2024/3005, adopted on 27 November 2024, aims at improving the transparency and integrity of ESG rating activities. Nevertheless, it remains unclear whether this regulatory intervention effectively addresses the agency costs associated with investors' reliance on ESG ratings.

¹⁰ F. ANNUNZIATA, and M. SIRI, "The New EU Regulation on ESG Ratings: Fit for Purpose?", x, 2025; I.H.Y. CHIU, Regulating ESG Rating and Data Product Providers: Critically Examining EU Regulation through the Lens of Functional Regulatory Consistency. *European Journal of Risk Regulation* 2024.

Research Question and Methodology

8. THE FOCUS OF THE RESEARCH - This research aims at examining the agency structure behind ESG ratings, focusing on the conceptualization of ESG evaluations as a delegated phenomenon, where investors delegate their evaluation process. While this delegation simplifies decision-making and helps investors to benefit from specific expertise, it also induces agency costs because certain challenges prevent investors as principals to control their ESG rating agency, which could lead to the agent's mistakes and self-seeking conduct going unnoticed. As a result, informed investor decision-making could be distorted, which is at odds with investors protection as a fundamental goal of the EU following the Case C-352/20 *Alapkezelő v Magyar Nemzeti Bank* where the court ruled that the protection of investors is an objective of general interest pursued by the EU. To explore this issue, a Law & Economics framework will be applied to analyze the costs investors incur when they choose to engage ESG rating agencies.¹¹
9. CENTRAL RESEARCH QUESTION - At the core of the research lies the central research question: *Does the ESG rating Regulation effectively address the agency costs associated with ESG ratings in terms of investor protection, and if not, how can the Regulation be improved?* To answer this, the research will have four sub-questions. The research will first analyze the specific agency costs investors encounter when relying on ESG ratings. It will then examine the existing regulatory framework governing ESG ratings, followed by an evaluation whether the Regulation effectively addresses the challenges created by these agency costs. Finally, the research will propose improvements to the Regulation where necessary.
10. THE FIRST SUB - QUESTION - The first sub-question "What are the agency costs of ESG ratings that investors encounter?", will be addressed using a descriptive research method. This analysis involves a comprehensive review of relevant literature, as well as an examination of the current state of ESG ratings by consulting surveys, reports, and legislative proposals. By synthesizing insights from these sources, the research aims to identify and categorize the specific agency costs that investors face when

¹¹ Court of Justice 24 October 2022, Case C-352/20 *Alapkezelő v Magyar Nemzeti Bank*, ECLI:EU:C:2022:606.

relying on ESG rating agencies. Each identified agency cost will be analyzed in detail, focusing on how it constitutes an agency cost and why it arises in the context of ESG ratings. This structured approach will provide a foundation for evaluating regulatory responses in subsequent sections of the research.

11. THE SECOND SUB – QUESTION - The second sub-question “How are ESG ratings regulated?”, will be examined with a descriptive research method. In order to know how ESG ratings are regulated, this research is going to deep dive into the Regulation (EU) 2024/3005 on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities.
12. THE THIRD SUB – QUESTION - For the third sub question “Does the ESG rating Regulation effectively address the agency costs associated with ESG ratings in terms of investor protection?” an evaluative method is used. This question will be answered by assessing whether the Regulation effectively addresses agency costs, as identified in the first section. Investor protection will serve as the evaluative criterion, and to determine whether agency costs are effectively addressed in terms of investor protection the analysis will focus on two key dimensions of investor protection: transparency and integrity.

To effectively evaluate the Regulation’s alignment with investor protection, it is essential to operationalize these two key dimensions of the evaluative criterion. Transparency is a broad concept that can be understood in different ways. In the context of ESG ratings, transparency could encompass two different meanings, namely transparency for more clarity or transparency for more comparability. Clarity refers to the accessibility and comprehensibility of information, ensuring that ESG ratings are presented in a straightforward manner. This allows investors to easily interpret and use the ratings in their decision-making process. Another essential dimension of transparency is comparability, which enables investors to assess ESG ratings across different rating agencies. Comparability regarding ESG ratings is crucial for investors. This is especially the case considering the substantial differences among ESG rating

providers using distinct methodologies in terms of the ESG topics they address, how they prioritize these topics and the metrics employed to assess ESG performance.¹²

Integrity in ESG ratings signifies that the assigned scores accurately reflect the true ESG performance of companies or investment products. It ensures that ratings are methodologically sound, free from conflict of interest and bias, and resistant to manipulation. Integrity functions as a form of quality control, reinforcing the trustworthiness and reliability of ESG ratings.¹³

13. SUB QUESTION 4 – The fourth sub-question “How can the Regulation be improved to effectively address the agency costs associated with ESG ratings in terms of investor protection?”, will be examined through a normative research method. Building on the finding of the previous sub-question, this section will explore potential modifications to the Regulation that could enhance transparency and strengthen integrity. By analyzing the outcomes of the evaluation, the study aims to identify specific improvements that would ensure a more effective framework for investor protection.

14. EFFECTIVENESS - It is also essential to clarify what is meant by “effectiveness”, as the term can be interpreted in various ways. One approach could be to apply the concept of Pareto efficiency to examine whether one of the two dimensions of investor protection can be improved without diminishing the other one. The second approach that could be considered, is the Kaldor Hix-efficiency. It evaluates whether both dimensions of transparency and integrity can be enhanced, even if one experiences a trade-off, provided that the overall benefits outweigh the costs.¹⁴ Since the main research question aims to assess the overall improvement of investor protection – rather than improvements within individual dimensions in isolation – the Kaldor Hicks concept is the most appropriate framework for this research.

¹²C. BALL, “What is transparency?” *Public integrity* 2009, 11(4), 293; IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 26.

¹³ Other definitions of integrity exist – for example the definition in COLAERT, V., “The changing nature of financial regulation: sustainable finance as a new EU policy objective.” *Common Market Law Review* 2022, 59(6), 1674 – 1675. – which share certain elements with the definition used in this research, such as “reliable information” and “trust”. However, a custom definition is better suited to the objectives of integrity within the context of ESG ratings.

¹⁴ B.P. BROWNSTEIN, “Pareto optimality, external benefits and public goods: A subjectivist approach.” *Journal of Libertarian Studies* 1980, 4(1), 93-106.

CHAPTER 1: What are the agency costs of ESG ratings that investors encounter?

SECTION 1. The term ‘ESG rating’

§ 1. Definition

15. DEFINITION – Central to the agency cost analysis is the concept of an “ESG rating”, which is the subject of the delegation from the investor to the ESG rating agency. The concept of ESG rating does not have a universally accepted definition. However, two definitions are particularly prominent in the literature. The first definition is given by the International Organization of Securities Commissions, hereinafter referred to as IOSCO and the second one is cited in the ESG rating Regulation.¹⁵

16. DEFINITION BY IOSCO - IOSCO refers to an ESG rating as “*a broad spectrum of rating 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”*”.¹⁶

17. DEFINITION IN THE REGULATION - On the 27 of November 2024, the ESG rating Regulation was adopted. The Regulation also provides a definition of an ESG rating. The concept of an ESG rating is “*an opinion or a score, or a combination of both, regarding a rated item’s profile or characteristics with regard to environmental, social and human rights, or governance factors, or regarding a rated item’s exposure to risks or impact on environmental, social and human rights, or governance factors, that is based on both an established methodology and a defined ranking system of rating categories, irrespective of whether such ESG rating is labelled as ‘ESG rating’, ‘ESG*

¹⁵ Art. 3, ESG rating Regulation; IOSCO, Environmental, Social and Governance (ESG) Ratings and Data Products Providers- Final report, November 2021, 44.

¹⁶ IOSCO, Environmental, Social and Governance (ESG) Ratings and Data Products Providers- Final report, November 2021, 44.

opinion' or 'ESG score'.” ESG ratings can thus be described as assessments relating to a company or entity's exposure to environmental, social and/or governance factors and their impact on society.¹⁷

The Regulation further elaborates on the notion of ‘opinion’ and ‘score’ used in the definition of an ESG rating. An opinion is described as an *ESG assessment that is based on a rule-based methodology and defined ranking system of rating categories, involving directly a rating analyst in the rating process*. A score is defined as *an ESG measure derived from data, using a rule-based methodology, and based only on a pre-established statistical or algorithmic system or model, without any additional substantial analytical input from a rating analyst*. The inclusion of the term ‘score’ in the European definition helps clarify – compared to the IOSCO definition – that both human and automated assessments fall within its scope.¹⁸

It is noted that IOSCO refers to “environment and society”, while the EU definition includes “environmental, social, human rights, and governance”.¹⁹ For the purpose of this research, however, these elements are all understood under the broader umbrella of ESG, as further explained in §2.

§2. The three ESG factors

18. ENVIRONMENTAL - The 'E' in ESG stands for "Environmental" and broadly, represents protecting nature and humanity. It can refer to the mitigation and adaptation to climate change, but also to the environment in general, such as preserving biodiversity, waste management, preventing pollution and to encourage the circular economy. The environmental part of ESG looks at how a company performs as a steward of its environment. It takes into account the company's use of natural resources and the impact of its activities on the environment. These can include both direct activities as well as activities in the supply chain. The environmental factor can examine

¹⁷ Art. 3, (1), ESG rating Regulation.

¹⁸ Art. 3, (2) and (3), ESG rating Regulation.

¹⁹ Art. 3, ESG rating Regulation; IOSCO, Environmental, Social and Governance (ESG) Ratings and Data Products Providers- Final report, November 2021, 44.

a company's disclosure of environmental data, impact, and efforts to reduce carbon emissions.²⁰

19. SOCIAL - The 'S' stands for 'Social' and refers to the social aspect in ESG ratings. The focus is on people and relations. It can cover issues such as (in-)equality, inclusiveness, labor relations, investment in people and their skills as well as human rights issues. It is a factor that relates mainly to the relationships between a company, suppliers, employees, and people or institutions outside the company. Labor issues also fall under the social aspect. Labor disputes or heavy strikes can have a serious impact on the way a company is perceived.²¹

20. GOVERNANCE - The 'G' stands for 'governance' and covers the governance inside public and private institutions, including management structures, employee relations, shareholders rights, health, safety, and executive compensation. It refers to the decision-making, from policymaking by governments to the distributions of rights and responsibilities between different participants in companies, including the board of directors, managers, shareholders, and all stakeholders in general. An example of an

²⁰ C. DEGREEF, “Het ESG-debat. Stand van zaken vanuit het Europees en Belgisch perspectief”, *NWJ* 2024, afl. 504, 550; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (304); G. SCHAIKO and M. CHRISTIANS, “European Green Deal: de motor richting een duurzame Europese economie”, *MER* 2023, afl. 1, 23; P.R. RAU, and T. YU, “A survey on ESG: investors, institutions and firms”, *China Finance Review International* 2024, Vol. 14 No. 1, 6; P. MATOS, “ESG and responsible institutional investing around the world: A critical review,” *CFA Institute Research Foundation Literature Review* 2020, 2014; R. ECCLES and J. STROEHLE, “Exploring social origins in the construction of ESG measures”, *Oxford University Research Archive* 2018, 9; European Union, “What is sustainable finance?”, https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance_en?prefLang=nl; S&P Global, “Understanding the ‘E’ in ESG”, 23 October 2019, <https://www.spglobal.com/en/research-insights/articles/understanding-the-e-in-esg>.

²¹ European Union, “What is sustainable finance?”, https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance_en?prefLang=nl; C. DEGREEF, “Het ESG-debat. Stand van zaken vanuit het Europees en Belgisch perspectief”, *NWJ* 2024, afl. 504, 550; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (304); G. SCHAIKO and M. CHRISTIANS, “European Green Deal: de motor richting een duurzame Europese economie”, *MER* 2023, afl. 1, 23; P. MATOS, “ESG and responsible institutional investing around the world: A critical review,” *CFA Institute Research Foundation Literature Review* 2020, 2014; R. RAU, and T. YU, “A survey on ESG: investors, institutions and firms”, *China Finance Review International* 2024, Vol. 14 No. 1, 6; S&P Global, “What is the ‘S’ in ESG?”, 24 February 2020, <https://www.spglobal.com/en/research-insights/articles/what-is-the-s-in-esg>.

important governance issue is the demand for better representation of women in the board of directors and in executive positions and equal pay for women.²²

§3. The users and their motivations for ESG ratings

21. INVESTORS AND BENCHMARK ADMINISTRATIONS – ESG ratings serve a variety of stakeholders. The first category of users are the investors and benchmark administrations. They are progressively integrating ESG ratings into their sustainable investment strategies to factor-in risks and/or impacts associated with ESG issues. ESG ratings are often used for pre-investment decision-making (e.g., to inform about a selection of equities to include in a portfolio or a fund), post-investment analytics (e.g., to rate the sustainability of an investment product or fund) or as a basis for investment screening or engaging with companies (where investors, as shareholders, interact with representatives of the company in which they invest to influence management decisions).²³

22. COMPANIES - The second category of users are the companies. They use ESG ratings to identify and consider operational risks and investments opportunities, while also assessing their performance in relation to ESG factors compared to industry peers.²⁴

²² C. DEGREEF, “Het ESG-debat. Stand van zaken vanuit het Europees en Belgisch perspectief”, *NWJ* 2024, afl. 504, 550; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (304); G. SCHAIKO and M. CHRISTIANS, European Green Deal: de motor richting een duurzame Europese economie”, *MER* 2023, afl. 1, 23; P. MATOS, “ESG and responsible institutional investing around the world: A critical review,” *CFA Institute Research Foundation Literature Review* 2020, 2014; R. RAU, and T. YU, “A survey on ESG: investors, institutions and firms”, *China Finance Review International* 2024, Vol. 14 No. 1, 7; European Union, “What is sustainable finance?”, https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance_en?prefLang=nl; S&P Global, “What is the ‘G’ in ESG?”, 24 February 2020, <https://www.spglobal.com/en/research-insights/articles/what-is-the-g-in-esg#:~:text=Highlights,managers%2C%20shareholders%2C%20and%20stakeholders>.

²³ European Commission, *Commission staff working document the impact assessment report Accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 10; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (311); P. MATOS, “ESG and responsible institutional investing around the world: A critical review,” *CFA Institute Research Foundation Literature Review* 2020, 2008.

²⁴ European Commission, *Commission staff working document the impact assessment report Accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 10; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (311);

23. THE USE OF ESG RATINGS - ESG ratings play a key role in informing stakeholders and helping them to make decisions regarding sustainable financial products. The ratings also offer significant advantages for the companies being rated. ESG ratings help to identify potential issues in environmental, social and governance practices at early stage. The possibility to also compare with industry peers promotes the sustainable development. Additionally, companies with strong sustainability performances can gain advantages from these ratings such as a positive signal to shareholders and other stakeholders.²⁵

§4. The providers of ESG-ratings

24. THREE SEGMENTS – Different types of ESG rating providers exist, each with distinct approaches to data collection and analysis. Different authors such as F. Li and A. Polychronopoulos or Ç. Yilmaz and D. Taskin propose to categorize the providers of ESG ratings into a three-tier classification.²⁶

25. FUNDAMENTAL PROVIDERS - The first category of providers are the fundamentals. Fundamental providers focus on publicly available data. They gather information from open sources such as company reports, websites, social media, and non-governmental organizations (NGO's). The collected data is then offered to third parties as a product. Their sole service is data provisions, without assigning ratings to companies. Bloomberg and Refinitiv are examples of fundamental providers.²⁷

²⁵ Proposal (European Commission) for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities, 13 June 2023, 2023/0177, 1 and 15; M. BANKE, S. LINGER and C. POTT, "ESG ratings in the Corporate Reporting of DAX40 Companies in Germany: Effects on Market Participants", *Sustainability* 2022, 9742; R. BOFFO and R. PATALANO, *ESG Investing: practices, progress and challenges*, Paris, 2020, 11; V. COLAERT and A. VAN CAENEGEM, "Duurzaamheid gefinancierd: role en plichten van financiële dienstverleners" in B. AKKERMANS, B. HOOPS, E. VAN DER SIJDE and B. VERHEYE, B. (eds.) *Privaatrecht 2050: De weg naar ecologische duurzaamheid*, Brugge, Die Keure, 2022, 97; European Council, "Environmental, social and governance (ESG) ratings: Council and Parliament reach agreement", 5 February 2024, <https://www.consilium.europa.eu/en/press/press-releases/2024/02/05/environmental-social-and-governance-esg-ratings-council-and-parliament-reach-agreement/>.

²⁶ C. YILMAZ, and D. TASKIN, "ESG Ratings: An evolution and discussion" in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development*. Palgrave Studies in Impact Finance, Rome, Palgrave Macmillan, 2024, 303 (312); V. D'AMATO, R. D'ECCLESIA and S. LEVANTESI, "Fundamental ratios as predictors of ESG scores: a machine learning approach." *Decisions Econ Finan* 2021,1096; F. LI and A. POLYCHRONOPOULOS, "What a difference an ESG rating provider makes!", *Research Affiliates* 2020,4-5.

²⁷ Ibid.

26. SPECIALIST PROVIDERS - The second category of providers are the specialists. Specialist providers possess expertise in specific ESG areas. They concentrate on thematic data, such as carbon emissions, human rights, or gender equality, among other focused aspects. In this category TruCost (now owned by S&P Global), the nonprofit Carbon Disclosure Project (CDP), and Equileap (gender equality data) are good examples.²⁸

27. COMPREHENSIVE PROVIDERS - The last category of providers are the comprehensives. The comprehensive providers combine available data with subjective data generated through their own analysis, including direct interviews or questionnaires with companies. They create internal rating methodologies by blending both objective and subjective information. This category corresponds to the majority of the providers. MSCI, Sustainalytics, Vigeo Eiris, ISS, TruValue Labs, and RepRisk are examples of comprehensive providers.²⁹

§5. The importance of ESG-ratings

28. TWO PERSPECTIVES - From a broad perspective, the ESG analysis done by investors is vital because the world's resources are limited, and humanity faces significant inequalities across genders, cultures, and nations. All these factors are issues that ESG focuses on, recognizing that ESG factors not only influence a company profitability but also contribute to societal progress. By promoting responsible actions, ESG helps bridge gaps between different segments of society. As investor priorities shift toward building a more sustainable world ESG factors have become increasingly important for companies. This significance can be analysed through two primary lenses: the perspective of external stakeholders and on the other hand the financial considerations.³⁰

²⁸ Ibid.

²⁹ Ibid.

³⁰ C. YILMAZ, and D. TASKIN, "ESG Ratings: An evolution and discussion" in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (309).

a. The third-party (external stakeholders) perspective

29. THE INVESTORS - Investors increasingly demand transparency regarding a company's ESG initiatives. They seek detailed information about ESG risk mitigation strategies, and preparedness for potential challenges. Such transparency enables investors to evaluate these factors effectively and decide whether they align with their risk tolerance and sustainability goals.³¹
30. THE CONSUMERS - Modern consumers value sustainability and are drawn to companies with compelling ESG narratives. They expect businesses to demonstrate efforts toward environmental conservation and responsible resource use. Companies that prioritise ESG can attract more consumers, foster stronger community relationships, and support sustainable growth.³²
31. THE EMPLOYEES - ESG-oriented organizations are appealing for talented professionals and help retain skilled employees. A purpose-driven workplace can enhance employee motivation and, in turn, boost overall productivity.³³

b. The financial perspective

32. In many circles, ESG is promoted not only as beneficial for society but also advantageous for companies and investors. However, one might question whether the enthusiasm surrounding ESG has significantly outpaced the reality of what it truly is and what it can deliver. This section will illustrate how interpretations of the financial

³¹ B.J. LEITE and V.B. UYSAL, "Does ESG matter to investors? ESG scores and the stock price response to new information." *Global Finance Journal* 2023, 57, 1-2; C. YILMAZ, and D. TASKIN, "ESG Ratings: An evolution and discussion" in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (309); P. MATOS, "ESG and responsible institutional investing around the world: A critical review," *CFA Institute Research Foundation Literature Review* 2020, 2010.

³² C. YILMAZ, and D. TASKIN, "ESG Ratings: An evolution and discussion" in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (310).

³³ C. YILMAZ, and D. TASKIN, "ESG Ratings: An evolution and discussion" in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (310); L. LIU and N. NEMOTO, "Environmental, Social and Governance (ESG) Evaluation and Organizational Attractiveness to Prospective Employees: Evidence from Japan", *Journal of Accounting and Finance* 2021, Vol. 21(4), 1.

perspective on ESG ratings may vary, with different scholars offering nuanced perspectives.

33. A HIGHER INVESTMENT RETURN – The Morgan Stanley report of 2023 highlighted that sustainability-focused funds have shown to achieve better long-term returns compared to traditional funds. In the first half of 2023, sustainable funds achieved a median return of 6.9%, outperforming traditional funds, which posted a 3.8% return. This marks a reversal of their underperformance in 2022, according to the latest *Sustainable Reality* report from the Morgan Stanley Institute for Sustainable Investing. These funds can benefit from more strategic capital allocation, reduced operational costs, and lower energy and water usage of the companies in which they invest.³⁴

However, recent events could change this view. The latest Covid-crisis and the Russia-Ukraine conflict triggered the most significant surge in natural gas prices seen in the past decade. This abrupt shock disrupted the business models of many European companies, squeezing profit margins and shifting corporate priorities. Geopolitical events like this can dramatically influence fossil fuel prices, which in return affect the valuation of publicly listed firms.³⁵

The war's impact on the ecological transition remains uncertain. On the one hand, the conflict could delay progress by increasing reliance on traditional energy sources. On the other hand, it might accelerate the transition by prompting countries to invest in independent, cleaner, and more sustainable energy systems. This uncertainty has important implications for how gas rationing might influence stock market returns.³⁶

Depending on how the green transition evolves, firms that have invested heavily in environmentally friendly technologies may either gain a competitive edge or face

³⁴ C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (310); The Morgan Stanley Report, *Sustainable Funds Beating Peers in 2023*, 17 August 2023.

³⁵ C. GIRARDONE and O. RICCI, “Emerging Issues in Banking”, *Review of Corporate Finance*, 2023, 32.

³⁶ Ibid.

higher costs. The question can then be raised whether European firms experienced lower financial returns following gas rationing announcements and if the ESG performance influences the reaction to these announcements.³⁷

The study of O. Ricci, G. Santilli, G. Scardozzi, F. Saverio Stentella Lopes (2024) indicates that companies with high ESG scores were less negatively affected by gas rationing during the Russia-Ukraine conflict. This resilience is largely attributed to the environmental dimension of the ESG score. Furthermore, efficient use of fossil resources appears to cushion the impact of geopolitical risks on stock prices. Nonetheless, other authors such as M. Deng, L. Leippold, A.F. Wagner, and Q. Wang highlighted that the Russia-Ukraine crisis may slow down the ecological transition.³⁸

34. PERFORMANCE ON THE STOCK MARKET, CAPITAL COSTS AND PROFITS -

Various studies have explored the financial implications of investing in companies with strong ESG ratings, producing a range of results regarding the performance on the stock market, the capital costs, and the profits. On the one hand, many findings have highlighted a positive correlation. Different research indicates that ESG-focused companies often outperform in the stock market. Their enhanced risk management and innovative practices make them safer and more attractive in the long term. Higher ESG ratings are also linked to reduced capital costs for firms. By building a positive reputation, expanding their investor base, and minimizing risk, sustainable firms position themselves to better navigate through future challenges. Moreover, studies from Bain&Company and EcoVadis reveal that ESG-compliant and diverse firms achieve 3-4% higher profit margins compared to their peers. Factors such as gender diversity in executive roles, renewable energy use, ethical labour practices, and employee's satisfaction could contribute significantly to financial success.³⁹

³⁷ Ibid.

³⁸ C. GIRARDONE and O. RICCI, "Emerging Issues in Banking", *Review of Corporate Finance*, 2023, 32; M. DENG, M. LEIPPOLD, A.F. WAGNER, and Q. WANG, "Stock prices and the Russia-Ukraine war: sanctions, energy and ESG.", *Discussion paper series*, 2022, 20-21; O. RICCI, G. SANTILLI, G. SCARDOZZI, and F.S.S. LOPES, "ESG resilience in conflictual times." *Research in International Business and Finance* 2024, vol. 71, p.102411.

³⁹ C. YILMAZ, and D. TASKIN, "ESG Ratings: An evolution and discussion" in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (310); Ecovadis, "ESG activities correlate to stronger financial performance, reveals new study from Bain&Company and Ecovadis", April 2023; T. WHELAN, U.

On the other hand, scholars like B. Cornell and A. Damodaram argue that the financial case for ESG investments is not always compelling. Their research suggests that while socially responsible firms may enjoy lower discounts rates – reflecting reduced risk – this also implies lower expected returns for investors. The evidence supporting the idea that ESG-oriented firms consistently achieve higher profits or faster growth is relatively weak. While some companies do benefit from sustainable practices, others may incur significant costs without realizing corresponding advantages. Furthermore, the notion that ESG-focused investing delivers consistent excess returns is not strongly supported. In line with broader finding in the active investing literature there is little evidence that active ESG strategies outperform passive ESG approaches.⁴⁰ Edmans et al suggest that a reason for mixed academic evidence could be that academic studies rely on ESG ratings which could be a flawed proxy for environmental and social performance.⁴¹

SECTION 2. How did ESG ratings emerge?

35. CSR AS PRECURSOR - Back in the late 1970's, we can already find the first signs of organizations providing data on the impact of organizations on the environment, social and governance factors. They offered a wide variety ranging from overall rating scores to ratings on specific issues or providing tools for the evaluation of companies' performances. The first sustainability issues then entered the capital markets, often driven by NGO's which were seeking to inform investors about companies' involvement in controversial issues such as nuclear weapon development or Apartheid in South-Africa.⁴² However, before the term 'ESG' came onto the scene as known today, the term Corporate social responsibility (CSR) was more often used. CSR can be seen as the 'precursor' of the concept of ESG. CSR emerged as the leading term

ATZ, T. VAN HOLT and C. CLARK, "ESG and Financial Performance: Uncovering Evidence from 1.000 Plus Studies Published between 2015-2020", *NYU Stern Center for Sustainable Business* 2021,10.

⁴⁰ B. CORNELL, and A. DAMODARAN, "Valuing ESG: Doing good or sounding good?" *NYU Stern School of Business* 2020, 22-23.

⁴¹ A. EDMANS, T. GOSLING, D. JENTER, "Sustainable Investing: Evidence from the Field", HKU Jockey Club Enterprise Sustainability Global Research Institute - Archive, European Corporate Governance Institute – Finance Working Paper No. 1028/2024, September 20, 2024, 47.

⁴² F. BERG, J. KÖLBEL, and R. RIGOBON, "Aggregate Confusion: The divergence of ESG ratings", *Review of Finance* 2022, 5; R. ECCLES and J. STROEHLE, "Exploring social origins in the construction of ESG measures", *Oxford University Research Archive* 2018, 3-4.

associated with sustainable business practices during the 2000s and the 2010s. It is based on the idea that a company's responsibility goes beyond generating economic profit to include a broader impact on society. The focus has initially been on limiting the negative impacts of the businesses' activities, before extending it to the creation of positive outcomes as well.⁴³

36. ESG NOW AS A PREDOMINANT TERM – In contrast to the 2010s, ESG has overtaken CSR as the predominant term for describing current trends in sustainable business. It encompasses a broader set of environmental, social, and governance factors, offering a more comprehensive view of a business's sustainability risks and impacts. With its detailed framework, ESG also enables a more quantifiable assessment of these risks and impacts. The demand for ESG ratings is expected to grow substantially in the coming years. This demand is also driven by the changing nature of risks for companies, by growing investor awareness of the financial implications of those risks and by the growth in investment products that explicitly meet certain sustainability standards.⁴⁴

SECTION 3. What are the challenges of ESG ratings?

37. AN OVERARCHING PROBLEM - Unlike corporate disclosure of financial information, which is well defined by national and international accounting standards, disclosure of non-financial data, such as environmental, social and governance (ESG) information, remains unorganized, with no accepted standards to refer to. Nevertheless, demand for companies' non-financial information is rapidly increasing, especially as a source of information for what is referred to as responsible investments, impact investing or ESG investing. An ever-growing number of NGOs and commercial data providers setting ESG standards are trying to meet this demand by addressing the information asymmetry on non-financial issues between companies and investors by

⁴³ G. CROISANT and R. BARRETT, "The ESG megatrend: an introduction" in D. DE MEULEMEESTER (ed.), *ESG and International Arbitration. Beyond the Acronyms. Reports from the CEPANI Colloquium held on 17 November 2023*, Kluwer, 2023, 8.

⁴⁴ G. CROISANT and R. BARRETT, "The ESG megatrend: an introduction" in D. DE MEULEMEESTER (ed.), *ESG and International Arbitration. Beyond the Acronyms. Reports from the CEPANI Colloquium held on 17 November 2023*, Kluwer, 2023, 9; R. BOFFO and R. PATALANO, *ESG Investing: practices, progress and challenges*, Paris, 2020, 11; R. ECCLES and J. STROEHLE, "Exploring social origins in the construction of ESG measures", *Oxford University Research Archive* 2018, 2.

providing reliable information and creating ratings. And although some organizations have been established with the explicit aim of standardizing non-financial reports, most ESG metrics are very diverse in application and in terms of indicators measured, as well as in the weight given to a particular rating. Thus, there is a wide gap between the attempts to set standards and the data actually provided. In addition, different data providers may have different assessments of a companies' non-financial performance. This is also partly due to the difficulty of capturing vague concepts such as "sustainability". Such differences have a big impact because they lead to significantly different ratings and associated recommendations, creating a confusing cluster of data that can overwhelm or even misinform investors. Furthermore, it can undermine the credibility of companies' ESG disclosures.⁴⁵

38. THE CHALLENGES – ESG ratings face several challenges that could undermine the transparency and the integrity of ESG ratings. The five most pressing challenges are non-transparency, the conflicts of interest and inherent biases, as well as problems with data quality, methodological issues, greenwashing and conceptual issues. If investors cannot control their rating, they will hesitate to rely on it, incurring additional costs.

§1. Non-transparency

39. AN OVERARCHING CHALLENGE – The first challenge with ESG ratings is the lack of transparency relating to the characteristics and methodologies of ESG rating provider. This transparency issue can be regarded as an overarching challenge that underpins and exacerbates many other difficulties within the ESG rating landscape. Many organizations, such as the European Commission and IOSCO, have highlighted the deficiency in transparency regarding the methodologies used, which encompasses elements like the quality of the underlying data, definitions of materiality, the timing of

⁴⁵ European Commission, *Commission staff working document the impact assessment report Accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 8; M. GARGANTINI, and M. SIRI, "Information Intermediaries and Sustainability – ESG ratings and benchmarks in the European Union" in K. ALEXANDER, M. SIRI, AND M. GARGANTINI, (eds), *The Cambridge Handbook of EU Sustainable Finance: Regulation, Supervision and Governance*, Cambridge University Press, 2025 2; R. ECCLES and J. STROEHLE, "Exploring social origins in the construction of ESG measures", *Oxford University Research Archive* 2018, 1-2.

data collection, and the frequency of the review or update of the ESG ratings. As a result, ESG ratings fail to fulfill their intended function, lacking the capability of adequately inform users, investors, and rated companies in making well-informed decisions regarding ESG-related risks, impacts and opportunities. Investors either hesitate to rely on these ratings or find it necessary to obtain additional information to validate the assessments provided by ESG rating agencies through additional in-house ratings.⁴⁶

40. BLACK BOX - A common criticism is that the evaluation criteria, the methods of data collection, the definitions used, and the weighting given for each E, S and G factor of ESG ratings are considered to be a ‘black box’, whilst it should be transparent. This opacity stems in part from the fact that ESG rating agencies consider their models as confidential to the extent that they are considered to be intellectual property developed by ESG rating agencies. Consequently, the clarity about what they do and how they do it is missing.⁴⁷

§2. Conflicts of interest and biases

a. Conflicts of interest

41. FOUR POTENTIAL CONFLICTS OF INTEREST – The study commissioned by the European Commission, led by the Directorate-General for Financial Stability, Financial Services and Capital Markets Union, identified the lack of clarity about, and control on

⁴⁶ European Commission, *Commission staff working document the impact assessment report Accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 9; ESMA, *Outcome of ESMA Call for Evidence on Market Characteristics of ESG rating and Data Providers in the EU*, 24 June 2022, ESMA 22-328-603, 3; IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 1, 14 and 26; E. ESCRIG-OLMEDO, M.A. FERNANDEZ-IZQUIERDO, I. FERRERO-FERRERO, J.M. RIVERA-LIRIO, and M.J. MUNOZ-TORRES, “Rating the raters: Evaluating how ESG Rating Agencies Integrate Sustainability Principles”, *Sustainability* 2019, 7; M. GARGANTINI, and M. SIRI, “Information Intermediaries and Sustainability – ESG ratings and benchmarks in the European Union” in K. ALEXANDER, M. SIRI, AND M. GARGANTINI, (eds), *The Cambridge Handbook of EU Sustainable Finance: Regulation, Supervision and Governance*, Cambridge University Press, 2025, 4.

⁴⁷ European Commission, *Commission staff working document the impact assessment report accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 22; IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 26; S. ABHAYAWANSA and S. TYAGI, “Sustainable investing: The black box of environmental, social and governance (ESG) ratings”, *Journal of Wealth Management* 2021, 4.

the operations of ESG rating providers constitutes a problem driver in the current ESG rating market. One of the primary concerns surrounding this matter addresses potential conflicts of interest. The study pointed out four primary conflicts of interest relating to ownership, product mix, separation of commercial and analytical teams, and methodology governance.⁴⁸

42. OWNERSHIP – The study highlights a conflict of interest when the rating provider is not considered as independent from the companies that are evaluated. For instance, if the parent company of the rating provider possesses a portfolio of other companies rated by the same provider, there is a perception that it could influence the rating process. Additionally, this issue extends to “sister firms” of ESG rating providers, which may receive more favorable ratings from the affiliated ESG rating providers compared to the assessments provided by independent firms.⁴⁹

43. MIX OF PRODUCTS AND SERVICES OFFERED – Certain ESG rating providers assess companies while simultaneously offering paid advisory or consulting services to the same companies, either directly or through third-party recommendations. These practices are viewed by both the companies and the investors as a significant potential conflict of interest and may create restraints towards companies willing to pay for such services. There is a concern that these situations could lead to perverse incentives, such as initially assigning lower ratings and then substantially improving them after the advisory services are called-upon. Additionally, some ESG rating providers charge companies which have been rated, to access their own reports, further fostering a

⁴⁸ European Commission, *Commission staff working document the impact assessment report accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 20; European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 68 and 169; IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 31.

⁴⁹ European Commission, *Commission staff working document the impact assessment report accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 20; European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 68 and 169; IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 31; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (350).

perception of bias toward companies with the financial means to engage in such transactions.⁵⁰

44. SEPARATION OF COMMERCIAL AND ANALYTICAL TEAMS – The study concluded that providers offering multiple products (such as ESG ratings, ESG data, and ESG benchmarks) may need to implement a heightened and appropriate separation between departments to mitigate potential conflicts of interest. While most ESG rating providers have implemented some rules regarding departmental separation, there is limited and unclear information on the effectiveness of such measures and whether they implement a “Chinese wall”, a business term describing a virtual barrier intended to prevent the exchange of information between departments. Additionally, there is a concern that conflicts of interest may arise if teams responsible for product and service provision are susceptible to be influenced by teams within the commercial part of the business.⁵¹

45. METHODOLOGY GOVERNANCE – The fourth potential conflict of interest could emerge if an ESG rating provider fails to establish processes ensuring that the methodology is consistently applied and that analysts are not swayed by outside parties.⁵²

⁵⁰ European Commission, *Commission staff working document the impact assessment report accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 20-21; European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 68-69 and 169; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (350); E. ESCRIG-OLMEDO, M.J. MUNOZ-TORRES and M.A. FERNANDEZ-IZQUIERDO, “Socially responsible investing: Sustainability indices, ESG rating and information provider agencies”, *Int. J. Sustain. Econ.* 2010, 2, 456.

⁵¹ European Commission, *Commission staff working document the impact assessment report accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 21; European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 69 and 169.

⁵² European Commission, *Commission staff working document the impact assessment report accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 21; European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 69-70; R. BOFFO AND R. PATALANO, *ESG Investing: practices, progress and challenges*, Paris, 2020, 40.

b. Biases

46. FIVE POTENTIAL BIASES – In the survey conducted for the Study on Sustainability-related Ratings, Data, and Research, five potential categories of biases have been disclosed. The three most prominent biases are the company-size bias, the geographical bias, and the industry bias. Next to these three biases, there are also two less prominent biases, namely the company engagement bias and the language bias.⁵³

47. COMPANY SIZE BIAS – Bigger enterprises tend to score higher in the ESG ratings than mid-sized and small companies. This bias is mainly based on larger companies having more financial means to prepare and disclose more sustainable-related information than small companies. Larger companies can often count on in-house sustainability teams and have the resources to finance those teams to develop targeted sustainability-related disclosures.⁵⁴

48. GEOGRAPHIC BIAS – When looking at the average, European-based companies receive higher sustainability-related ratings than peers headquartered in other parts of the world. This bias could be explained by the fact that the European Union requires companies with more than 500 employees to publish a non-financial statement. This requirement is not imposed in the other parts of the world.⁵⁵

⁵³ European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 108-109; R. RAU, and T. YU, "A survey on ESG: investors, institutions and firms", *China Finance Review International* 2024, Vol. 14 No. 1, 9.

⁵⁴ European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 109-111; P. MATOS, "ESG and responsible institutional investing around the world: A critical review," *CFA Institute Research Foundation Literature Review* 2020, 2007-2008; R. BOFFO AND R. PATALANO, *ESG Investing: practices, progress and challenges*, Paris, 2020, 36 and 64; R. ECCLES and J. STROEHLE, "Exploring social origins in the construction of ESG measures", *Oxford University Research Archive* 2018, 5; R. RAU, and T. YU, "A survey on ESG: investors, institutions and firms", *China Finance Review International* 2024, Vol. 14 No. 1, 9; S. ABHAYAWANSA and S. TYAGI, "Sustainable investing: The black box of environmental, social and governance (ESG) ratings", *Journal of Wealth Management* 2021, 5; S. DREMPETIC, C. KLEIN, B. ZWERGEL, "The influence of Firm Size on the ESG score: Corporate Sustainability Ratings Under Review", *Journal of Business Ethics* 2020, 333-360; T. DOYLE, "Ratings that don't rate: The subjective world of ESG ratings agencies", *Harvard Law School Forum on Corporate Governance*, <https://corpgov.law.harvard.edu/2018/08/07/ratings-that-dont-rate-the-subjective-world-of-esg-ratings-agencies/>.

⁵⁵ European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 112-113; P. MATOS, "ESG and responsible institutional investing around the world: A critical review," *CFA Institute Research Foundation Literature Review* 2020, 2007; R. ECCLES and J. STROEHLE, "Exploring social origins in the construction of ESG measures", *Oxford University Research Archive* 2018, 5; R. RAU, and T. YU, "A survey on ESG: investors, institutions and firms", *China Finance Review*

49. INDUSTRY SECTOR BIAS – Most sustainability ratings are adjusted according to industry standards to reflect variations in material importance across sectors. However, this approach may lead to a biased rating based solely on its industry rather than considering its specific risks. The assumption that all companies in an industry face identical risks oversimplifies the assessment process, as each company has its own risk profile that is shaped by its unique business model. This approach may lead to an industry bias, causing companies to be inaccurately underrepresented or overrepresented in sustainability ratings as providers attempt to standardize ratings specific to each industry. Moreover, investors who use these ‘normalized’ ratings may fail to recognize the inherent bias present in the industry-wide ratings.⁵⁶

50. COMPANY ENGAGEMENT BIAS AND THE LANGUAGE BIAS – The possibility for the company engagement bias arises when ESG rating providers interact with companies during the rating process for verification purposes. The survey also highlighted a last bias, namely the language bias. ESG rating providers tend to unfairly prioritize companies that report in English over those that solely report in local languages. This discrepancy occurs particularly when the assessment process disregards reportings, sources, and data provided in local languages.⁵⁷

§3. Data issues

51. NUMEROUS ISSUES – ESG data have become a cornerstone of responsible investing, offering insights not typically found in standard financial statements but considered material from an environmental, social and governance perspective. Initially,

International 2024, Vol. 14 No. 1, 9; S. ABHAYAWANSA and S. TYAGI, “Sustainable investing: The black box of environmental, social and governance (ESG) ratings”, *Journal of Wealth Management* 2021, 5; T. DOYLE, “Ratings that don’t rate: The subjective world of ESG ratings agencies”, *Harvard Law School Forum on Corporate Governance*, <https://corpgov.law.harvard.edu/2018/08/07/ratings-that-dont-rate-the-subjective-world-of-esg-ratings-agencies/>.

⁵⁶ European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 113-114; R. RAU, and T. YU, “A survey on ESG: investors, institutions and firms”, *China Finance Review International* 2024, Vol. 14 No. 1, 9; T. DOYLE, “Ratings that don’t rate: The subjective world of ESG ratings agencies”, *Harvard Law School Forum on Corporate Governance*, <https://corpgov.law.harvard.edu/2018/08/07/ratings-that-dont-rate-the-subjective-world-of-esg-ratings-agencies/>.

⁵⁷ European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 114.

independent ESG data providers catered to a niche group of institutional investors. However, in response to growing investor demand and increased data availability, ESG information is now widely accessible, appearing on financial platforms like Bloomberg and across various websites. The data offers a valuable snapshot of a company's performance on a range of ESG issues. Yet, the rapid expansion in ESG data availability has also raised concerns about its quality. This can be seen as another challenge that ESG-ratings can encounter. The literature states different types of problems that could be experienced such as self-reporting data concerns, a variety of sources, different types of ESG data processing, noisy data, data gaps and assumptions, limitations of imputations in ESG data and incomparable reporting standards.⁵⁸

52. SELF-REPORTING DATA CONCERNS - Companies collect and report their own data, which is often unaudited and inconsistent, creating challenges of comparability. To provide more context, Sakis Kotsantonis and George Serafeim selected a random sample of 50 large, publicly listed Fortune 500 companies from various sectors. For each company, data on Employee Health and Safety reporting was manually collected from their most recent sustainability reports. The research reveals that the companies used over 20 different approaches to report Employee Health and Safety data, varying in terminology and, most notably, units of measurements. This inconsistency presents a significant challenge for comparing companies. Since these metrics do not necessarily measure the same aspect of Employee Health and Safety, identifying top performance is not straightforward. To illustrate this point, multiple distributions could be used instead of one and those distributions might not be comparable. This raised critical questions such as which metric best reflects strong Employee Health and Safety performance? If multiple metrics are relevant, how should they be aggregated to assess a company's overall performance? Should equal weight be given to all measures, or should factors such as injury rates carry more significance than the total number of accidents?⁵⁹

⁵⁸ P. MATOS, "ESG and responsible institutional investing around the world: A critical review," *CFA Institute Research Foundation Literature Review* 2020, 2007.

⁵⁹ C. YILMAZ, and D. TASKIN, "ESG Ratings: An evolution and discussion" in A.I., HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 347; S. KOTSANTONIS AND G. SERAFEIM, "Four Things No One Will Tell You About ESG Data" *Journal of Applied Corporate Finance* 2019, 54-55.

53. NON - RELIABILITY – A measure is considered to be reliable if it consistently produces the same results when applied multiple times. While this concept may seem straightforward, it is not guaranteed for many non-financial performance metrics. For instance, when a questionnaire is completed at different times, by different individuals, or in various divisions of the same company, the answers can differ significantly, making the data inconsistent. Moreover, many non-financial performance surveys encompass diverse topics, making it unlikely that any single individual within an organization possesses all the necessary information to answer comprehensively. As a result, the accuracy of survey responses often depends on the organization's ability to consolidate information from multiple sources.

Research by B. Gerhart, G. McMahan and S. Snell highlights the issue, showing that when two respondents from the same organization describe their workplace, their answers regarding a seemingly straightforward question like, “Do applicants for the job take formal tests (paper and pencil or work sample) before being hired?”, the correlation between the two responses was just 0.38 – a rather weak result.

The challenges are even greater when measuring complex topics such as human rights, equal opportunity, or environmental hazards. Unlike describing the presence of an employment test, these areas often rely on a single correspondent from each organization, making reliability even harder to achieve.

Unreliable measures can lead to serious consequences. Poor performers might misuse them to claim improvements in critical areas, and stakeholders may misinterpret the data when evaluating a company. Therefore, ensuring the reliability of non-financial performance metrics is essential to prevent such issues and maintain the integrity of organizational assessments.⁶⁰

⁶⁰ A. CHATTERJI and D. LEVINE, “Breaking down the wall of codes: evaluating non-financial measurements”, *Calif. Manage Rev* 2006, 48, 5-6.

54. COMPARISON WITH OTHER SECTORS FOR RELIABILITY– An examination of other industries in which ratings – defined as opinions provided by different evaluators – play a significant role offers valuable insights into the reliability and agreement of such assessments.

In the credit rating industry, the study from Charlin and Cifuentes (2017) reported that the reliability of credit ratings was approximately 0.90, while agreement, measured using a seven-category scale, ranged between 0.62 and 0.78. These figures indicate a relatively high level of consistency and concurrence among credit rating agencies.⁶¹

Another study, from Asthon (2012), provides a comparative analysis of rating reliability across various disciplines. The finding indicate that the average reliability of wine ratings was approximately 0.50, with an agreement level of only 0.34. In contrast, other disciplines such as meteorology, business, auditing, personnel management, medicine, and clinical psychology exhibited reliability levels ranging from 0.70 to 0.91, with agreement levels fluctuating between 0.49 and 0.75. These findings underscore significant variations in rating consistency across different fields.

Against this backdrop, the reliability and agreement of ESG ratings appear particularly concerning. ESG ratings demonstrate an average reliability of just 18.3% and an agreement level of only 5.4 %, figures that fall significantly below those observed in other sectors, including the wine sector. Charlin et al. indicate that this lack of reliability and agreement is not unexpected, given that the ESG ratings' landscape still has to establish a clear link or causal relationship between specific ESG factors and measurable financial performance metrics.⁶²

⁶¹ *Credit Rating Agencies (CRA's) offer services that consist of assessing the creditworthiness of a debtor or of a financial obligation, quantified through a system of symbols that ranks the result of the evaluation.* (D. CASH, "Sustainability Rating Agencies vs Credit rating agencies" in M. La Torre (ed), *Palgrave Studies in impact finance*, Rome, Palgrave Macmillan, 65.)

⁶² R. ASHTON, "Reliability and Consensus of Experienced Wine Judges: Expertise Within and Between." *Journal of Wine Economics* 2012, 7 (1): 70–87; V. CHARLIN, A. CIFUENTES AND J. ALFARO, "ESG ratings: an industry in need of a major overhaul." *Journal of Sustainable Finance & Investment* 2022, 14(4), 1050–1051; V. CHARLIN AND A. CIFUENTES, "Reliability and Agreement of Credit Ratings in the Mexican Fixed-Income Market." *Journal of Credit Risk* 2017, 13 (3): 21–45.

55. VARIETY OF SOURCES – The collection of ESG data varies across providers, as each employs distinct methodologies that integrate information from multiple sources. These sources typically include publicly disclosed corporate reports, third-party publications such as those from press agencies and non-governmental organizations, and other publicly available datasets. Additionally, some providers gather data through direct engagement with assessed companies via questionnaires, while others rely on third-party suppliers who produce or compile data through subscriptions or strategic partnerships. The diversity in data collection methods contributes to inconsistencies in data quality, availability, and comparability across ESG assessments.⁶³

56. TYPES OF ESG DATA PROCESSING – ESG data can undergo various processing acts before being used for analysis. It may be presented in its raw form as initially collected, aggregated from multiple sources, or processed to enhance usability through data cleaning techniques.⁶⁴

57. NOISY DATA – Another challenge is the problem of accurately measuring ESG performance. In 2022, the study of Florian Berg, Julian F. Kölbel, Anna Pavlova, and Roberto Rigobon showed that the primary source of this disagreement lies in the differences in measurement, indicating that ESG attributes are assessed imperfectly. In other words, the available measures of ESG ratings are noisy which leads to variations in ratings across different agencies.⁶⁵

58. DATA GAPS AND ASSUMPTIONS – Even when data is disclosed, assessing what constitutes strong or weak performance can be challenging. The issue becomes even more complex when key ESG metrics are not reported at all. The lack of standardized regulations on ESG disclosure means that not all companies report on ESG issues, and

⁶³ IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 20; S. ABHAYAWANSA and S. TYAGI, “Sustainable investing: The black box of environmental, social and governance (ESG) ratings”, *Journal of Wealth Management* 2021, 5.

⁶⁴ IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 20.

⁶⁵ F. BERG, J.F. KOELBEL, A. PAVLOVA and R. RIGOBON, “ESG confusion and stock returns: Tackling the problem of noise.”, Working paper 30562, *National Bureau of Economic Research* 2022, 1-70; R. RAU, and T. YU, “A survey on ESG: investors, institutions and firms”, *China Finance Review International* 2024, Vol. 14 No. 1, 8; S. CAPRIOLI, J. FOSCHI, R. CRUPI, and A. SABATINO, “Denoising ESG: quantifying data uncertainty from missing data with Machine Learning and prediction intervals.” *arXiv:2407.20047* 2024, 1.

those that do often follow inconsistent approaches. Sakis Kotsantonis and George Serafeim illustrated this challenge by manually collecting data on employee health and safety for a sample of 50 Fortune 500 companies, specifically examining the presence of a health and safety policies, the lost time incident rate and the number of workplace fatalities. The finding of this research indicates that approximately 50% of these companies disclose having health and safety policies, while only 15% report lost time incident rates and workplace fatalities. Notably, employee health and safety are considered a material ESG issue in 9 out of 11 sectors, based on SASB's framework, yet disclosure remains inconsistent, even among large-cap firms. Smaller companies even tend to provide less ESG-related information.

This inconsistency presents a fundamental challenge for researchers and analysts, who must navigate substantial data gaps between companies, time periods, and ESG metrics. This is where data imputation plays a critical role. Although rarely discussed by ESG data providers, imputation techniques significantly impact company rankings and ESG performance assessments. Different gap-filling approaches can vastly yield different results, influencing ESG ratings and contributing to discrepancies across rating agencies. The two most used imputation methods for ESG data gaps are namely the rules-based approach and the input-output approach.⁶⁶

- I. THE RULE-BASED APPROACH – The rule-based approach involves filling in the missing data using predefined assumptions for specific ESG metrics. For instance, when data on workplace fatalities is unavailable, one might assume a value of zero, adopting an “innocent until proven guilty” perspective. Alternatively, sector or regional averages may be applied to avoid incentivizing non-disclosure.

⁶⁶ IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 20; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 347; S. KOTSANTONIS AND G. SERAFEIM, “Four Things No One Will Tell You About ESG Data” *Journal of Applied Corporate Finance* 2019, 54-55.

This approach is computationally simple, requiring no advanced statistical modeling. However, meaningful imputations depend on a strong understanding of business practices, industry dynamics, and ESG-specific issues. For example, banks operating in highly regulated markets tend to outperform industry averages on business ethics score to non-disclosing companies in such regions. While this method offers flexibility, its reliance on arbitrary assumptions can introduce biases and impact the comparability of ESG scores.⁶⁷

- II. INPUT-OUTPUT APPROACH – The input-output approach is estimating a company’s performance on a given ESG metric depending on industry-specific and macroeconomic data. Industry-level data is scaled to reflect the company’s size of operations, providing an estimate of its direct impact. Additionally, macroeconomic data is used to assess the broader flow of goods and services across sectors, capturing indirect impacts associated with the company’s inputs. Based on these estimates, an input-output model assigns performance scores for a given ESG metric by accounting for both direct and indirect business activities.

This approach is particularly well-suited for environmental metrics, where top-down methodologies and macroeconomic assumptions can be applied, and relevant data is readily available. However, its application is more limited for social metrics, where industry averages are less correlated with firm size or operational scale, making it more challenging to generate reliable company-level estimates.⁶⁸

- III. STATISTICAL IMPUTATION MODELS – More advanced imputation methods go beyond simple mean imputation, offering a range of computational

⁶⁷ IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 20; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 347; S. CAPRIOLI, J. FOSCHI, R. CRUPI, and A. SABATINO, “Denoising ESG: quantifying data uncertainty from missing data with Machine Learning and prediction intervals.” *arXiv:2407.20047* 2024, 2; S. KOTSANTONIS AND G. SERAFEIM, “Four Things No One Will Tell You About ESG Data” *Journal of Applied Corporate Finance* 2019, 54-55.

⁶⁸ Idem.

techniques to estimate missing ESG data. These methods can be classified into single imputation – where missing values are estimated only once – and multiple imputation, where missing values are estimated multiple times, analyzed separately and then aggregated to improve accuracy. Multiple imputation better accounts for variability in unobserved data, resulting in more precise imputations. There are two methods that can be used, namely the Regression methods and the Predictive Mean Matching (PMM).⁶⁹

A. REGRESSION METHOD – Regression-based imputation estimates missing ESG values by identifying relationships between observed data and a set of predictor variables. For each ESG metric with missing data (dependent variable, Y), a regression model is constructed using independent variables (X) that vary over time or remain constant. Variants of regression imputation include single imputation and multivariate imputation via chained equations (MICE).⁷⁰

B. PREDICTIVE MEAN MATCHING (PMM) – Predictive Mean Matching (PMM) is a machine-learning-based alternative to regression imputation. While still relying on linear regression, PMM identifies a set of observed values similar to the missing entry and selects one from these for imputation. This method is widely used in single and multiple imputation contexts due to its ability to preserve the distribution of observed data.⁷¹

59. AN ILLUSTRATION – Sakis Kotsantonis and George Serafeim demonstrate the impact of different imputation techniques using the case of Lufthansa’s employee turnover rate in 2017, which was reported at 12,9%. This indicates that roughly one in ten employees leaves after a year. This figure had been increasing over time as the

⁶⁹ Idem.

⁷⁰ IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 20; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 347; S. KOTSANTONIS AND G. SERAFEIM, “Four Things No One Will Tell You About ESG Data” *Journal of Applied Corporate Finance* 2019, 54-55.

⁷¹ Idem.

company restructured its operations. If the true value were unknown, different imputations models would yield significantly different estimates.

Using the Rules-based approach the results would be as following: Assessing Lufthansa the worst performance in its GICS industry (assuming higher turnover is worse) would result in an imputed value of 20%, an overestimation of more than 7 percentage points. Alternatively, imputing the industry average (8,9%) would understate the true value by over 4 percentage points, understating the actual turnover rate by nearly 9 percentage points.

Using the regression methods, the results would be the following: Incorporating country, industry, sales, profitability, market multiples, and employee count into a regression model with five iterative imputations would yield an estimate of 4.0%, understating the actual turnover rate by nearly 9 percentage points.

Using the PMM approach the results would be the following: This method would produce an estimate of 4.6%, also underestimating the true value but to a lesser extent (8.3%).

These results highlight how different imputation techniques can lead to substantial discrepancies, reinforcing the importance of selecting appropriate models based on the dataset and research context.⁷²

60. LIMITATIONS OF IMPUTATIONS IN ESG DATA – A fundamental challenge with ESG data imputation is the inherent bias toward large- capitalization companies⁷³, which tend to have more resources of comprehensive ESG reporting. As a result, observed ESG averages may be skewed upwards, failing to capture the worst performers. Since most imputation techniques rely on existing data distributions, they struggle to estimate value beyond the observed range, potentially leading to misleading conclusions.⁷⁴

⁷² Idem.

⁷³ Para. 47.

⁷⁴ Idem.

61. INCOMPARABLE REPORTING STANDARDS – A critical question is whether the substantial improvement in ESG disclosure over the past decade has led to progress in defining what constitutes strong or weak performance. More specifically, does the primary challenge lie in the inconsistency of ESG metrics, or is it the lack of disclosure and the resulting reliance on data imputation? The study of Dane Christensen, George Serafeim, and Anywhere Sikochi provides strong evidence the former hypothesis: companies with higher levels of ESG disclosure tend to have more disagreement, or variation, in their ESG ratings. Variations in how companies report the same attribute such as using intervals, raw numbers, ratios, or ordinal scales, lead to data inconsistencies.⁷⁵

§4. Methodological issues

62. THE ISSUE – The methodological approaches used in ESG ratings vary significantly. When combined with challenges related to the availability, quality, and comparability of ESG data, this variability can lead to low correlation and substantial divergence, even among products designed to achieve the same objective.⁷⁶

63. DIFFERENT SECTOR CLASSIFICATIONS – Sector categorization directly influences a company’s rating based on sector-specific risk factors, weightings, and statistical metrics. Two primary approaches are employed in a sector taxonomy. First, there is the production-based approach, which classifies companies based on the nature of their business operations. Second, there is the market-based approach, which categorizes them according to their primary revenue source. For instance, S&P uses the market-based approach and employs the Global Industry Classification Standard (GICS), which encompasses 11 sectors, 25 industry groups, 74 industries, and 163 sub-

⁷⁵ C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development*. Palgrave Studies in Impact Finance, Rome, Palgrave Macmillan, 2024, 347; D. CHRISTENSEN, G. SERAFEIM, AND A. SIKOCHI, “Why is corporate virtue in the eye of the beholder? The case of ESG ratings,” *Harvard Business School Working Paper*; S. KOTSANTONIS AND G. SERAFEIM, “Four Things No One Will Tell You About ESG Data” *Journal of Applied Corporate Finance* 2019, 56.

⁷⁶ IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 19.

industries. Conversely, FTSE Russell adopts a production-based approach, implementing the Industry Classification Benchmark (ICB), which encompasses 11 industries, divided into 20 supersectors, which are further divided into 45 sectors, which then contain 173 subsectors. Based on different industry segmentations and related factor specifications within the framework, rating for the same company may vary from one agency to another.⁷⁷

64. MATERIALITY DIFFERENCES - ESG risk factors vary by industry. For instance, waste management is critical in oil and gas, whereas data security is crucial in finance. Each rating agency defines material factors differently, causing divergence in ESG ratings.⁷⁸

65. DIFFERENT SCALES AND FACTORS - Each agency uses unique rating scales and factors, making direct comparisons between ratings inherently complex. A useful analogy to illustrate this challenge is the rating of wine. Assessing wine involves considering multiple factors – many of them subjective – such as aroma, typicity, intensity, sweetness, acidity, color, bouquet, flavor, or finish. Similarly, an ESG rater must account for a diverse set of elements, including biodiversity, employee engagement, political contributions, strategic oversight, executive compensation, workplace benefits and human rights considerations. Recognizing these challenges, the wine industry has established a consensus on key factors that be evaluated in a rating. In contrast, ESG ratings lack standardized criteria, leading to inconsistencies in assessments across different agencies. This absence of uniformity complicates investor

⁷⁷ C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development*. Palgrave Studies in Impact Finance, Rome, Palgrave Macmillan, 2024, 348.

⁷⁸ C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development*. Palgrave Studies in Impact Finance, Rome, Palgrave Macmillan, 2024, 303 (347-348); E. ESCRIG-OLMEDO, M.J. MUNOZ-TORRES and M.A. FERNANDEZ-IZQUIERDO, “Socially responsible investing: Sustainability indices, ESG rating and information provider agencies”, *Int. J. Sustain. Econ.* 2010, 2, 454; K. SAADAOUI and T. SOOBAROYEN, “An Analysis of the methodologies adopted by CSR Rating Agencies”, *Sustain. Account. Mana.* 2018, 9, 9; S. SCALET, T.F. KELLY, “CSR Rating Agencies: What is Their Global Impact?”, *J. Bus. Ethics* 2010, 94, 72.

decision-making and raises concerns about the comparability and reliability of ESG ratings.⁷⁹

66. DIFFERENT MATERIALITY APPROACHES IN ESG RATING METHODOLOGIES – ESG rating providers can adopt different materiality approaches to assess corporate ESG performance, which can lead to divergence in ESG ratings. The European Securities and Market Authority (ESMA) identified two primary methodologies. The first approach, ESG risk ratings, is based on the concept of financial materiality and is the most commonly used. It evaluates a company’s exposure to ESG-related risks and opportunities and assesses how effectively these risks are managed, particularly in terms of their financial implications. The second approach, ESG impact ratings, is based on impact materiality and focuses on measuring a company’s broader effect on ESG factors, including its social and environmental impact on people, the planet, and society as a whole.⁸⁰

Interviews conducted by ESMA with ESG ratings providers revealed that financial materiality remains the predominant approach. Five providers indicated that their rating methodologies primarily assess companies’ exposure to and management of financially material ESG risks. In contrast, two providers reported using the double materiality, considering both the company’s ability to manage financial ESG risks and opportunities and their ability to manage their material impacts on people and planet.⁸¹

Despite the conceptual distinction between risk and impact ratings, the practical differences between these approaches may be limited and thus be considered a minor problem. Both often rely on similar ESG metrics, which simultaneously capture financial risks of companies and their wider societal and environmental effects. Moreover, some ESG factors inherently possess both risk- and impact-related

⁷⁹ C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development*. Palgrave Studies in Impact Finance, Rome, Palgrave Macmillan, 2024, 348; V. CHARLIN, A. CIFUENTES AND J. ALFARO, “ESG ratings: an industry in need of a major overhaul.” *Journal of Sustainable Finance & Investment* 2022, 14(4), 1051.

⁸⁰ B. BIJELIC, B. MICHEL, AND K. MANN, *Behind esg ratings: Unpacking sustainability metrics*, OECD, 2025, 17; I.H. CHIU, “The EU sustainable finance agenda: developing governance for double materiality in sustainability metrics.” *European Business Organization Law Review* 2022, 23(1), 103.

⁸¹ Ibid.

dimensions. For example, controversy-based metrics can reflect a company's reputational risk while also indicating adverse effects on people and the environment. Similarly, input-based metrics can be designed to also assess a company's ability to manage social or environmental harm. For instance, investments in upgrading facilities to reduce exposure to climate-related hazards may simultaneously enhance worker safety and minimize environmental damage.⁸²

67. DIVERGENCE BASED ON MEASUREMENTS, SCOPE AND WEIGHT - ESG ratings vary significantly across agencies due to the lack of standardized data measurement criteria. Additionally, sustainability data is predominantly non-financial and encompasses diverse content. A study conducted by MIT highlighted this disparity, revealing an average correlation of only 0.61 among major ESG rating agencies such as MSCI Stats, Sustainalytics, Moody's, S&P, Refinitiv and MSCI. By contrast, conventional credit ratings from Moody's and S&P exhibit a much higher correlation of 0.99. The divergence can be attributed to three main factors: measurements (56% - differences in how the same risk factor is measured using different raw data), scope (38% - differences in the risk factors included in scoring models), and weight (6% - variations in the importance assigned to risk factors). For example, in 2023, these inconsistencies raise concerns about whether ESG ratings accurately reflect an organization's ESG performance. This variability poses a significant challenge. First, the inconsistency in ESG ratings complicates the assessment of corporate, fund, and portfolio ESG performance, thereby undermining the primary purpose of these ratings. Second, discrepancies among ESG rating agencies weaken companies' incentives to enhance their ESG performance. Conflicting evaluations create uncertainty about which actions will be recognized and rewarded by the market, potentially leading to underinvestment in ESG initiatives.⁸³

⁸² Ibid.

⁸³ F. BERG, J. F. KÖLBEL, AND R. RIGOBON, "Aggregate confusion: The divergence of ESG ratings", *Review of Finance* 2022, 1315-1344; C. YILMAZ, and D. TASKIN, "ESG Ratings: An evolution and discussion" in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (351-352); S. ABHAYAWANSA and S. TYAGI, "Sustainable investing: The black box of environmental, social and governance (ESG) ratings", *Journal of Wealth Management* 2021, 4.

- I. SCOPE DIVERGENCE – Each rating agency chooses to break down the concept of ESG performance into distinct indicators and arranges them in different hierarchies. Consequently, the rating agencies come to different conclusions. Rating agencies like Moody’s ESG, S&P Global, MSCI and Sustainalytics have three dimensions when they break-down the concept of ESG performance namely E, S and G, whilst other rating agencies like Refinitiv have four dimensions and the rating agency KLD even has seven dimensions. This is only at the first level of difference. Below this first-level dimension, there are between one and three levels of sub-categories. These conflicting structures create challenges in understanding why and how different rating agencies evaluate the same company differently.⁸⁴
- II. MEASUREMENTS DIVERGENCE – Category scores reflect a rating agency’s evaluation of a specific ESG category. They are derived from various sets of indicators, each based on different measurement protocols. Consequently, variations in category scores developed by different rating agencies can be seen as measurement divergence. Additionally, certain rating agencies use different sets of indicators tailored for specific industries.⁸⁵

⁸⁴ European Commission, *Commission staff working document the impact assessment report accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 17; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (351-352); F. BERG, J. KÖLBEL and R. RIGOBON “Aggregate Confusion: The divergence of ESG ratings”, *Review of Finance* 2022, 9-11; B. STACKPOLE, *Why sustainable business needs better ESG ratings*, MIT Management Sloan School, 6 December 2021, <https://mitsloan.mit.edu/ideas-made-to-matter/why-sustainable-business-needs-better-esg-ratings>.

⁸⁵ European Commission, *Commission staff working document the impact assessment report accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 17; European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 3; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (351-352); F. BERG, J. KÖLBEL, and R. RIGOBON, “Aggregate Confusion: The divergence of ESG ratings”, *Review of Finance* 2022, 11-16; P. MATOS, “ESG and responsible institutional investing around the world: A critical review,” *CFA Institute Research Foundation Literature Review* 2020, 2008; B. STACKPOLE, *Why sustainable business needs better ESG ratings*, MIT Management Sloan School, December 6 2021, <https://mitsloan.mit.edu/ideas-made-to-matter/why-sustainable-business-needs-better-esg-ratings>.

III. WEIGHT DIVERGENCE – Each rating agency can decide on its own how much weight it grants to each ESG category. An investor can decide to invest in a company that has a good overall rating, whereas such company could only be performing well in one of the aspects and have a poorer performance in other aspects that may be more relevant for the investor. Issues also arise when agencies give different weight to similar criteria, leading furthermore to inconsistent rankings for the same company.

Two examples from E. ESCRIG Olmedo et al. can illustrate this. For instance, to decide on a ESG factor, in its 2008 annual assessment, SAM rated Telefónica – one of the largest telecommunications companies globally – at 81,4 on average. However, Accountability Rating 2008 gave Telefónica a score of 51. This inconsistency becomes even more problematic when a company’s position or status in term of corporate social responsibility (CSR) is represented symbolically, or through numerical or linguistic scales, further complicating comparisons and interpretations. Another example is electric cars. The environmental impact of certain energy sources can be reasonably debated. Considering how much the environmental impact of electric vehicles depends on how one weighs the inputs – such as the energy and rare earth minerals used in their production and operation – against the outputs, like the car’s zero emissions during use.⁸⁶

68. INTRACORRELATION BETWEEN E, S, G AND ESG RATINGS – In 2024, the study from Monica Billio, Aoife Claire Fitzpatrick, Carmelo Latino and Lorian

⁸⁶ European Commission, *Commission staff working document the impact assessment report accompanying the document Proposal for a Regulation of the European Parliament and of the Council on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities*, 13 June 2023, (SWD (2023) 204 final), 19; European Commission, Environmental Resources Management (ERM), *Study on Sustainability-Related Ratings*, November 2020, 3; B. STACKPOLE, *Why sustainable business needs better ESG ratings*, MIT Management Sloan School, December 6 2021, <https://mitsloan.mit.edu/ideas-made-to-matter/why-sustainable-business-needs-better-esg-ratings>; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (351-352); E. ESCRIG-OLMEDO, M.J. MUNOZ-TORRES and M.A. FERNANDEZ-IZQUIERDO, “Socially responsible investing: Sustainability indices, ESG rating and information provider agencies”, *Int. J. Sustain. Econ.* 2010, 2, 454; F. BERG, J. KÖLBEL, AND R. RIGOBON, “Aggregate Confusion: The divergence of ESG ratings”, *Review of Finance* 2022, 16-18; IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 20; S. SCALET, T.F. KELLY, “CSR Rating Agencies: What is Their Global Impact?”, *J. Bus. Ethics* 2010, 94, 72; K. SAADAOUI and T. SOOBAROYEN, “An Analysis of the methodologies adopted by CSR Rating Agencies”, *Sustain. Account. Mana.* 2018, 9, 9.

Pelizzon analyzed the correlation between the ESG pillar and its individual E, S and G pillars and the intra-correlation between the E-S-G pillars based on data from Bloomberg, Refinitiv, RobecoSAM and Sustainalytics.

A key finding of this analysis is the strong correlation between the Environmental pillar and overall ESG ratings, consistently exceeding 0.76 across all rating agencies. This suggests that environmental factors play a dominant role in ESG assessments. However, the alignment weakens for the Social pillar. While RobecoSAM, Refinitiv, and Sustainalytics show high Social-ESG correlations, Bloomberg's Social pillar exhibits a notably lower correlation (0.68), indicating greater divergence in its evaluation methodology.

The Governance pillar also displays varying degrees of correlation with ESG ratings across agencies. It shows the weakest association for Refinitiv (0.43) and Bloomberg (0.70), while RobecoSAM (0.95) and Sustainalytics (0.85) demonstrate significantly stronger correlations. This suggests that Governance holds less weight in ESG assessments for some agencies, particularly Refinitiv and Bloomberg.

Furthermore, Bloomberg and Refinitiv show weak correlations between Governance and the Environmental and Social pillars, implying independent assessments rather than an integrated ESG approach. In contrast, RobecoSAM exhibits strong inter-pillar correlations (all above 0.84), suggesting a uniform rating approach across E, S and G dimensions.

In conclusion, the analysis reveals that the Environmental (E), Social (S), and Governance (G) pillars contribute differently to the overall ESG rating. However, a consistent pattern emerges: the Environmental pillar consistently plays a predominant role in shaping ESG ratings across all agencies, highlighting the non-linear nature of ESG rating computation. In other words, the three pillars do not contribute equally or in a fixed proportion to the ESG rating. Furthermore, an analysis of the intra-correlations among the E, S and G pillars indicates a low correlation between them, suggesting that each pillar captures distinct dimensions of ESG performance. These

variations highlight fundamental differences in ESG rating methodologies among agencies.⁸⁷

69. INTER-CORRELATIONS: THE EVOLUTION OF THE DIVERGENCE OVER TIME – The same study from 2024 also delves into an analysis of the inter-correlations between different ESG rating agencies. The study aims to shed light whether EU firms receive consistent assessments across different rating agencies for the E, S and G components, beyond the broader divergences observed in ESG ratings. The analysis uses the same four agencies with data from 2016 to 2020 and uses Refinitiv's scores as a reference point.

The findings reveal substantial dispersion across all pillars and score levels, highlighting a lack of consensus among the four rating agencies. Notably, this discrepancy is most pronounced in the Governance pillar, where disagreement is more significant compared to the Social and Environmental dimensions. While all agencies contribute to this variation, Bloomberg is primarily responsible for a higher prevalence of outliers in the Environmental and Social ratings. In contrast, the Governance pillar exhibits the wildest dispersion, mainly influenced by RobecoSAM. These findings underscore the complexity of rating discrepancies and suggests that agencies exhibit varying degrees of agreement depending on the ESG pillar.

The study also provides an insight into the relative magnitudes of dispersion and their evolution over time. The results indicate that the Governance dimension consistently exhibits the highest average standard deviation, followed by Social, Environmental, and cumulative ESG scores. Surprisingly, the cumulative ESG rating – expected to reflect an average of the three pillars – displays the lowest standard deviation. This suggests that rating agencies exhibit greater agreement when evaluating the overall ESG score than when assessing individual E, S and G dimensions.

⁸⁷ IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 20; M. BILLIO, A. C. FITZPATRICK, C. LATINO, L. PELIZZON, "Unpacking the ESG ratings: Does one size fit all?", *Leibniz Institute for Financial Research* 2024, SAFE Working Paper, No. 415, 8-10; S. ABHAYAWANSA and S. TYAGI, "Sustainable investing: The black box of environmental, social and governance (ESG) ratings", *Journal of Wealth Management* 2021, 6.

Two key factors were given in the study to explain the pattern. First, ESG frameworks establish sector-specific materiality baselines, influencing how rating agencies weigh various factors. For instance, emissions may carry greater significance in evaluating oil companies than technology firms, yet the precise contribution of such factors to the overall environmental score remains unclear. Second, the qualitative nature of governance and social metrics – such as policies and management competencies – introduces additional complexity, potentially contributing to the pronounced variation observed among ratings agencies.⁸⁸

§5. Greenwashing and conceptual issues

A. Greenwashing

70. NO DEFINITION OF GREENWASHING – The concept of greenwashing is a getting increasing attention, but the exact meaning of this concepts remains a challenge in the research as there is an absence of a universally accepted definition concerning the scope, intentionality, or level of deception. The European Supervisory Authorities (ESA's) have set out a high-level common understanding of greenwashing: '*a practice where sustainability related statements, declarations, actions, or communications do not clearly and fairly reflect the underlying sustainability profile of an entity, a financial product, or financial services. This practice may be misleading to consumers, investors, or other market participants.*' Greenwashing could be referred to the practice of creating a misleading or false impression about organizations environmental efforts.⁸⁹

71. SAVE THE TOWEL – The term 'greenwashing' first coined in 1986 by Jay Westerveld, who criticized hotels' "save the towel" campaigns, suspecting they were more about reducing laundry costs than genuine environmental concerns. In the mid-1980s, Chevron commissioned a series of expensive television and print ads to convince

⁸⁸ Ibid.

⁸⁹ C. YILMAZ, and D. TASKIN, "ESG Ratings: An evolution and discussion" in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (349); ESMA, *The financial impact of greenwashing controversies*, 19 December 2023, ESMA50-524821-3072, 4.

the public of its environmental bona fides, despite being one of the largest polluters and became infamous for greenwashing. In the 2000s the ESG phenomenon emerged, and it started to be used by greenwashers. Businesses are attaching the ESG label to non-sustainable products as a marketing ploy or to charge higher prices. Large ESG-funds may carry fossil-fuel stocks in their portfolios. ESG ratings are exploited because of transparency of the score is questionable. Besides, a company may have a good score in one aspect but underperform in another, yet the overall ESG rating might still be high.⁹⁰

72. DIFFERENT FORMS – Greenwashing can manifest in various forms, making it difficult for investors to assess the true sustainability of financial products. Common examples include naming, empty claims, cherry-picking or that ESG ratings are backward-looking.

73. NAMING - The study of Alexander Cochardt, Stephan Heller, and Vitaly Orlov examines the growing trend of rebranding mutual funds with ESG-related terminology. Although this phenomenon is relatively recent – only about 5% of all fund name changes in 2020 include ESG terms – the research observed a steady upward trend in ESG -related name changes over the 16-year period covered in their sample (January 2005 to February 2021). The dataset included 378 equity funds, comprising 2.292 fund shares classes, that underwent an ESG-related name change during this timeframe.

The majority of these changes (57.67%) represent a transition from non-ESG to ESG-themed fund names, particularly concentrated in the later years of the sample. The most common ESG-related buzzword used in the fund names are ‘Sustainable’ ‘ESG’ and ‘Responsible’.

The study finds that smaller, older, and less attractive funds are more likely to adopt ESG terminology in their names as a strategy to regain investor interest and capital inflows. Following the name change, these funds adjust their portfolio by increasing

⁹⁰ C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (350-351).

diversification – holding more stocks but allocating less capital to each – and by reducing exposure to companies with significant ESG controversies. As a result, their overall ESG scores and peer-adjusted ESG rankings improve, leading to abnormal inflows exceeding 13% in the 12 months following the name change.

However, the research reveals no evidence that these rebranded funds demonstrate genuine commitment to sustainable investing. Specifically, they do not alter their pre-existing voting behavior to support ESG-related shareholder proposals. In fact, they become even less likely to vote in favor of such proposals when their vote has the potential to influence the outcome.

These findings carry important implications for investors. Many rely heavily on fund names when evaluating a fund’s ESG commitment, making them vulnerable to potential greenwashing.⁹¹

74. EMPTY CLAIMS – Exaggerations and failure to fulfill promises, can severely undermine investor confidence. Overstating ESG claims frequently involves omitting important details and being vague, especially when it comes to impact and measuring sustainability objectives. An example would consist of a top tier “ecology” fund which claims to promote an unspecified environmental objective without explaining how the ESG rating actually measures the attainment of the environmental objective and how this is monitored over time.⁹²

75. CHERRY-PICKING AND BACKWARD-LOOKING - Entities can selectively choose ESG ratings that portray them favorably from a sustainability perspective, cherry-picking those that present the most favorable image of them. Users of ESG ratings also tend to forget that ESG are back-ward-looking whilst many expect them to cover impact that is forward-looking.⁹³

⁹¹ A. COCHARDT, S. HELLER, and V. ORLOV, “Do mutual funds greenwash? evidence from fund name changes. Evidence from Fund Name Changes”, *Swiss Finance Institute Research Paper* 2023, 3 and 21.

⁹² Progress report on Greenwashing (31 May 2023), ESMA30-1668416927-2498 (2023), 26.

⁹³ M. BILLIO, A. C. FITZPATRICK, C. LATINO, L. PELIZZON, “Unpacking the ESG ratings: Does one size fit all?”, *Leibniz Institute for Financial Research* 2024, SAFE Working Paper, No. 415, 19; Progress report on Greenwashing (31 May 2023), ESMA30-1668416927-2498 (2023), p.28 and 48.

B. Conceptual issues

76. CORPORATE PRIORITIES OVER ENVIRONMENTAL AND SOCIAL GOALS – ESG has faced criticism for prioritizing corporate interests over meaningful environmental and social impact. As Kenneth Pucker, the former COO at Timberland, pointed out, “Asset managers have incentives to drive equity returns, not solve water problems in Egypt or deforestation in Malaysia” emphasizing that this focus aligns with the compensation structures rather than with the broader societal goals. This raises the question: Is ESG a tool for corporate exploitation or a genuine effort to benefit the planet?⁹⁴
77. CRITICISM -Evidently, not all use of ESG in marketing amounts to greenwashing. The concept of ESG rating was developed with the best intentions to guide companies toward sustainable practices while addressing pressing global challenges. However, even the well-meaning use in marketing has provoked some criticism. Therefore, marketing could become an agency cost in the case of greenwashing.
78. ESG AS A MARKETING STRATEGY – Critics argue that ESG serves as a branding and public relations tool rather than a mechanism for substantial change. Given that a company’s primary duty is often perceived as maximizing financial returns, ESG initiatives are seen by some as strategies to enhance brand image and profitability rather than as a commitment to sustainability. The study of Edmans et al. also shows that marketing considerations – such as enhancing a fund’s sustainability rating and improving the fund’s reputation – are key drivers behind the incorporation of environmental and social factors into stock selection for a significant number of sustainable funds.⁹⁵

⁹⁴ C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (348); B. STACKPOLE, *Why sustainable business needs better ESG ratings*, MIT Management Sloan School, December 6 2021, <https://mitsloan.mit.edu/ideas-made-to-matter/why-sustainable-business-needs-better-esg-ratings>.

⁹⁵ A. EDMANS, T. GOSLING, D. JENTER, “Sustainable Investing: Evidence from the Field”, HKU Jockey Club Enterprise Sustainability Global Research Institute - Archive, European Corporate Governance Institute – Finance Working Paper No. 1028/2024, September 20, 2024, 39; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development. Palgrave Studies in Impact Finance*, Rome, Palgrave Macmillan, 2024, 303 (348).

79. REALITY VERSUS IDEALS: While ESG presents an appealing framework, real-world events often challenge its principles. For example, the invasion in Ukraine has shifted focus back to energy security, potentially increasing reliance on fossil fuels and jeopardizing the goal of achieving net-zero emissions by 2050.⁹⁶ This highlights the tension between aspirational ESG goals and the practical demands of global crises.⁹⁷

80. WEAK CORRELATION WITH STATED OBJECTIVES – ESG ratings have been criticized for their weak correlation to meaningful progress on environmental, social, and governance issues. For instance, Bloomberg criticized MSCI for explaining 155 rating upgrades related to governance (42%), social (32%), and environmental (26%) improvements. However, these upgrades were frequently based on superficial “check-the-box” measures rather than substantive changes in corporate practices. Companies with high ESG ratings often underperform in critical areas like labor and environmental compliance compared to their non-ESG counterparts, further question the reliability and intent behind ESG scores.⁹⁸

SECTION 4. Conclusion

81. CONCLUSION OF CHAPTER 1 – This first chapter aimed to identify and map out the agency costs associated with ESG ratings. The research shows that these costs stem from various issues, including non-transparency, conflict of interest and biases, data issues, methodological issues, greenwashing and conceptual issues.

⁹⁶ Para. 33.

⁹⁷ A. EDMANS, T. GOSLING, D. JENTER, “Sustainable Investing: Evidence from the Field”, HKU Jockey Club Enterprise Sustainability Global Research Institute - Archive, European Corporate Governance Institute – Finance Working Paper No. 1028/2024, September 20, 2024, 39; C. YILMAZ, and D. TASKIN, “ESG Ratings: An evolution and discussion” in A.I. HUNJRA and J.W. GOODELL (eds), *The Palgrave Handbook of Green Finance for Sustainable Development*. Palgrave Studies in Impact Finance, Rome, Palgrave Macmillan, 2024, 303 (348).

⁹⁸ Ibid.

CHAPTER 2. Regulation on the transparency and integrity of ESG rating activities

SECTION 1. The objectives of the Regulation

§1. The general and specific objectives

82. GENERAL OBJECTIVES – The Regulation aims to enhance the European Single Market’s potential and support the transition towards a more sustainable, inclusive economy in line with the European Green Deal and the UN Sustainable Development Goals. This initiative seeks to empower investors with better information on investment sustainability and assist companies in understanding their own sustainability performance. The objective of this initiative is to improve the quality and transparency of ESG ratings, enabling more informed investment decisions and create trust in ESG ratings by ensuring fair market practices and effective conflict-of-interest management.⁹⁹

83. SPECIFIC OBJECTIVES – The Regulation has two specific objectives. The first one is to enhance transparency around ESG ratings by clarifying their meaning, the methodologies, and the data sources. Secondly, this Regulation aims to ensure clarity on the operations of ESG rating providers while preventing and mitigating conflicts of interest within these organisations.¹⁰⁰

84. THE ACTIONS TAKEN BY THE COMMISSION – In order to meet the general and specific objectives, the Commission has committed to improve the reliability, comparability, and transparency of ESG ratings. The Regulation specifically aims to enhance the quality of ESG rating information by (i) increasing the transparency regarding the rating characteristics and methodologies, and (ii) providing clearer guidelines for the operations of ESG rating providers to prevent and manage conflicts of interest effectively. The framework will support rated entities in managing ESG risks and understanding the impact of their operations. A vital component of this initiative is

⁹⁹ Proposal of the ESG rating Regulation, 1-2 and 57.

¹⁰⁰ Ibid.

to build trust and confidence in ESG rating providers by fostering a well-regulated market that ensures the ethical management of potential conflict of interest.¹⁰¹

§2. Action taken by the Commission to monitor the objectives

85. MEASURING THE OUTCOME TOWARDS THE GENERAL OBJECTIVES –

Monitoring progress towards the general objectives is inherently complex, as it is methodologically challenging to isolate the impact of the proposed measures on ESG ratings from other influencing factors. Despite this, the Regulation suggests tracking on these overarching goals by firstly observing investment trends in companies engaged in sustainable economic activities across ESG dimensions. Secondly, the Regulation wants to collaborate with supervisors and relevant stakeholders to evaluate whether greenwashing concerns related to ESG ratings are diminishing. The progress report on greenwashing from ESMA establishes connections with ESG ratings and how the legal gaps of ESG rating exacerbate greenwashing.¹⁰²

SECTION 2. The role of ESG ratings according to the Regulation

86. IMPORTANT ROLE IN GLOBAL CAPITAL MARKETS – ESG ratings are essential

for global capital markets, guiding sustainable investment, borrowers, and issuers in making informed, sustainable investment and financing decisions. Financial institutions - including banks, investment firms, insurers, and re-insurers – often rely on these ratings to assess sustainability performance and identify related risks and opportunities. As result, these ratings significantly impact market operations and strengthen investors and consumer trust.¹⁰³

87. THE PROPER FUNCTIONING OF THE UNION SUSTAINABLE FINANCE

MARKET - Additionally, ESG rating are crucial for the functioning of the EU

¹⁰¹ Proposal of the ESG rating Regulation, 2; G. CROISANT and R. BARRETT, “The ESG megatrend: an introduction” in D. DE MEULEMEESTER (ed.), *ESG and International Arbitration. Beyond the Acronyms. Reports from the CEPANI Colloquium held on 17 November 2023*, Kluwer, 2023, 25.

¹⁰² Proposal of the ESG rating Regulation, 10 and 19.

¹⁰³ Proposal of the ESG rating Regulation, 15; P. MATOS, “ESG and responsible institutional investing around the world: A critical review,” *CFA Institute Research Foundation Literature Review* 2020, 2008.

sustainable finance market, supporting investment strategies, risk management, and disclosure requirements for investors and financial institutions.¹⁰⁴

SECTION 3. The structure of the Regulation

§1. Subject matter and scope

88. THE SUBJECT MATTER - The Regulation sets a unified framework to improve the integrity, transparency, comparability where possible, responsibility, reliability, good governance, and independence of ESG rating activities, contributing to the transparency and quality of ESG ratings. Its purpose is to support a well-functioning internal market, to ensure strong protection for consumers and investors, and to combat greenwashing and misinformation. It does so by establishing transparency requirements for ESG ratings and operation standards for ESG rating providers.¹⁰⁵

89. GENERAL SCOPE – The Regulation applies to ESG rating issued by ESG rating providers active in the European Union. Three conditions are relevant (1) an ESG rating provider (personal scope), (2) operating in the EU (territorial scope) and (3) that issues an ESG rating (functional scope).¹⁰⁶

90. PERSONAL SCOPE – The personal scope is limited by the Regulation to ESG rating providers. These providers are defined as legal entities whose services include issuing and publishing or distribution ESG ratings on a professional basis. Consequently, natural persons are excluded from the scope. Legal entities that publish or distribute ESG ratings for non-commercial purposes are also excluded. Academics, journalists, and NGOs, for example, are not included in the personal scope. However, the latter are considered to pursue commercial purposes when they charge certain fees.¹⁰⁷

91. TERRITORIAL SCOPE – The territorial scope is determined in two alternative ways. The first way is linked to the location of the recipient of the ESG rating. It applies when an ESG rating provider contractually issues or distributes an ESG rating to companies

¹⁰⁴ Idem.

¹⁰⁵ Art. 1, ESG rating Regulation.

¹⁰⁶ Art. 2(1), ESG rating Regulation.

¹⁰⁷ Art. 3(4), 24, 2(2)q, ESG rating Regulation.

incorporated under the law of an EU member state, companies listed on a regulated market in an EU member state, or to an EU government agency. If the provider is located in the EU, the publication of their ESG rating (such as on the website) is sufficient to be covered by the ESG rating Regulation.¹⁰⁸

92. FUNCTIONAL SCOPE – The functional scope aims to make a clear distinction between the regulated activity, in particular the issuance (including distribution and publication), and the use, which is not regulated. For the definition of an ESG rating, see paragraph 16.

§2. The requirements to provide ESG ratings in the Union and a register for information

93. REQUIREMENTS - To operate as an ESG rating provider within the European Union, any legal entity must first obtain formal approval through one of four regulatory pathways.¹⁰⁹ Providers are required to secure:

- i. An authorization granted by the European Securities and Market Authority (ESMA). This serves as the primary route for obtaining an approval to provide ESG ratings in the European Union.¹¹⁰
- ii. An equivalence decision, which allows certain providers outside the EU to offer ESG ratings under specific conditions to operate in the EU.¹¹¹
- iii. An endorsement, which allows entities outside the EU, belonging to the same group as an ESG rating provider located in the Union, to have their ESG ratings recognized within the Union, provided they meet specific regulatory criteria.¹¹²
- iv. A recognition, which enables non-EU rating providers to operate within the EU if they fulfill certain standards and requirements.¹¹³

¹⁰⁸ Art. 2(1)(a)(i) and (ii),(b) ESG rating Regulation.

¹⁰⁹ Art. 4, ESG rating Regulation.

¹¹⁰ Art. 6 – 9, ESG rating Regulation.

¹¹¹ Art. 10, ESG rating Regulation.

¹¹² Art. 11, ESG rating Regulation.

¹¹³ Art. 12, ESG rating Regulation.

94. TEMPORARY REGIME FOR SMALL ESG RATING PROVIDERS – The Regulation introduces a temporary regime for small ESG rating providers, allowing them to operate under a lighter set of obligations, provided they notify and are registered by ESMA. This exemption lasts for up to three years or until they no longer qualify as small, after which they must fully comply with the Regulation and apply for an authorization.¹¹⁴

95. COOPERATION ARRANGEMENTS – When ESMA works with other jurisdictions, either inside or outside the EU, the rules they follow must keep shared information secret and protected. Any information they exchange should only be used to help them to perform their official work. If ESMA needs to send personal data to a country outside the EU, they must follow the European data protection Regulation to make sure people’s personal information stays safe and private.¹¹⁵

96. REGISTER AND ACCESSIBILITY OF INFORMATION – ESMA will establish and maintain a register which contains information on the identity of the different ESG providers. The register is publicly accessible on the website of ESMA.¹¹⁶

§3. Organizational requirements, processes and documents concerning governance

97. GENERAL PRINCIPLES – The Regulation puts forward certain general principles. ESG rating providers must ensure their rating activities remain fully independent from political or economic pressures and are carried out according to strict internal rules and procedures. They must use reliable data, apply transparent and rigorous rating methodologies, and regularly review their systems and processes to maintain high standards. Oversight functions must be independent, well-resourced, and have full access to information needed for effective monitoring. ESG ratings should be based on thorough analysis, and rated entities must be given a chance to correct any factual errors before a rating is published. However, ESG rating providers are not required to disclose trade secrets or intellectual property related to their methodologies.¹¹⁷

¹¹⁴ Art. 5, ESG rating Regulation.

¹¹⁵ Art. 13, ESG rating Regulation.

¹¹⁶ Art. 14, ESG rating Regulation.

¹¹⁷ Art. 15, ESG rating Regulation.

98. ORGANIZATIONAL REQUIREMENTS – The Regulation sets out certain organizational requirements. ESG rating providers must keep their rating activities separate from other services such as consulting, credit rating, investment services, and auditing, to avoid conflicts of interest. In some cases, they may be allowed to offer certain activities, like investment services or benchmarks, but only if strict safeguards are in place and approved by ESMA. Employees involved in ESG rating must be properly trained, act independently, and avoid personal or financial ties to the entities they rate, including restriction on holding certain financial instruments. ESG rating providers must also protect confidential information, handle complaints fairly and transparently, and respond to reasoned concerns from stakeholders in a timely manner. Outsourcing is permitted, but providers may apply for exemptions from some governance rules, provided they can show that their internal controls and size justify such treatment.¹¹⁸

§4. Transparency

99. TRANSPARENCY – The Regulation requires ESG rating providers to publicly disclose their methodologies, models, and key assumptions used in their rating activities clearly on their websites. They are required to publish separate ratings for environmental, social, and governance factors, unless they opt for an aggregated ESG rating and include specific additional disclosures. Information must be made available both to the public and to users, rated items, and issuers, with relevant links attached when ESG rating are shared. ESMA is responsible for developing technical standards to detail how this information should be disclosed, including formats and templates, and the European Commission has the authority to adopt these standards.¹¹⁹

100. These transparency requirements will be addressed in a sequential manner, beginning with disclosures to ESMA, followed by information provided to clients, and finally made publicly available on the provider's website.

¹¹⁸ Art. 16-22, ESG rating Regulation.

¹¹⁹ Art. 23-24, ESG rating Regulation.

A. Information to be provided in the application for authorization to ESMA

101. GENERAL INFORMATION – The applicant must provide its full legal name, the address of its registered office within the European Union, and details of its official website. If available, the applicant should also include its Legal Entity Identifier (LEI).¹²⁰
102. CONTACT AND ORGANIZATIONAL DETAILS – The Regulation requires the applicant to include the name and contact details of a designated representative who will act as the primary point of communication. Additionally, the applicant must specify its legal status and ownership structure, providing a clear understanding of the entities involved in the organization. He must also provide details about any entity within the same ownership structure that will provide ESG ratings or engage in activities against the separation of business and activities, outlined under art. 16(1) of the Regulation.¹²¹
103. PERSONAL IDENTIFICATION DATA – The applicant must provide the identity of their senior management team and disclose information on their qualification, experience, and training relevant to ESG rating activities. Furthermore, the application should specify the number of ESG rating analyst, employees, and other personnel directly involved in the rating process. The level of expertise and training of these individuals should also be outlined to demonstrate their competency in conducting ESG assessments.¹²²
104. SCOPE AND METHODOLOGY – The Regulation requires the applicant must describe the expected market coverage of its ESG ratings, outlining the industries, sectors, and regions it intends to assess. Additionally, a detailed explanation of the methodologies and procedures used for issuing and reviewing ESG ratings must be provided. The applicant should indicate whether it will use information regulated in EU law¹²³ and whether its methodologies are based on scientific evidence. Furthermore, the

¹²⁰ Annex I, (a), ESG rating Regulation.

¹²¹ Annex 1, (b), (c), (d), (e), ESG rating Regulation.

¹²² Annex 1, (f), (g), ESG rating Regulation.

¹²³ Regulation on sustainability-related disclosures in the financial services sector (2019/2088) and Directive on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings (2013/34).

applicant should specify whether its approach aligns with the targets and objectives of the Paris Agreement or other relevant international agreements on sustainability and climate change.¹²⁴

105. CONFLICT OF INTEREST AND COMPLIANCE POLICIES – To maintain the integrity of ESG ratings, applicants must implement policies and procedures to identify, manage, and disclose any conflict of interest. These measures must comply with Article 15 of the ESG rating Regulation.¹²⁵¹²⁶

106. OPERATIONAL AND OUTSOURCING ARRANGEMENTS – If the applicant plans to outsource any activities related to ESG ratings, it must provide relevant documentation outlining these arrangements. Additionally, the applicant must disclose any other related activity it currently conducts or intends to carry out, including plans for obtaining endorsements under applicable regulations.¹²⁷

107. SPECIFIC COMPLIANCE MEASURES AND PREVIOUS ACTIVITIES – Where applicable, the applicant must provide information on the specific compliance measures it has implemented in accordance with Article 16(2) and (3) of the ESG rating Regulation.¹²⁸ Furthermore, the applicant should provide documentation regarding any previous ESG rating activities it has undertaken, demonstrating its experience and track record in the field.¹²⁹

B. Organizational requirements

i. Record keeping information

108. DOCUMENTATION REQUIREMENTS – While the application itself is the primary source of information shared directly with ESMA, the authority has the power

¹²⁴ Annex 1, (h), (i), ESG rating Regulation.

¹²⁵ Art. 15 of the ESG rating Regulation sets out the general principles. (Para. 97).

¹²⁶ Annex 1, (j), ESG rating Regulation.

¹²⁷ Annex 1, (k), (l), ESG rating Regulation.

¹²⁸ Art. 16 (2) and (3) ESG rating Regulation outline expectations to the general prohibition on ESG rating providers engaging in certain financial or advisory activities, allowing limited involvement if strict safeguards against conflicts of interest are implemented and approved by ESMA (Para. 98).

¹²⁹ Annex 1, (m), (n), ESG rating Regulation.

to request additional information and conduct unannounced on-site inspections. To facilitate such requests and inspections, the Regulation requires that certain data be maintained in a reproducible format for a period of five years. Additionally, there are specific documentation requirements related to organizational structures and assessment processes.¹³⁰

109. **IDENTITY** – Where applicable, ESG rating providers must document the identities of the rating analysts involved in their determination, as well as the individuals responsible for approving the final rating. Additionally, they must record the identities of those involved in developing the rule-based methodology and those who have formally approved the rating methodology.¹³¹

110. **ORGANISATION** – ESG rating providers must maintain detailed records including the date on which an action was taken, an indication of whether the ESG rating was solicited or unsolicited, an account records detailing fees received and account records for each user. Additionally, all documents related to any complaint must be recorded and preserved.¹³²

111. **REVIEW** – The ESG rating Regulation requires ESG rating providers to maintain comprehensive records detailing their procedures and methodologies. These records must include documentation of established procedures and rating methodologies, as well as internal records, external communications, and work papers that form the basis of any ESG rating decision. In addition, providers must document the procedures and measures implemented to comply with regulatory requirements, the specific methodologies used to determine ESG ratings, and any changes to or deviations from standard procedures and methodologies.¹³³

ii. Outsourcing

112. **OUTSOURCING** - When ESG rating providers outsource functions, services, or activities related to ESG rating provision, they must ensure compliance with specific

¹³⁰ Art. 32 (1) and 34 (1), ESG rating Regulation.

¹³¹ Annex II, 1, (a), (i) and (ii), ESG rating Regulation.

¹³² Annex II, 1, (a)(i), (b), (c) and (i), ESG rating Regulation.

¹³³ Annex II, 1, (d), (e), (b), (c), (i), (g) and (h), ESG rating Regulation.

conditions. The service provider must possess the necessary capacity, expertise, and legal authorization to perform the outsourced functions, taking corrective measures if compliance or effectiveness is at risk. Additionally, they must retain sufficient expertise to oversee outsourced activities and manage associated risks. Service providers are required to disclose any developments that could impact their ability to fulfill their duties in accordance with legal and regulatory standards. Furthermore, ESG rating providers must have the ability to terminate outsourcing agreements when necessary and implement contingency plans to mitigate operation risk associated with third-party involvement in the ESG rating process.¹³⁴

C. Disclosure requirements

i. Minimum disclosure to the public

113. WEBSITE AND ESAP – On a separate section of the website, rating providers must make available information about methodologies, models and key assumptions underlying ratings. That information must also be made available through the European Single Access Point (ESAP).¹³⁵

114. DATA COLLECTION – The information includes an overview of data sources, specifying whether information is obtained from sustainability statements or sustainability-related disclosures, as well as indicating whether sources are public or non-public. Additionally, they must provide details on data processing methods, how missing data is estimated, and the frequency of data updates. Where applicable, providers should disclose the use of artificial intelligence in data collection, including its limitations and associated risks. Furthermore, any constraints related to data sources used in ESG rating construction must be clearly stated, along with industry classification system applied.¹³⁶

115. ESTABLISHING OF THE ESG RATING – The public is informed how the rating is established through the service providers' website. This includes an overview

¹³⁴ Annex II, 2, (a) - (f), ESG rating Regulation.

¹³⁵ Art. 23 and Annex III, 1, ESG rating Regulation.

¹³⁶ Annex III, 1, (b), (c), (k), and (m), ESG rating Regulation.

of the methodologies used, any changes made, and whether the analysis is backward-looking or forward-looking, along with the time horizon considered. Providers must also clarify whether and how their methodologies are grounded in scientific evidence. Where applicable, they should disclose the role of artificial intelligence in the rating process, including its limitations and potential risks. Moreover, any constraints in the methodologies used for constructing ESG ratings must be clearly outlined.¹³⁷

116. **PRODUCT INFORMATION** – Each ESG rating must be accompanied by the necessary information. This product information consists of two parts, specifically characteristics and instructions of use. Within the characteristics, a distinction is made between ratings of specific issues, individual factors, or aggregate scores. Furthermore, ESG rating providers must specify the topics covered within the Environmental (E), Social (S), and Governance (G) factors and indicate whether these align with sustainability reporting standards. For aggregated ESG ratings, the weighting of the three overarching categories must be disclosed, providing percentage allocations for E, S and G factors along with an explanation of the weighting methodology. Moreover, information should be provided on whether the rating is expressed in absolute or relative terms. Lastly, any limitation on the information available to ESG rating providers should be disclosed.¹³⁸

The rating’s objective must be explicitly stated, including whether it assesses risks, impacts, or both, in line with the double materiality principle. In cases of double materiality, the proportion of risk and impact materiality should be disclosed. Finally, the extent to which the ESG rating aligns with international treaty goals, particularly the Paris Climate agreement for Environmental factors, must be specified.¹³⁹

117. **CONFLICTS OF INTERESTS** – ESG rating providers must disclose details on their ownership structure, the primary risks of conflicts of interest, and the measures implemented to mitigate them. In addition, providers must offer general information on the criteria used to determine client fees, outlining the factors considered in pricing.

¹³⁷ Annex III, 1, (a), (e), (k), and (m), ESG rating Regulation.

¹³⁸ Annex III, 1, (g), (h), (i), (j) and (q), ESG rating Regulation.

¹³⁹ Annex III, 1, (f), (o), (p), ESG rating Regulation.

Furthermore, an overview of the business and payment model should be provided to enhance clarity regarding the financial framework of ESG rating services.¹⁴⁰

ii. Additional disclosure to users of ESG ratings and rated items

118. DATA COLLECTION – The process of data collection for ESG ratings involves distinguishing between exact data and estimations, as well as verifying the data used. When exact data is used, it must be specified whether the data is publicly available and whether it originates from regulated sources, such as corporate sustainability reports or disclosures by financial products and market participants. Notably, ESG rating providers should indicate whether the information is derived from transparency obligations under the Taxonomy Regulation, particularly regarding environmentally sustainable economic activities.¹⁴¹ Additionally, providers must disclose whether the data has undergone an audit. For estimated data, including industry averages and modeled assumptions, the methodology used for estimation should be clearly explained.¹⁴²

Regardless of whether exact data or estimates are employed, providers must also outline their policies for updating and revising historical data, specifying the date of the most recent updates. Additionally, they should disclose data quality control measures, their frequency, and the remediation process for addressing any identified issues, as well as any steps taken to mitigate limitations in data sources.¹⁴³

Where relevant, ESG rating providers must provide information on their engagement with rated entities, including whether on-site reviews or visits have been conducted and at what frequency. If an unsolicited rating is issued, a clear statement must accompany the rating, indicating whether the rated entity or a related third party was informed, whether it participated in the rating process, and whether the rating provider had access

¹⁴⁰ Annex III, 1, (d), (n), (l), ESG rating Regulation.

¹⁴¹ The Taxonomy Regulation uses four conditions to prescribe when an economic activity is environmentally sustainable. For more information: M. OCH, “The EU Taxonomy Regulation and the Prevention of Greenwashing” in K. ALEXANDER, M. GARGANTINI and M. SIRI (eds), *The Cambridge Handbook of EU Sustainable Finance: Regulation, Supervision and Governance*, Cambridge University Press, 2025, 357-378.”

¹⁴² Annex III, 2, (b) (i) and (ii), ESG rating Regulation.

¹⁴³ Annex III, 2, (b) (ii), (iii), (iv) and (v), ESG rating Regulation.

to internal documents and management. Furthermore, if artificial intelligence is used in data collection or rating methodologies, an explanation of its application and potential limitations must be provided.¹⁴⁴

119. OVERVIEW OF THE RATING METHODOLOGIES – ESG rating providers must communicate, where applicable, the scientific evidence and assumptions underpinning the ratings, as well as the key performance indicators (KPIs) used for Environmental (E), Social (S), and Governance (G) factors, along with respective weighting methods. For aggregated ESG ratings, providers must present the results for each E, S, and G category in a manner that facilitates comparability.¹⁴⁵

Furthermore, any potential shortcomings in the methodologies must be identified, accompanied by measures taken to address them. Providers should also outline their policies for revising methodologies and disclose when a rating has been upgraded or downgraded due to material changes in rating methodologies, models, key assumptions, or data sources, including estimates. The reasons for such changes and their implications for the rating must be clearly explained, along with the date of the last methodology revision.¹⁴⁶

For ESG ratings covering environmental factors, providers must indicate whether, and to what extent, the rating correlates with the percentage of taxonomy alignment under Regulation (EU) 2020/852 or aligns with other international agreements. Any significant deviations from these standards should be justified.¹⁴⁷

Where artificial intelligence is used in data collection or rating processes, a clear explanation of its methodology and limitations must be provided. Finally, in cases where significant new information about a rated entity emerges that could affect the ESG rating, providers must disclose how this information has been considered and whether it has led to any modifications in the assigned rating.¹⁴⁸

¹⁴⁴ Annex III, 2, (c) (d), (e), ESG rating Regulation.

¹⁴⁵ Annex III, 2, (a) (i) - (iii), ESG rating Regulation.

¹⁴⁶ Annex III, 2, (a) (iv) - (vii), ESG rating Regulation.

¹⁴⁷ Annex III, 2, (a), (viii), ESG rating Regulation.

¹⁴⁸ Annex III, 2, (e) and (f), ESG rating Regulation.

§5. Independence and conflicts of interest

120. **GOVERNANCE STRUCTURES** - ESG rating providers must maintain strong governance structures and take all necessary measures to avoid conflict of interest that could compromise the integrity of their ratings. They must ensure that no relationships or ownership ties influence the rating process and are required to disclose any existing or potential conflicts to ESMA, which may intervene if such conflicts are not properly managed. Employees involved in ESG ratings must be appropriately skilled, act independently, avoid personal interests that might interfere with their duties and follow strict internal control procedures. ESG rating providers are also required to treat users fairly by ensuring that their fee structures are fair, transparent, and non-discriminatory. ESMA holds the authority to requires pricing documentation and take enforcement actions if these principles are not upheld.¹⁴⁹

§6. Supervision of ESMA

121. **ESMA'S POWER REGARDING THE SUPERVISION OF ESG RATING PROVIDERS** - All stages of the process will be supervised by ESMA. They will issue and update guidelines on the cooperation between ESMA and the competent authorities, that each Member State shall designate for the purpose of this Regulation. ESMA has the power to request information upon simple request or by discission but however may not use its power to require the disclosure of information or documents which are subject to legal privilege. ESMA can carry general investigations and has the power to conduct on-site inspections. Several provisions in the proposal also specify the supervisory measurements, fines, and periodic penalties that ESMA may impose. Lastly, ESMA also has the right to charge authorization and supervisory fees.¹⁵⁰

¹⁴⁹ Art. 25-27, ESG rating Regulation.

¹⁵⁰ Art. 28 – 42, ESG rating Regulation.

§7. Cooperation between ESMA and national competent authorities

122. COOPERATION – ESMA can delegate its tasks to a competent authority of a Member State if it is necessary for the proper performance of a supervisory task. To establish a good cooperation, the two authorities shall provide each other, without undue delay, the information required for carrying out their duties under this Regulation. If a competent authority in a Member State identifies actions that infringe upon this Regulation within its own territory or that of another Member State, it shall notify ESMA. Lastly, ESMA, the competent authorities, and all persons who work there shall ensure the obligation of professional secrecy.¹⁵¹

§8. Delegated and implementing acts

123. DELEGATED AND IMPLEMENTING ACTS - The European Commission is granted the power to adopt delegated acts related to ESG ratings for a renewable period of five years starting from January 2025, with oversight and potential revocation by the European Parliament or the Council. The delegated acts are related to the scope, an application for an authorization to operate in the Union, the recognition of ESG rating providers outside the Union, the register of ESG rating providers and accessibility of information on the ESAP, the separation of business and activities, transparency requirements, procedural rules for taking supervisory measures and imposing fines, supervisory fees, and the amendments to Regulation 2019/2088.¹⁵² Delegated acts only enter into force if no objections are raised within a set timeframe, and the Commission must consult Member States experts beforehand. The European Securities Committee will assist the Commission under the procedures established by EU law. Additionally, updates to existing regulations now require financial entities disclosing ESG ratings in marketing materials to include related information and website links, with further technical standards to be developed by the ESAs.¹⁵³

¹⁵¹ Art. 43-46, ESG rating Regulation.

¹⁵² Recital (45), Art. 2, (3), art. 6 (3), art. 12 (9), art. 14, (8), art. 16 (5), 23(4), (5), art. 24 (3), (4), art. 39 (9), art. 42 (2), art. 47, art. 49 ESG rating Regulation.

¹⁵³ Art. 47-50, ESG rating Regulation.

§9. Transitional and final provisions

124. TRANSITIONAL AND FINAL PROVISIONS - ESG rating providers operating in the EU must notify ESMA by August 2026 if they intend to continue their activities, and they must apply for authorization or recognition within four months thereafter, otherwise they must cease operations. Small ESG rating providers have until November 2026 to notify ESMA, and those that do so may continue operating temporarily until a decision is made. The Commission will review the application and impact of the Regulation by January 2029, focusing on its effects on sustainable investment, market structure, and the quality of ESG ratings. This Regulation officially enters into force shortly after its publication and will apply across the EU starting from July 2026.¹⁵⁴

SECTION. 4. Conclusion

125. CONCLUSION CHAPTER 2 – On 27 November 2024, Regulation (EU) 2024/3005 on the transparency and integrity of Environmental, Social, and Governance (ESG) rating activities was adopted, introducing a licensing regime under ESMA and imposing transparency and organizational standards on ESG rating agencies.

¹⁵⁴ Art. 51- 53, ESG rating Regulation.

CHAPTER 3. Does the Regulation meet the challenges of the agency costs in terms of investor protection?

126. EVALUATIVE CRITERION - The third chapter of this research will assess whether the Regulation effectively addresses agency costs, as identified in the first chapter. Investor protection will serve as evaluative criterion. To determine whether agency costs are sufficiently mitigated in terms of investors protection, the analysis will focus on two key dimensions: transparency and integrity.

To properly evaluate the Regulation's alignment with investor protection, it is necessary to operationalize these two dimensions. Transparency is a broad concept that can be understood in multiple ways. In the context of ESG ratings, transparency encompasses two distinct aspects: clarity and comparability. Clarity refers to the accessibility and comprehensibility of information, ensuring that ESG ratings are presented in a straightforward manner. This allows investors to easily interpret and use the ratings in their decision-making process. Another essential dimension of transparency is comparability, which enables investors to assess ESG ratings across different rating agencies. Comparability regarding ESG ratings is crucial for investors. This is especially the case considering the substantial differences among ESG rating providers using distinct methodologies in terms of the ESG topics they address, how they prioritize these topics and the metrics employed to assess ESG performance.¹⁵⁵

Integrity in ESG ratings signifies that the assigned scores accurately reflect the true ESG performance of companies or investment products. It ensures that ratings are methodologically sound, free from conflict of interest and bias, and resistant to manipulation. Integrity functions as a form of quality control, reinforcing the trustworthiness and reliability of ESG ratings.¹⁵⁶

¹⁵⁵C. BALL, "What is transparency?" *Public integrity* 2009, 11(4), 293; IOSCO, *Environmental, Social and Governance (ESG) Ratings and Data Products Providers - Final report*, 2021, 26.

¹⁵⁶ Other definitions of integrity exist – for example the definition in V. COLAERT, "The changing nature of financial regulation: sustainable finance as a new EU policy objective." *Common Market Law Review* 2022, 59(6), 1674 – 1675. – which share certain elements with the definition used in this research, such as "reliable information" and "trust". However, a custom definition is better suited to the objectives of integrity within the context of ESG ratings.

SECTION 1. Non-transparency

127. CLARITY - The Regulation performs well in enhancing the first dimension of transparency, namely more clarity.¹⁵⁷ This is particularly evident by the introduction of a website that provides public access to essential information about the ESG ratings. By improving accessibility, the Regulation addresses the black box¹⁵⁸ problem, which could help to reduce the opacity traditionally associated with EGS ratings.

128. COMPARABILITY - However, when it comes to comparability, the Regulation is less robust. Although the website increases clarity by providing more information, it is questionable whether this enables investors to meaningfully compare ratings across agencies. Instead, the additional information may simply expose the complexity of ESG rating, without equipping investors with the necessary tools. The Regulation's emphasis on transparency remains narrowly focused on enhancing clarity, rather than fostering comparability between rating agencies.

129. INTEGRITY –In terms of integrity, it depends on the specific information that is required by the Regulation. This information will be handled in the next sections.

SECTION 2. Conflicts of interest and biases

§1. Conflicts of interests

130. CLARITY – The second key objective of the Regulation is the mitigation of conflicts of interest, identified earlier as problems with ownership, the mix of products and services offered, the separation of the commercial and analytical teams and methodology governance.¹⁵⁹¹⁶⁰ In terms of clarity, the Regulation enhances this dimension of transparency by requiring ESG rating providers to disclose ownership structures and key risks of conflicting interests, along with strategies for mitigating

¹⁵⁷ Art. 3 (para 17), art. 14 (para 96), art. 18 (para.98), art. 23 (para.99), art. 24 (para.99), art. 27 (para 120); Annex III (para 114 -119), ESG rating Regulation.

¹⁵⁸ Para. 40.

¹⁵⁹ Para 83.

¹⁶⁰ Para. 41,42,43,41 and 42.

those risks.¹⁶¹ This information, made publicly available on their website, significantly improves the accessibility and comprehensibility of ESG data, enabling investors to better understand the impact of conflicts of interest on the ESG rating.

131. COMPARABILITY - When it comes to comparability, it may remain difficult to fully capture the impact of conflicts of interest on ESG ratings, even with increased transparency, making comparability between ratings from conflicted and non-conflicted agencies challenging.¹⁶²

132. INTEGRITY- In addition to requiring general transparency regarding the conflict of interest, the Regulation specifically addresses the four types of conflicts identified earlier as undermining integrity. It mandates the disclosure of ownership structures, prohibits certain product mixes, imposes “Chinese wall” requirements to separate teams, and addresses conflicts related to methodological governance by assigning individual names for ratings. Through these measures, the Regulation enhances integrity by actively reducing conflicts of interest.¹⁶³

§2. Biases

133. NO MENTION – While the Regulation focusses heavily on addressing conflicts of interest, it makes no explicit mention of biases related to company size, geography, industry sector, company engagement, or language.¹⁶⁴ As a result, there is no significant improvement in terms of clarity, comparability, or integrity in this field. However, the Regulation does require ESG rating agencies to implement a complaint mechanism through which companies can raise concerns about potential biases.¹⁶⁵ Nevertheless, the overall impact of individual complaints on the systemic reduction of bias is likely to be limited.

¹⁶¹ Annex III (1) (d) and (n) (para 117), ESG rating Regulation.

¹⁶² Recital (38), (39), (40) ESG rating Regulation; art. 15(1), (5), (6) and (10) (para. 97), art. 16 (para.98), art. 17(2), (3), (4), (7) and (8) (para.98), art. 25 (para 120), art. 26 (para 120), ESG rating Regulation; Annex III (1) (d) and (n) (para 117), ESG rating Regulation.

¹⁶³ Recital (38), (39), (40) ESG rating Regulation; art. 15(1), (5), (6) and (10) (para. 97), art. 16 (para.98), art. 17(2), (3), (4), (7) and (8) (para.98), art. 25 (para 120), art. 26 (para 120), ESG rating Regulation; Annex II, (1) (a) (para 109, 110), ESG rating Regulation.

¹⁶⁴ Para. 46, 47, 48, 49 and 47.

¹⁶⁵ Art. 19, ESG rating Regulation. (Para. 98)

SECTION 3. DATA ISSUES

134. CLARITY – The Regulation contributes to greater clarity, by helping the public to understand how data is treated and used, as agencies must disclose their data sources and how estimates are used.¹⁶⁶ This will support accessibility and comprehensibility of ESG information. The Regulation also contains references to the annexes that are specifically related to the agency costs that investors encounter. For instance, the Regulation addresses concerns around self-reporting¹⁶⁷ through Annex III,(2) (b) iv and (2) (c)¹⁶⁸ or the agency cost related to a variety of data sources¹⁶⁹ through Annex III,(1)(c) and (2)(b), i.¹⁷⁰ Data gaps and assumptions are also a concern as providers can use different approaches to fill in the data gaps such as the rule-based approach, the input-output approach, the regression method or the predicted mean matching method¹⁷¹. The Regulation addresses these concerns in Annex III, (2) (a) i, (2) (b) ii.¹⁷²
135. COMPARABILITY – Comparability will improve when two rating agencies disclose that they rely on the same sustainability reporting frameworks. However, when agencies use different frameworks or rely on estimates – which can vary significantly depending on the methodology – comparability will not be enhanced.
136. INTEGRITY- Regarding integrity, the Regulation promotes higher standards by requiring providers to ensure the quality and reliability of the information they use.¹⁷³ While this could lead to an improved ESG rating, the requirements remain vague as those measures are not specified, offering no clear guidance on how these quality standards should be met. The expected improvement of integrity will be limited. Especially given the low reliability of data, more specific requirements to substantiate

¹⁶⁶ Annex III (1) k ,m (para 114 and 115) and q (para 116), (2) (b) (para 118) and (f) (para 119) ESG rating Regulation.

¹⁶⁷ Para. 52..

¹⁶⁸ Para. 118.

¹⁶⁹ Para. 55.

¹⁷⁰ Para. 114 and 118.

¹⁷¹ Para. 58.

¹⁷² Para. 118 and 119.

¹⁷³ Art. 15 (11) (12) (para. 97), ESG rating Regulation.

quality controls are necessary. Moreover, Annex III serves primarily to inform investors rather than enhance the actual quality or integrity of the rating.

SECTION 4. Methodological issues

137. CLARITY – The Regulation provides investors with important information, such as the methodologies and industry classification, accessible through the website of the company.¹⁷⁴ This information contributes to the clarity of the methods used for ESG ratings by enhancing both accessibility and comprehensibility of the information. In doing so, the Regulation also addresses several agency costs-related challenges. To tackle the issues of weight divergence, rating agencies are required in Annex III, (1) (h) and (2) (a) (ii) to explain the weighting of E, S and G factors.¹⁷⁵ In response to the inconsistencies around the different sector classifications, Annex III, (1) (b) requires disclosure of the industry classification used by each provider.¹⁷⁶ Given the variability in the scales and factors applied, Annex III (1) (i) requests the specification of all the elements covered by the ESG rating.¹⁷⁷ Furthermore, to address the concerns related to differing materiality approaches, providers are required in Annex III (1) (f) to clarify the role of double materiality in their assessments.¹⁷⁸ The issue of scope divergence is addressed in Annex III (1) (g), which requires the disclosure of the scope of the ESG rating.¹⁷⁹ Lastly, Annex III (2) (a), ii obliges rating agencies to disclose the key performance indicators they rely on, thereby helping to resolve the discrepancies in measurement practices.¹⁸⁰ Together, these disclosures are intended to help investors better understand and interpret ESG ratings.

138. ENVIRONMENTAL PILLAR - The study from Monica Billio, Aoife Claire Fitzpatrick, Carmelo Latino and Lorian Pelizzon¹⁸¹ highlights that the environmental

¹⁷⁴ Recital (32), (33), (36); art. 15, (7), (8), (9), (para. 97), art. 23 (para.99), ESG rating Regulation; Annex III, (1), (a), (b), (e), (f), (g), (h), (i)(m), (o), (p) (para. 114,115 116) (2), (a),iii, iv, v, vii, viii, (2),(e) (para.119), ESG rating Regulation.

¹⁷⁵ Para.67, 116 and 119.

¹⁷⁶ Para. 63 and 114.

¹⁷⁷ Para. 65 and 116.

¹⁷⁸ Para. 66 and 116.

¹⁷⁹ Para. 67 and 116.

¹⁸⁰ Para 67 and 119.

¹⁸¹ Para. 68.

pillar tends to play a predominant role in shaping overall ESG ratings across all agencies. By requiring the separate disclosure of Environmental, Social, and Governance scores, the Regulation enhances the clarity of ESG ratings. This separation could ensure that the environmental component no longer overshadows the social and governance pillars, allowing each pillar to be evaluated on its own merits and offering investors a more accurate and balanced understanding.

139. COMPARABILITY- Comparability will be improved by allowing investors to understand the specific weighing at the E, S and G level.¹⁸² This marks the beginning of a more structured methodological approach but still falls short of providing a robust framework that would make ESG ratings more comparable, because each of those overarching categories contains different levels of indicators being weighed against each other.

140. SEPARATE E, S AND G RATING – The study from Monica Billio, Aoife Claire Fitzpatrick, Carmelo Latino and Lorian Pelizzon¹⁸³ states that rating agencies tend to show more alignment in their assessment of overall ESG score than in their individual E, S and G components. This discrepancy may cause challenges for comparability, as differences in the evaluation of the separate E, S and G factors are likely to be even more pronounced across ESG rating providers. While the provision of separate E, S and G ratings offers investors more detailed options for analysis and comparison, it may also increase complexity, as disagreements between providers on individual factors could make meaningful comparisons more difficult and time-consuming.

141. INTEGRITY – The Regulation emphasizes the importance of ESG rating providers applying sound procedures, establishing internal control mechanisms, and adhering to general standards. Integrity is expected to improve through increased

¹⁸² art. 23, (2) and (3) (para 99) and Annex III, (2)(a) iii (para 119), ESG rating Regulation.

¹⁸³ Para. 68.

transparency of the methodologies used. However, the Regulation does not impose specific standards to ensure the methodological soundness.¹⁸⁴

SECTION 5. Greenwashing and conceptual issues

142. CLARITY – Although the Regulation acknowledges the issue of greenwashing in article 1 of the Regulation, it does not explicitly address it through concrete measures. As a result, the clarity of ESG ratings has not significantly improved in this regard.¹⁸⁵

143. COMPARABILITY AND INTEGRITY – Improvements in comparability and integrity under the Regulation are limited, as they only occur when greenwashing practices interact with other identified challenges – such as conflicts of interest or the use of estimated data. In the absence of direct measures targeting greenwashing itself, any enhancement in these areas remains indirect and dependent on how greenwashing compares to other concerns.

SECTION 6. Conclusion

144. CONCLUSION OF CHAPTER 3 – This chapter evaluated the effectiveness of the ESG rating Regulation in addressing agency costs through the lens of investor protection, focusing on the dimensions of transparency – encompassing two distinct aspects: clarity and comparability - and integrity. The Regulation makes commendable progress in enhancing clarity. However, it falls short in achieving meaningful comparability, leaving investors with limited tools to assess ESG ratings across providers. Similarly, while integrity is partially reinforced, gaps remain. Overall, the Regulation represents a step in the right direction but requires further refinement to fully mitigate agency costs in ESG rating practices.

¹⁸⁴ art. 15, (7), (8), (9), (para 97), art. 23 (para. 99), ESG rating Regulation; Annex II, (1), (d), (e), (f), (g), (h) (para 111), ESG rating Regulation.

¹⁸⁵ Art. 1, ESG rating Regulation (para. 88).

CHAPTER 4. Ways of improvement for the Regulation

145. IMPROVEMENTS - The Regulation has been adopted, making a significant step toward enhancing transparency and integrity for ESG ratings. However, the European Commission is now tasked to further elaborate the transparency obligations outlined in the Regulation.¹⁸⁶ This presents a valuable opportunity to address certain challenges within the framework of the Regulation itself. At the same time, critical attention will be given to those aspects of the Regulation that do not provide sufficient flexibility or scope for the Commission to act. Such limitations may hinder the ability to effectively respond to evolving issues in ESG practices.

146. KALDOR HICKS EFFICIENCY - To effectively address the agency costs linked to ESG ratings from an investors' perspective, the concept of Kaldor Hicks efficiency will be applied. This approach allows for an assessment of whether improvements in transparency –specifically along the dimensions of clarity and comparability- and integrity can be achieved, even if they come with trade-offs, provided there is an overall gain in terms of investor protection. As long as the overall gains exceed the losses, the change is considered efficient. Currently, as seen in the previous chapter, the Regulation is strong in terms of clarity. However, achieving greater comparability or integrity might require sacrificing some of that clarity or reduce the freedom of the ESG rating agencies. Evaluating such trade-offs through the lens of Kaldor Hicks efficiency helps to determine whether these regulatory adjustments ultimately benefit the broader concept of investor protection.

SECTION 1. More transparency

147. STANDARDIZATION – Comparability among ESG ratings will only be improved if transparency is structured consistently across all rating agencies. This means that information must not only be disclosed, but also presented in a uniform

¹⁸⁶ Recital (45), Art. 2, (3) (para 89) art. 6 (3) (para. 93), art. 12 (9) (para. 93), art. 14, (8) (para. 96), art. 16 (5) (para. 98), 23 (4), (5) (para. 99), art. 24 (3), (4) (para. 99), art. 39 (9) (para. 121), art. 42 (2) (para. 121), art. 47 (para. 123), art. 49 (para. 123), ESG rating Regulation.

manner and located in the same place across providers. To achieve this, it is essential that the European Commission ensures a high degree of standardization and consistency when adopting the Delegated Acts. These acts will define the format, location, and method of disclosure. Without such consistency, the intended benefits of increased transparency may fall short, and investors will continue to face challenges in comparing ESG ratings effectively.

SECTION 2. Conflicts of interests and biases

§1. Conflicts of interests

148. **HEIGHTENED SCRUTINITY** – To enhance both comparability and integrity of ESG ratings, ESMA should apply heightened scrutiny on ratings agencies with potential conflicts of interest. By closely monitoring these agencies and ensuring that no undue influence affects their assessments, ESMA can help to safeguard the objectivity of ESG ratings.

§2. Biases

149. **BIASES NOT MENTIONED** - While the Regulation places significant emphasis on conflicts of interest, it noticeably omits references to biases. A whole chapter (chapter 3) is dedicated to conflict of interest without once mentioning biases. This omission is particularly striking given that biases, although perhaps not as extensively addressed in the literature as conflicts of interest, are recognized as a challenge to the accuracy of ESG ratings. The absence of a focus on biases in the Regulation may undermine its ability to fully address the integrity issues associated with ESG ratings. The Regulation's effectiveness in safeguarding the reliability of ESG ratings would be enhanced by explicitly addressing the issue of biases and adding this challenge to chapter 3 of the Regulation.
150. **KEY SUSTAINABILITY REPORTING FRAMEWORKS** - ESMA should conduct a thorough analysis of how biases influence ESG ratings, particularly those affecting certain sectors, small enterprises, and foreign companies. As part of this effort,

it is important that ESMA identifies the key sustainability reporting frameworks most commonly used by ESG rating providers. Based on this analysis, ESMA should develop and promote publicly accessible learning materials tailored to the needs of these potentially disadvantaged groups.

SECTION 3. Data issues

151. GUIDANCE - To enhance comparability and integrity in ESG ratings, ESMA should provide clearer guidance on the appropriate sustainability reporting frameworks to be used, as well as detailed instructions on acceptable methods for making estimations when data is missing.
152. FINDING A RIGHT BALANCE - While such standardization may reduce the freedom currently afforded to ESG rating agencies – and could potentially limit the development of innovative methodologies – it would also bring significant benefits. By promoting consistency and transparency, this proposal would support more reliable ESG assessments and ultimately strengthen investor protection. Striking the right balance between flexibility and standardization will be key to achieving these goals.

SECTION 4. Methodological issues

153. AVOIDING DIRECT INTERVENTION - As discussed in Chapter 3 of this research, the Regulation places greater emphasis on clarity rather than on comparability and integrity. It aims to enhance the clarity of information, while avoiding direct intervention in the methodologies used by rating agencies. Instead of harmonizing methodologies, the Regulation ensures that ESG rating providers retain full control and independence in their choice of methodologies, maintaining a variety of approaches within the market.¹⁸⁷

¹⁸⁷ Recital (36), ESG rating Regulation: “*This Regulation should not interfere with ESG rating methodologies or the content of ESG ratings. Diversity in the methodologies of ESG rating providers ensures that the broad requirements of users of ESG ratings can be met and promotes competition in the market.*”

154. **A BURDEN FOR INVESTORS** - Clarity can provide investors with greater insights into the procedures used by ESG rating providers, potentially enabling them to make more informed investment decisions. However, this approach also could impose significant burdens on investors, requiring them to invest in considerable time and effort to understand and compare all the information. In the long run, this could discourage thorough due diligence, as the process becomes overly time-consuming and complex.
155. **CONSISTENT TERMINOLOGY** - A first recommendation to effectively improve the Regulation to address the agency costs associated with ESG ratings in terms of investors, would be to enforce the use of consistent terminology across ESG rating providers. The use of consistent terminology could enable investors to compare ratings more easily across different providers. This alignment in terminology would help to eliminate a barrier that investors could face when trying to interpret and evaluate ESG ratings from multiple sources.
156. **STANDARDIZATION OF CRITERIA** - By prioritizing clarity, the Regulation takes an important step forward but falls short of addressing comparability and integrity. Implementing standardization criteria could strike a more effective balance, ensuring the soundness of the methods underlying the ESG ratings. The purpose would be that investors are not only informed but can have a set of criteria that are the same across the providers to help them better compare ESG ratings. A standardized set of criteria could also help to improve the quality and trustworthiness of ESG ratings and thus improve the integrity of ESG ratings.
157. **FINDING A BALANCE** - These recommendations aim to find a balance between maintaining operational independence of providers and establishing a framework that offers guidance for investors. This allows to find a middle ground between giving providers complete freedom and imposing a rigid, uniform methodology on all of them. Such an approach would still preserve the diversity of methodologies – a feature the European Union seeks to protect¹⁸⁸ – while simultaneously enhancing the usefulness and reliability of ESG ratings for investors. However, it may reduce the freedom currently afforded to

¹⁸⁸ Recital (36), ESG rating Regulation.

ESG rating agencies – and could potentially limit the development of innovative methodologies – but it would also bring significant benefits. Ultimately, these measures could enhance the quality of ESG assessments and contribute to stronger investor protection. Achieving the right balance between flexibility and standardization will be crucial to achieving these goals.

SECTION 5. Greenwashing

158. **HIGH RISK CHANNEL** – In the ESMA’s high-level understanding of greenwashing, ESG ratings are identified as a high-risk channel. The report highlights several challenges - such as the lack of transparency in explaining how ESG ratings measure environmental objectives over time¹⁸⁹, and persistent data and methodological issues, including a focus on disclosure quality over actual performance and insufficient disclosure of methodological changes¹⁹⁰. These concerns align closely with the issues the Regulation aims to address. Given these developments, ESMA should now provide clarity on whether ESG ratings continue to show a high risk for greenwashing, or whether the new regulatory measures have effectively mitigated these concerns.

SECTION 6. Validity as an additional objective of the Regulation

159. **ADDING VALIDITY** – Building on the previous discussion, an additional recommendation would be to include validity as an additional objective of the Regulation. While the Regulation currently aims to enhance integrity, transparency, comparability, reliability, responsibility, good governance, and independence of ESG rating activities, it notably omits validity – a concept often emphasized as crucial in evaluating ESG ratings. This omission may limit the Regulation’s effectiveness. Validity ensures that ESG ratings genuinely measure what they claim to assess, addressing the alignment between the ratings and the underlying sustainability criteria. Including validity in the regulatory framework of article 1 of the Regulation could

¹⁸⁹ Para. 51, Progress report on Greenwashing (31 May 2023), ESMA30-1668416927-2498 (2023).

¹⁹⁰ Para. 61, 107 and 108, Progress report on Greenwashing (31 May 2023), ESMA30-1668416927-2498 (2023).

strengthen the Regulation by adding a layer of assurance that ratings are not only comparable and transparent but also accurate and meaningful.¹⁹¹

SECTION 7. Conclusion

160. CONCLUSION OF CHAPTER 4 – Chapter 4 proposes concrete improvements to the ESG rating Regulation aimed at better addressing agency costs from the perspective of investor protection. Through the lens of Kaldor Hicks efficiency, it emphasizes that trade-offs can be justified if the overall gain in investor protection outweighs the loss. Key recommendations include greater standardization in disclosures to improve comparability, enhanced scrutiny of conflicts of interest, explicit recognition and regulation of biases, clearer guidance on data estimation practices, ESMA providing clarity on whether ESG ratings continue to show a high risk for greenwashing and the inclusion of validity as a formal regulatory objective.

¹⁹¹ A. CHATTERJI and D. LEVINE, “Breaking down the wall of codes: evaluating non-financial measurements”, *Calif. Manage Rev* 2006, 48, 6-7.

CHAPTER 5. Conclusion

161. The rapid growth of sustainable finance reflects a strong investors interest in aligning portfolios with sustainability goals. However, the complexity and resources required for conducting independent sustainability assessments have led investors to rely on ESG rating agencies, introducing a range of costs. This research tries to find an answer to the question “*Does the ESG rating Regulation effectively address the agency costs associated with ESG ratings in terms of investor protection, and if not, how can the Regulation be improved?*”
162. The research explores the range of agency costs that investors are likely to encounter, including non-transparency, conflict of interest and biases, data issues, methodological issues, greenwashing and conceptual issues. (Chapter 1). On the 27 November 2024, the Regulation (EU) 2024/3005 on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities was adopted, creating a license with ESMA and subjecting ESG rating agencies to transparency and organizational requirements. (Chapter 2)
163. To examine whether this Regulation effectively addresses the agency costs in the context of investor protection, this research focuses on the two key dimensions of transparency – operationalized as clarity and comparability – and integrity. While the Regulation makes notable progress in enhancing clarity for every agency cost except greenwashing, particularly through disclosure requirements, and public access to data and methodological information, it falls short in significantly improving comparability across ESG ratings agencies. Integrity is partly strengthened through measures targeting conflicts of interests, data issues and methodological issues but vague standards and the absence of concrete provisions on biases limit its overall effectiveness. Although some greenwashing risks and conceptual issues are indirectly mitigated, the Regulation does not explicitly confront the issue, leaving room for ambiguity (Chapter 3).

164. While the Regulation marks a significant step forward, further improvements are necessary to effectively address the agency costs from a perspective of investor protection. Key recommendations include increasing standardization to improve comparability, explicitly addressing biases alongside conflict of interest, providing clearer guidance on data use and estimation methods, and promoting consistent terminology and criteria. Additionally, ESMA should provide clarity on whether ESG ratings continue to pose a high risk for greenwashing. Ultimately, the inclusion of validity as a regulatory objective could strengthen the framework by ensuring that ESG ratings truly reflect sustainability performance. (Chapter 4).

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Appendix

Gebruik van GenAI bij een schrijfofdracht

Conform de afspraken gemaakt in de universiteit en faculteit, communiceren studenten transparant over het gebruik van GenAI. Ze voegen dit ingevulde formulier toe als bijlage aan hun schrijfofdracht. Alle aanvinkopties zijn toegelaten op voorwaarde dat studenten de gedragscode en [de KU Leuven richtlijnen](#) volgen.

Naam student: Aline SOENEN

Studentnummer: r0846442

Geef met "X" aan:

- ☐ Ik heb **geen** AI Writing/Coding/Visualisation-assistent gebruikt.
- ☒ Ik heb **wel** een AI Writing/Coding/Visualisation-assistent gebruikt. Geef in dat geval aan welke (bijv. ChatGPT/GPT4/Grammarly...): ChatGPT

Geef met "X" aan (mogelijk meerdere keren) op welke manier je de AI Writing/Coding/Visualisation-assistent hebt gebruikt:

- ☒ Als hulp bij **de verwoording van de tekst**

Gedragscode: Deze toepassing is vergelijkbaar met het gebruik van spellingscontrolesoftware

- ☐ Als **zoekmachine** om meer te leren over een onderwerp of om **nieuwe ideeën** op te doen

Gedragscode: Deze toepassing is vergelijkbaar met een Google-zoekopdracht of het raadplegen van Wikipedia. Houd er rekening mee dat de output van GenAI evolueert en na verloop van tijd kan veranderen. Verifieer ook steeds of het idee nieuw is of niet. Het idee is waarschijnlijk gerelateerd aan bestaand werk, dat moet worden geciteerd.

- ☐ Voor **literatuuronderzoek**

Gedragscode: Deze toepassing is vergelijkbaar met een Google Scholar-zoekopdracht. Door GenAI gegenereerde tekst heeft mogelijk geen of verkeerde referenties. Het is jouw verantwoordelijkheid om de afwezigheid van referenties na te gaan of de correctheid te verifiëren.

- ☐ Om **programmeercode** te genereren

Gedragscode: Vermeld het gebruik van GenAI correct en citeer.

- ☐ Om **grafieken** te genereren

Gedragscode: Vermeld het gebruik van GenAI correct en citeer.

- ☐ Om **tekstblokken** te genereren

Gedragscode: **Het invoegen van tekstblokken zonder aanhalingstekens van tekst die gegenereerd is via GenAI in je werk is niet toegestaan.** Artikel 84 van het examenreglement bepaalt dat je werk moet worden beoordeeld op basis van je eigen kennis. Als het echt nodig is om een tekstblok geproduceerd door GenAI in te voegen, vermeld je dit als citaat met aanhalingstekens. Beperk ook dit echter tot een minimum.

- ☐ **Andere**

Gedragscode: Neem contact op met je promotor. Leg uit hoe je voldoet aan artikel 84 van de examenregeling. Leg uit wat het nut of de toegevoegde waarde van het gebruik van de AI-tool is: [Klik of tik om tekst in te voeren](#).

Bijkomende richtlijnen en opmerkingen:

- GenAI kan niet worden gebruikt met betrekking tot gegevens of onderwerpen die onder een **geheimhoudingsovereenkomst** vallen.
- GenAI kan niet worden gebruikt met betrekking tot gevoelige of persoonlijke gegevens vanwege **privacykwesties**.
- Neem een **wetenschappelijke en kritische houding** aan bij interactie met GenAI en het interpreteren van de output ervan.
- Als student ben je verantwoordelijk voor naleving van **artikel 84 van het OER**: je werk moet je eigen kennis weerspiegelen. Hou er rekening mee dat plagiaatregels ook van toepassing zijn op het gebruik van AI-tools.
 - o Examenreglement artikel 84: " Elk gedrag van individuele studenten waardoor zij een juist oordeel omtrent de kennis, het inzicht en/of de vaardigheden van henzelf of van andere studenten geheel of gedeeltelijk onmogelijk maken of onmogelijk pogen te maken, wordt als een onregelmatigheid beschouwd die aanleiding kan geven tot een aangepaste sanctie. Een bijzondere vorm van een dergelijke onregelmatigheid is plagiaat, namelijk de overname zonder adequate bronvermelding van het werk (ideeën, teksten, structuren, ontwerpen, beelden, plannen, codes, ...) van anderen of van eerder werk van zichzelf, op identieke wijze of onder licht gewijzigde vorm. Elk bezit tijdens een examen van een niet-toegestaan hulpmiddel (zie artikel 65) wordt als een onregelmatigheid beschouwd."

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