MARCH 11, 2022

**Re: ESMA’s call for evidence on market characteristics for ESG rating providers in the EU**

To the European Securities and Markets Authority:

Inclusive Development International is a US-based non-governmental organization that works to advance social, economic and environmental justice by supporting communities around the world to defend their rights in the face of harmful corporate projects. Through research, casework and policy advocacy, we hold corporations and development agencies accountable to their human rights and environmental responsibilities and promote a more just and equitable international economic system.

As a non-governmental advocacy organization, we offer a unique and important perspective on the role of ESG rating providers in promoting or hindering efforts to hold companies accountable to their human rights responsibilities under the UN Guiding Principles on Business and Human Rights and OECD Guidelines for Multinational Enterprises. Our interest in ESMA’s call for evidence on ESG ratings providers relates in particular to the extent to which ESG ratings appropriately reflect incidents of adverse human rights impacts caused or contributed to by corporations. Our research finds that ESG ratings of corporations frequently fail to do so.

A recent financial investigation we conducted, published on 9 March 2022, documents how dozens of companies doing business with the Myanmar military have received high enough ESG ratings to be included in the holdings of 344 ESG-labeled funds. Through these funds, $13.4 billion worth of ESG-labeled investments are going towards 33 companies that have funded, equipped or otherwise enabled Myanmar’s military regime, despite it having perpetrated [crimes against humanity](https://www.ohchr.org/EN/HRBodies/HRC/Pages/NewsDetail.aspx?NewsID=23475&LangID=E) and a brutal coup. The companies include arms manufacturers supplying weapons and surveillance drones to the military, firms providing communications technology, and oil and gas companies that have generated billions of dollars in revenue for the regime through joint ventures. Six years since the ethnic cleaning campaign and one year after the coup, twelve of the companies enabling the military have seen their ESG ratings improve, even as the junta continues to violently suppress peaceful protestors and opposition to its rule. Our full report is available at: [Myanmar ESG Files: How responsible investment is enabling a military dictatorship](https://www.inclusivedevelopment.net/MyanmarESGFiles/), and an accompanying database is available at: <https://www.inclusivedevelopment.net/policy-advocacy/stopesgreenwashing/>.

Another example of the failure of ESG ratings to reflect grave human rights impacts is the reaction to the collapse of the Xe-Pian Xe-Namnoy hydroelectric power dam in Laos in 2018. The [collapse](https://www.bbc.com/news/world-asia-44935495), a result of negligent [substandard construction](https://www.cnn.com/2018/07/27/asia/laos-dam-collapse-construction-intl/index.html), killed dozens and left thousands homeless. Yet, MSCI’s ESG ratings of the Korean developer, SK Inc, went [from a BBB before the disaster to a AA today](https://www.msci.com/research-and-insights/esg-ratings-corporate-search-tool/issuer/sk-inc/IID000000002241650), despite the lack of restitution for the victims, according to a [UN human rights expert](https://www.ohchr.org/EN/NewsEvents/Pages/DisplayNews.aspx?NewsID=25839&LangID=E).

Our findings demonstrate several systemic flaws of the ESG ratings industry, which extend far beyond the Myanmar and Laos dam case studies. These flaws converge to create a system that undermines efforts to hold companies accountable for breaching their international human rights responsibilities established by the UN and OECD. When a company implicated in human rights abuses is given a stamp of approval through high ESG ratings, investors and lenders are less likely to use their leverage over the company to compel action. As we have witnessed in our advocacy, this undercuts the ability of communities and human rights defenders to secure redress for corporate abuses. Moreover, high ESG ratings not only shields these companies from pressure from investors to address human rights impacts, but it rewards such companies with ESG investment.

For this reason, we are calling for regulation and reform of the ESG ratings industry to end false labeling and ensure that ESG ratings and the investment products tied to them are aligned with international human rights standards. **Financial securities regulators, including ESMA, should develop a consistent framework aligned with international human rights standards for both corporate ESG disclosures and external ratings.**

A fundamental flaw of the industry is ESG ratings firms’ emphasis on financial materiality. The ratings produced by firms including MSCI, FTSE Russell and S&P Dow Jones do not measure the impact of a company on human rights or the planet, but rather how ESG risks may impact a company’s profitability. This emphasis on financial materiality directly contradicts how ESG products are marketed to investors and the general public. **Legislative initiatives must address this concern by adopting standards based on the concept of ‘double materiality.’**

Additionally, our extensive research documents an unacceptable over-reliance on company self-reporting or policies and procedures as the basis for ESG ratings, without any reliable system to capture outcomes or performance of companies with respect to ESG issues. The industry lacks a system to gather and verify data on company performance on the ground. This results in an incomplete and inaccurate picture of a company’s ESG credentials. **To address this, human rights related ESG reporting standards must aim to capture actual human rights risks and impacts rather than company policies and procedures. ESG reporting should be subject to a robust and regulated audit and assurance framework. We urge ESMA to adopt such standards and incorporate into law penalties on companies and auditors that make false or misleading statements on ESG performance.**

Further, the current dominant approach to rating, which amalgamates E, S and G scores to create a single score, often obfuscate salient human rights and environmental impacts. Under the current dominant methodology, human rights risks and impacts such as the use of forced labor or displacement may be easily outweighed by unrelated factors, such as recycling initiatives or carbon emission polices. **For this reason, we urge securities regulators including ESMA to prohibit the use of aggregated ESG ratings, and instead require ratings firms to break down ESG scores into separate and distinct categories of environmental, social and governance issues.**

Importantly, the **ESG ratings of any company that has caused or contributed to serious human rights violations should be downgraded to such an extent that it will not be included in ESG indexes and funds.** That rating should stand until the harm has been remediated.

Lastly, ESG ratings assess a company’s relative performance against that of its industry peers. This creates a distorted picture of corporate performance. To align with international human rights standards, **companies should be assessed in absolute terms, against the same global standards of responsible business conduct.**

We urge the ESMA to consider in its investigation the importance of ensuring that ESG ratings are consistent with, and do not undermine, international human rights standards and the responsibilities of all business enterprises, including ESG ratings providers, under the UN Guiding Principles and OECD Guidelines. We trust that the above comments and our [report](https://www.inclusivedevelopment.net/myanmaresgfiles/) will assist the ESMA in this regard.

Sincerely,

A pair of glasses

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Natalie Bugalski

Legal and Policy Director