Introduction

Open MIC (Open Media and Information Companies Initiative) works to foster greater corporate accountability at media and technology companies, principally through shareholder engagement. We believe investors play a critical role in shaping rights-respecting companies and furthering the implementation of the United Nations Guiding Principles on Business and Human Rights (UNGPs).

We submit this comment in response to the United Nations Working Group on Business and Human Rights' call for input on Investors, ESG and Human Rights. In particular, our submission addresses the limitations of existing data, indexes, ratings, benchmarking, and funds labeled as ESG, specifically with regards to their failure to adequately account for adverse impacts to human rights in the digital context.

In this submission, we offer findings from Open MIC's research for a project commissioned by the NetGain Partnership in 2021 to explore finance-focused strategies to promote digital rights accountability in tech. As detailed in our *ESG(+D): Bridging the digital rights data gap* report, we found that while the proliferation of ESG ratings and standards in recent years should mean that more investors are redirecting capital to socially responsible companies, the largest tech companies remain popular with ESG investors despite their well documented human rights failures.[1]

Our research suggests the reason is twofold: mainstream ESG ratings fail to account for the unique human rights harms endemic to the tech sector and have methodological limitations that lend themselves to overestimation of tech sector ESG performance. Although there are numerous disparate initiatives that offer piecemeal standards and metrics to define and measure responsible tech practices, to-date none offer investors comprehensive, decision-useful information that would facilitate effective engagement and screening on digital rights issues.

There is thus an opportunity to bolster the leverage of responsible investors interested in promoting greater accountability in the tech sector by increasing transparency and regulation around mainstream ESG products and by redressing the ESG data deficit on tech-specific impacts through investor-friendly standards and metrics that accurately assess the human rights risks of the digital era.[2]

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[1] Hans Taparia, *New York Times*, "One of the Hottest Trends in the World of Investing Is a Sham" (September 29, 2022), https://www.nytimes.com/2022/09/29/opinion/esg-investing-responsibility.html.
[2] For an overview of digital human rights issues, see United Nations Office of the High Commissioner for Human Rights, "Hub for Human Rights and Digital Technologies," https://www.digitalhub.ohchr.org/.

Digital rights impacts are hard to assess.

Unlike environmental impacts, impacts to human rights and society more broadly are intrinsically harder to measure than the kind of straightforward, numerical rankings upon which investors typically rely. This is particularly true for the tech sector, where "S" impacts range from violations to individual rights like the right to privacy and non-discrimination to broader social ramifications like hate speech and the undermining of democracy. As one responsible tech researcher puts it, "most digital harms lack 'natural attributes' that are countable or physically measurable. Further complicating the challenge, there are few widely accepted methods for linking potential or actual digital harms and opportunities to revenue streams or return on investment."[3]

It is then no surprise that responsible investors feel mainstream ESG ratings are not useful tools for measuring the social impacts of tech companies; ratings agencies typically focus on supply chain risks or labor rights issues and fail to capture digital rights challenges. This is why all of the investors we interviewed indicated that while they buy third party data, they largely use it as a high-level screening tool and not as a means of identifying the important issues on which to engage tech companies. Investors told us they either determine engagement issues based on "art and intuition," rely on their close relationships with civil society partners to help identify focus areas for activism, or try to determine standards of best practices on their own.

The challenge of measuring tech sector social impacts contributes to the underestimation of the sector's overall social risk relative to others. As an actor in the impact investing space told us, unlike industries with externalities that are more readily measured, it is incredibly difficult to measure the cost to society or the economy of the Big Tech companies, and this is why even responsible investment portfolios are very tech-heavy.

Tech companies benefit when risk is measured in terms of profit, not people.

Facebook, Volkswagen, and Wirecard all had good ESG ratings from mainstream ratings agencies before starkly negative ESG incidents were uncovered.[4] The most fundamental reason companies with harmful business practices receive strong ESG ratings and consequently appear in ESG funds is that, for most mainstream ratings agencies, risk is not defined in terms

[3] Jordan Famularo, *Medium*, "Sustainability Reporting on Digital Harm: State of Play and Future Agenda" (July 21, 2022), https://medium.com/cltc-bulletin/sustainability-reporting-on-digital-harm-state-of-play-and-future-agenda-ca502a15a6f3.
[4] Dragon Yongjun Tang, Jiali Yan and Yaqiong Yao, *Northern Finance Association*, "The Determinants of ESG Ratings: Rater Ownership Matters" (July 18, 2021), https://portal.northernfinanceassociation.org/viewp.php?n=2240017640, p. 1.

of a company's social and environmental impact but in terms of how ESG factors affect a company's profitability.[5] One large asset manager we spoke with said that while they use third-party ESG data, they are aware that this data often excludes important human rights and DEI [diversity, equity, and inclusion] issues because these issues are not considered "material" risks.

While it may no longer be profitable for companies to ignore climate risk as the costs associated with climate change are likely to reach every corner of the economy, there are many other ESG impacts that do not pose immediate financial risk to companies or investors. This is particularly true of digital human rights risks. Technologies like facial recognition and surveillance tools are profitable despite -- or even as a result of -- their inherent violations of internationally-recognized human rights.[6] Absent significant damage to a company's reputation or legal action following a human rights controversy that makes headlines, human rights impacts may not be viewed by ESG raters as "material" issues for tech companies.

Human rights disclosures can obscure actual harmful impacts.

The data underlying ESG ratings generally come from five distinct sources: voluntary corporate reporting, regulatory filings, media coverage, questionnaires completed by companies, and modeled data.[7] This suggests an overwhelming reliance on company self-reporting. According to one civil society actor, the vast majority of ESG ratings criteria are based on public disclosure and are "devoid of any quantitative or qualitative analysis of human impact."

In practice, if a company fails to report its adverse impacts and these impacts are not reported in the media, they will not be factored into the company's ratings.[8] "The challenge with the 'S' in ESG is that while some things can be readily measured, other dimensions only emerge through

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[5] David Pred and Natalie Bugalski, *Business and Human Rights Resource Centre*, "Why ESG investing is bad for human rights - and what we can do about it" (March 21, 2022), https://www.business-humanrights.org/en/blog/why-esg-investing-is-bad-for-human-rights-what-we-can-do-about-it/; Taparia, op.cit.

[6] Digital technologies are "used to suppress, limit and violate rights, for instance through surveillance, censorship, and online harassment. This is especially true for those who are already vulnerable or have been left behind, or those who are seeking to defend and promote human and civil rights. The digitalisation of our societies has, in many instances, eroded social protections, deepened inequalities, and exacerbated existing discrimination, in particular through the use of technologies such as facial recognition, robotics, digital identification and biotechnology. AI-enabled tools in particular can cause profound harm in the absence of fairness, accountability, explainability and transparency:" United Nations Office of the High Commissioner for Human Rights, "About," https://www.digitalhub.ohchr.org/about.

[7] Florian Berg, Julian F. Kolbel, Anna Pavlova and Roberto Rigodon, Social Science Research Network, "ESG Confusion and Stock Returns: The Problem of Noise" (October 12, 2021), p. 12.

[8] Pred and Bugalski, op.cit.

contestation. If there are no activists challenging a company on an issue, it basically doesn't exist," says a civil society actor who organizes proxy campaigns in support of ESG issues.

This is particularly of concern in tech. Most big tech companies have sophisticated disclosures regarding their human rights commitments and processes for mitigating human rights risk. These policies and processes are generally thought of as market leading, with smaller tech companies and companies in other sectors lagging behind. As a result, these large tech companies are more likely to receive higher "S" scores from ESG raters, despite persistent evidence of adverse human rights impacts.

As one tech and human rights advocate explained, "Big Tech companies have become fairly fluent in the expected human rights narrative; they have all the UNGP expertise and requirements on paper. Companies are savvy in understanding what they need to do to tick the boxes, but when you look at what they're actually doing, it's in complete conflict."

Mixed signals from "S" and "G" ratings weaken tech company accountability.

As one civil society actor in the responsible investment space told us, "'ESG' has become a buzzword that means different things to different people. Without greater standardization to align ESG standards with international human rights norms, anyone can claim to be an ESG 'expert' and shape the meaning of this term."

Because ESG ratings agencies develop their ratings in-house, it is not clear how significantly human rights abuses impact a company's overall ESG score. These agencies decide which attributes are evaluated as part of their scoring procedure in addition to the relative importance of the attributes with respect to final scores. This has led to a low degree of correlation among the scores one company will receive from different ratings agencies.[9]

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[9] Florian Berg, Kornelia Fabisik and Zacharias Sautner, European Corporate Governance Institute - Finance Working Paper 708/2020, "Is History Repeating Itself? The (Un)Predictable Past of ESG Ratings" (August 24, 2021); Christensen et al, op.cit.; Florian Berg, Julian F. Koelbel and Roberto Rigobon, *Forthcoming Review of Finance*, "Aggregate Confusion: The Diversion of ESG Ratings" (August 15, 2019); Berg et al., "ESG Confusion," op.cit.; Aaron Chatterji, Rodolphe Durand, David Levine and Samuel Touboul, Berkeley Institute for Research on Labor and Employment, "Do Ratings of FIrms Converge? Implications for Strategy Research" (April 2014); Rajna Gibson Brandon, Philipp Krueger and Peter S. Schmidt, European Corporate Governance Institute, "ESG Rating Disagreement and Stock Returns" (August 2021).

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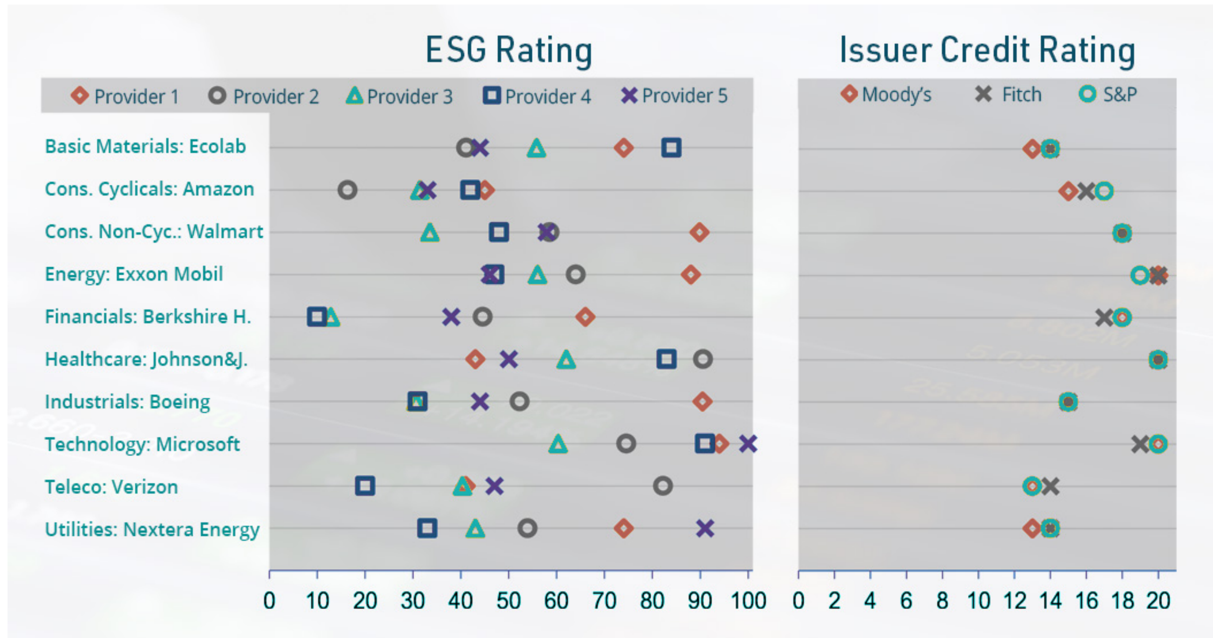

Source: OECD Business and Finance Outlook 2020: Sustainable and Resilient Finance, "Environmental, social and governance (ESG) investing" (2020), https://www.oecd-ilibrary.org/sites/e9ed300b-en/index.html?itemId=/content/component/e9ed300b-en

The lack of correlation across scores from different agencies is particularly true for the "S" and "G" of ESG. There is both less agreement across agencies on the most important issues for these categories and a worse understanding of how to quantify the real impacts of these issues.[10] Since "S" and "G" impacts are arguably the most salient for tech sector companies, these companies are more likely to have inconsistent ratings.[11]

In addition to the obvious shortcoming of obscuring the true human rights failures of companies, ratings disagreement has other important consequences. When companies receive mixed signals from ratings agencies on which actions are expected and valued by the market, this reduces the incentive to improve their practices and undermines attempts to link management compensation to ESG performance. It also makes it difficult for investors and other third parties to evaluate the performance of companies, funds, and portfolios, which in turn makes markets less likely to accurately price a company's ESG risks.[12]

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[10] Gibson Brandon et al., op.cit., p. 12-13.

[11] This is not to gainsay concerns about technology companies' environmental impacts, including data centers' demand for electricity and water resources. With that in mind, the CEOs of Microsoft, Nokia and two dozen other companies formed a European Green Digital Coalition in 2021 committing to become climate neutral or net-zero no later than 2040: European Commission, "Companies take action to support the green and digital transformation of the EU" (March 19, 2021).

[12] Berg et al., "Aggregate Confusion," op.cit., p. 2-3.

Rater bias for climate wins and profitability benefit Big Tech.

One group of researchers found that raters displayed evidence of having been influenced by a "halo effect" whereby a company that receives a high score in one category is more likely to receive high scores in all others.[13] There is also evidence of one ratings agency retroactively upgrading the "E" and "S" scores for companies that performed better in a given year.[14] The likely explanation for the upgrade is that investors select ESG ratings providers primarily on the extent to which their ratings predict returns.[15]

Both the halo effect and profitability biases stand to artificially inflate the ESG scores of large tech companies: these companies outperformed the market in recent years, and their relatively low climate risk often draws attention away from their failures in the social and governance categories.

There is evidence that these biases are reflected in investment decision making: 28 of the largest and best-known ESG funds have invested the majority of their clients' money in Microsoft, Alphabet, Apple, and Amazon. Meta was also overrepresented in the case of passive funds. The main reason for this preference for tech giants in ESG funds is their relatively small carbon footprint and, to an extent, their profitability: all these funds marketed themselves as ESG funds or socially responsible funds, but they are, for the most part, carbon-free funds.[16]

There is a dearth of data on privately-held tech companies.

Most existing social risk management data and metrics are for investors to assess the issues of mature companies, and whatever nascent ESG tools and data exist for assessing earlier-stage companies do not fully address the issues specific to emerging technologies, such as AI, cybersecurity, data privacy, or to tech-related social concerns like inclusion, human rights, democracy, and public safety.[17]

Ignoring the digital rights impacts of newer, privately-held companies is risky. By the time most tech entrepreneurs venture into the public financial markets, their business models have been well established and carefully crafted to withstand scrutiny by investment bankers as well as

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[13] Berg et al., "Aggregate Confusion," op.cit., p. 4.
[14] Berg et al., "History," op.cit., p. 3-4.
[15] Berg et al., "History," ibid., p. 3.
[16] Fernanda Wenzel, *Mongabay*, "Behind the buzz of ESG investing, a focus on tech giants and no regulation" (30 April 2021), https://news.mongabay.com/2021/04/behind-the-buzz-of-esg-investing-a-focus-on-tech-giants-and-no-regulation/.
[17] Susan Winterberg et al, Harvard Kennedy School Belfer Center for Science and International Affairs, "Responsible Investing in Tech and Venture Capital: Advancing Public Purpose in Frontier Technology Companies" (2020), p. 27.

institutional and retail investors, undermining investor leverage to hold them accountable for adverse human rights impacts.

Conclusion and Recommendations

The tendency for big tech companies to receive inflated ESG scores carries negative consequences. For one, ESG ratings inflation has been associated with future negative ESG incidents. This suggests that reducing the ESG ratings inflation associated with large tech companies could be an important factor in improving their practices. Further, the inconsistencies and limitations of the existing ESG ratings undermine the credibility and overall impact of responsible investing as a strategy for change and give fodder to critics of ESG.

There is an opportunity to bolster both tech sector accountability and responsible investment practices by engaging mainstream ESG raters to improve their methodologies, particularly in the "S" category and with a focus on digital rights issues. As one civil society actor told us, "challenging ratings agencies like MSCI, Sustainalytics, and ISS is a systemic, high leverage opportunity to address the big problems with responsible investment." Ratings agencies should acknowledge their own responsibility to respect human rights under the UNGPs. This arguably entails aligning their methodologies with internationally-recognized human rights instruments, including the full catalogue of human rights in their ratings, and measuring the extent of a company's adverse impacts to human rights in addition to or instead of the sophistication of company disclosures. For tech companies, digital rights impacts should be reflected as particularly salient and material.

There is a need for independent ESG ratings of newer ventures that reflect their level of maturity and are inclusive of human and digital rights issues. These ratings could then be integrated into existing venture capital and private equity industry databases and communications.[18] As one venture capitalist told us, "Some funds have their own frameworks, but there should be shared issues and metrics that are relevant to all, like the Data Convergence Project."

States should undertake the project of regulating ESG data both as a means of ensuring the coherence and credibility of the data but also to entrench mandatory disclosure of ESG-related information. This process has already begun at the US Securities and Exchange Commission, with a specific focus on climate-related data. There is also precedent for this in other countries: Colombia and Chile now require disclosure of ESG information according to SASB [Sustainability Accounting Standards Board] standards. A push for greater standardization and institutionalization of ESG ratings and standards would both improve ESG

[18] Winterberg et al., ibid., p. 31.

rater accountability and bolster ESG investors in the long term. A nascent example is the European Commission's recently proposed Regulation on transparency and integrity of ESG rating activities.

Our analysis also reveals that investors lack access to data that tells them about actual company impacts to digital rights. This is why several of the investors we interviewed indicated that they rely on their partnerships with civil society organizations to understand and prioritize the issues on which to engage tech companies. **The digital rights information gap can thus be bridged by knowledge sharing between investors in public and private markets and civil society organizations representing affected rights-holders.** "The investor community should engage more with civil society to get information about what a company is actually doing versus what they say they're doing," says an investor advocate in the tech and human rights space. "Big institutional investors don't have time to start engaging, so we need to put together a shadow index of what civil society sees these companies doing." United Nations Human Rights can play a role in facilitating investor and civil society engagement through convenings, publications, and multi-stakeholder groups.

Despite the limitations of current iterations, ESG standards and data are nonetheless important for accountability. As one civil society actor put it, "benchmarks and rankings can cause a race to the top because companies care more about scores than they do about controversies." Corporate respect for digital rights is thus contingent on these rankings being able to reflect company impacts in a fair, standardized manner and in a way that is useful to all kinds of investors.