

**REPORT OF INDEPENDENT INVESTIGATIVE COUNSEL REGARDING  
ALLEGED ANTI-ISRAEL BIAS IN MORNINGSTAR, INC. ESG PRODUCTS AND  
SERVICES**

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## I. INTRODUCTION

Morningstar, Inc. was founded in 1984 with the goal of bringing to the public the type of investment research then available to financial professionals. It became a publicly traded company in 2005, and now employs over 10,000 people operating in twenty-nine countries, providing data and analysis on a variety of investment vehicles to a customer base of financial advisors, asset managers, retirement plan sponsors, individuals, and private market investors. Beginning in 2015, Morningstar partnered with Sustainalytics, an Environmental, Social, and Governance (“ESG”) ratings and research firm, to supply investors with sustainability-focused ratings and data. Sustainalytics offers a range of research, ratings products, and services intended to support investors in developing and implementing responsible investment strategies, including by helping client-investors to evaluate financially material ESG issues that affect their investments, manage potential ESG-related risks in their portfolio, and comply with their own ESG-related mandates and regulatory requirements. In 2017, Morningstar purchased a 40% ownership stake in Sustainalytics. In 2019, Sustainalytics acquired GES International, a provider of engagement/stewardship services and international-norms based screening. Following the acquisition, Sustainalytics and GES began the process of integrating. Morningstar acquired the remaining 60% ownership interest in Sustainalytics in 2020.

The past decade has seen a steep growth trajectory in ESG investing. In the United States alone, the total volume of assets that money managers report as incorporating ESG factors increased from \$639 billion in 1995 to more than \$17 trillion projected by the end of this year.<sup>1</sup>

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<sup>1</sup> See *Report on US Sustainable and Impact Investing Trends*, US SIF Foundation (2020) at 9-10, <https://www.ussif.org/files/Trends%20Report%202020%20Executive%20Summary.pdf>; Saijel Kishan, *ESG by the Numbers: Sustainable Investing Set Records in 2021*, Bloomberg (Feb. 3, 2022), <https://www.bloomberg.com/news/articles/2022-02-03/esg-by-the-numbers-sustainable-investing-set-records-in-2021>. See also Boffo, R. & R. Patalano, *ESG Investing: Practices, Progress and Challenges*, Organisation for Economic Co-operation and Development (2020) at 15-16, <https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf>; Tania Lynn Taylor and Sean Collins, *Ingraining sustainability in the next era of ESG*

The corresponding growth in market demand for ESG ratings and ESG investment guidance occurred in a vacuum of governmental guidance or regulation. As of the date of this report, several jurisdictions—including the United States, the United Kingdom, the Netherlands, France, Japan, and India<sup>2</sup>—have recently proposed regulating legislation or guidelines for the ESG ratings industry. White & Case LLP’s review of the ESG ratings provider regulatory landscape and the most prevalent criticisms of ESG ratings providers revealed that a consensus is forming around three primary categories of best practices focused on transparency, consistency, and objectivity: (1) increasing transparency as to ratings sources and data products methodology, (2) developing and adhering to rigorous, internally consistent processes, and (3) creating and implementing governance and structural controls to identify, disclose, and mitigate actual or perceived conflicts of interest. The recommendations of this report were informed by those best practices.

Over the same period of time, while the ESG ratings industry experienced exponential growth, thirty-five U.S. states passed legislation targeting the Boycott, Divestment, Sanctions (“BDS”) movement—a self-identified “Palestinian-led movement for freedom, justice and equality”<sup>3</sup> that seeks to apply global political and economic pressure on Israel through boycotts of and divestment from businesses operating in Israel. Most U.S. anti-BDS statutes generally prohibit practices that boycott Israel, sanction Israel, or call for divestment from Israel. There is very little scholarship or direction to guide ESG ratings providers in navigating U.S. anti-BDS regulations.

Against the backdrop of increasing customer demand for ESG ratings and increasing U.S. regulation of anti-BDS activity, in March 2016, and then in April 2020, JLens—an “investor

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*investing: New opportunities are emerging for investment managers to adapt as investor preferences evolve*, Deloitte (Apr. 5, 2022), <https://www2.deloitte.com/us/en/insights/industry/financial-services/esg-investing-and-sustainability.html>.

<sup>2</sup> Earlier this year, India’s Securities and Exchange Board announced its intention to regulate ESG raters. It would be the first jurisdiction to regulate ESG data providers if its proposed regulatory framework is adopted. *See infra* § III(B).

<sup>3</sup> BDS, *What is BDS*, <https://bdsmovement.net/what-is-bds>.

network that explores a Jewish lens on impact investing”<sup>4</sup>—raised questions as to whether Morningstar’s Sustainalytics ESG ratings products, in particular those that focused on companies’ alignment with international human rights norms, were biased against Israel or violative of U.S. anti-BDS regulations. These allegations came during a time of rapid growth for Sustainalytics and the ESG rating industry as a whole, and during integration of several entities and products at Sustainalytics and Morningstar. During 2020 and 2021, the Illinois Investment Policy Board (“IIPB”), the Office of the New York State Comptroller, the Jewish United Fund of Metropolitan Chicago, and an internal employee group at Morningstar each asked Morningstar to respond to the JLens allegations. In response, Morningstar retained White & Case, LLP (“White & Case”) to conduct an independent investigation. This report provides the findings and recommendations resulting from that investigation.

White & Case identified five of Sustainalytics’ products as most relevant to this investigation: (1) Controversies Research, (2) ESG Risk Rating, (3) Global Standards Screening, (4) Global Standards Engagement, and (5) the Human Rights Radar. The Controversies Research product is designed to assess business risk, specifically a company’s level of exposure in negative ESG-related incidents and events, and the adequacy of the company’s management of these issues. Because involvement in controversies is partially indicative of an issuer’s overall ESG performance and risk, a company’s Controversies rating also factors into the ESG Risk Rating product. The ESG Risk Rating is Sustainalytics’ flagship product, and is designed to help investors identify and understand financially material ESG-related risks within their investment portfolios and how those risks might affect issuer performance. Global Standards Screening and Global Standards Engagement both concern an issuer’s impact on societal stakeholders and/or the

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<sup>4</sup> Home, JLens, <https://www.jlensnetwork.org/>.

environment, and the extent to which issuers cause, contribute to, or are associated with violations of international norms and standards. Global Standards Screening provides Sustainalytics' assessment as to whether a company is violating, or is at risk of violating, a principle or principles of the United Nations Global Compact in the areas of human rights, labor rights, the environment, and business ethics. Global Standards Screening also considers other norms and standards, including the OECD Guidelines for Multinational Enterprises, the United Nations Guiding Principles on Business and Human Rights, and their underlying conventions and treaties.

Relatedly, Global Standards Engagement is designed to work with companies that are screened by the Global Standards Screening to help effectuate change in the issuer's corporate policies and/or processes, and to ensure that the issuer has systems in place to improve its ESG practices. Finally, the Human Rights Radar seeks to provide information on issuers that are involved in regions in the world where Sustainalytics believes serious human rights violations to be taking place so that client-investors can identify and manage potential risk exposure based on corporate activities in high-risk countries and disputed territories, and the rated companies' management of their actual and potential human rights impact.

A full, detailed understanding of the research methodologies of each product is critical to fairly analyzing whether the various products and services reflect any bias towards Israel, and for that reason this report presents those methodologies in detail with complete transparency. As is described more fully below, we conclude as follows:

- Though Sustainalytics' customers may use its products and research to make decisions about excluding certain issuers from their portfolio—whether to advance the customer's own ESG goals and priorities, to comply with the customer's own responsible investment policies, or simply to make what the customer views as prudent investments—this investigation concludes that Morningstar's Sustainalytics products do not recommend or encourage divestment.



- The investigation found neither pervasive nor systemic bias against Israel in Sustainalytics’ products or services. One siloed product—the Human Rights Radar—was found to have a latent, disproportionate focus on the Israeli/Palestinian conflict which results in biased outcomes. However, this product has never been integrated into Sustainalytics’ client-facing online platform, Global Access, does not impact any other Sustainalytics research, and does not feed into Sustainalytics’ flagship product (the ESG Risk Ratings).
- While finding that none of the examined products and services recommend or encourage divestment, and while finding that—with one exception—the products and services offered by Sustainalytics do not exhibit pervasive or systemic bias, the independent investigation did find scattered instances of processes and procedures which can be improved. To that end, this report also makes several process and product line improvement recommendations to address and mitigate the potential for implicit and/or confirmation bias in certain of Sustainalytics’ products, and in Sustainalytics’ treatment of the Israeli/Palestinian conflict.<sup>5</sup>

## **II. ENGAGEMENT OF INDEPENDENT COUNSEL AND INVESTIGATION METHODOLOGY**

### **A. Independence of Investigation**

Morningstar appointed a Working Group led by two independent directors of the Board of Directors to guide White & Case’s independent investigation. White & Case used its professional judgment to recommend to the Working Group the manner in which the investigation would be carried out, and executed the investigative plan as approved by the Working Group. White & Case chose whom to interview and what materials to review, and met at least weekly with the Working Group to discuss the status of the investigation.

White & Case prepared this independent report summarizing the results of the investigation. The factual findings set forth in this report are solely advanced by White & Case. Neither Morningstar nor the Working Group exerted any influence over our reporting of the facts and findings.

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<sup>5</sup> In this report, we use the term “Israeli/Palestinian conflict areas” to refer to the territories subject to the Israeli/Palestinian conflict that are implicated in this investigation. Other terms, such as “Occupied Palestinian Territories,” are used only in direct quotes.

This investigation is not a direct response to the inquiry initiated by the IIPB, though Morningstar is welcome to use the results of this investigation in its subsequent engagement with the IIPB. White & Case is not serving as legal counsel for Morningstar in connection with the IIPB's inquiry.

White & Case has never previously provided legal representation to Morningstar or Sustainalytics. Neither Morningstar nor Sustainalytics has been a client of White & Case prior to the investigation, and White & Case has not accepted any other mandate from Morningstar since taking on the scope of this investigation. Morningstar approved White & Case's legal fees incurred during the investigation prior to delivery of the report, and payment was not contingent on any particular finding or outcome. As advised by the Working Group, White & Case on occasion communicated with Morningstar's General Counsel. However, in order to preserve the independence of the investigation, staff of the Morningstar's General Counsel Office did not sit on the Working Group, nor did they participate in or influence the creation of the final output.

### **B. Investigative Team**

The investigative team was led by Tara Lee, a partner in White & Case's Global Litigation and Investigations Practices and a member of the Firm's Business & Human Rights Core Team. Other lawyers on the team have additional experience in complex internal and government investigations, and are members in the White & Case's Business & Human Rights and ESG practice groups.

### **C. Scope and Methodology**

This investigation not only sought to address concerns expressed by JLens, the Office of the New York State Comptroller, and the Jewish United Fund of Metropolitan Chicago, but also took into consideration the related, pending inquiry from the IIPB and Morningstar employee

concern. Importantly, the investigation sought to avoid any conclusion regarding the merits of any viewpoints on the Israeli/Palestinian conflict. Instead, the investigation sought to assess (1) whether any of Morningstar's Sustainalytics products or services encourage client divestment from any of the companies within Sustainalytics' universe of covered issuers, and (2) whether any of the Morningstar's Sustainalytics products or services that consider the Israeli/Palestinian conflict exhibit improper bias against Israel in their ratings, analysis, or process.

White & Case engaged in a broad and thorough investigation. As detailed further below, we conducted more than forty interviews, including of current Sustainalytics personnel, from research analysts to the most senior leaders in the research division, Sustainalytics and Morningstar executives, and other Morningstar employees. We also interviewed and attempted to interview external stakeholders regarding the concerns they raised in connection with the issues that gave rise to this investigation.

White & Case collected more than 400 gigabytes of electronic records, comprising over 370,000 documents. Through data analytics and de-duplication, we narrowed the scope of documents to review about 139,000 documents.

In addition to internal documents, White & Case obtained access to Sustainalytics' client-facing reports, including through Sustainalytics' online platform, Global Access, and reviewed issuer assessments and reports available to Sustainalytics' clients. White & Case downloaded data directly from Global Access via its reporting functionality for local analysis, and obtained other client-facing data that is not available in Global Access (e.g., the Human Rights Radar). The specific research examples discussed in this report are current as of May 10, 2022.<sup>6</sup>

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<sup>6</sup> See *infra* § V.

White & Case also reviewed other relevant external materials from sources such as JLens, the United Nations, the European Union, anti-BDS legislation, related publicly available news coverage, and other external sources in order to better understand the context of the issues arising from the allegations implicated in this investigation and from the Israeli/Palestinian conflict itself.

This report is not a record of every single fact, document, or witness statement that we gathered, but instead focuses on key events and information. We are grateful to those individuals who made time to speak to our team and express their views to us. We are satisfied that the evidence we have seen has been sufficient to make the findings set out in this report and to make specific recommendations to Morningstar.

#### **D. Stakeholder Engagement**

As part of White & Case's investigation, we spoke with several Morningstar employees who had previously expressed concerns regarding the JLens allegations and IIPB inquiry, as well as external stakeholders (in particular, the Jewish United Fund of Metropolitan Chicago and JLens). In addition, we reviewed documents and communications related to the concerns raised by these employees and external stakeholders. The purpose of these particular interviews and document review was to better understand the concerns raised by the employees and external stakeholders, as well as their perspectives on the allegations that gave rise to this investigation, and their interactions with Morningstar and Sustainalytics leadership on these issues.

### **III. BACKGROUND ON THE ESG RATINGS INDUSTRY AND ESG RATINGS REGULATORY LANDSCAPE**

#### **A. Background on the ESG Ratings Industry**

ESG ratings firms assess the performance and risk of securities issuers across a broad range of environmental, social, and governance factors that are not typically captured during traditional financial reviews. These assessments are generally based on industry-specific factors and

incorporate data from public filings (10-Ks, sustainability reports, and proxy statements), news media reports, government sources, NGO data compilations, and direct corporate communications.<sup>7</sup> The industry’s rapid emergence has been driven by a small set of key players, long dominated by Morningstar’s Sustainalytics and MSCI.<sup>8</sup> Many traditional financial ratings companies are making ESG plays—typically through acquisition—and Moody’s, S&P, and Fitch are now considered market participants as well.<sup>9</sup>

The rapid expansion and lack of regulation of the ESG ratings industry and a wide-ranging global universe of ESG disclosure inputs has led to a significant divergence in ESG practices, methodologies, and resultant ratings among the industry leaders.<sup>10</sup> ESG raters vary widely in the data they consider, the weight they assign to various metrics, and how they use subjective factors in absolute and relative scores within and across industries.<sup>11</sup>

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<sup>7</sup> See Boffo, R. & R. Patalano, *ESG Investing: Practices, Progress and Challenges*, Organisation for Economic Co-operation and Development (2020) at 19, <https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf>; Billy Nauman, *Heavy flows into ESG funds raise questions over ratings*, Financial Times (Mar. 3, 2020), <https://www.ft.com/content/0bd9d2ea-5c15-11ea-8033-fa40a0d65a98>; <sup>8</sup> *Best ESG Rating Agencies – Who Gets to Grade*, The Impact Investor, <https://theimpactinvestor.com/esg-rating-agencies/>.

<sup>8</sup> See Betsy Atkins, *Demystifying ESG: Its History & Current Status*, Forbes (June 8, 2020), <https://www.forbes.com/sites/betsyatkins/2020/06/08/demystifying-esgits-history--current-status/?sh=159a81a12cdd>; *Rate the Raters 2020: Investor Survey and Interview Results Report*, SustainAbility (Mar. 2020), <https://www.sustainability.com/globalassets/sustainability.com/thinking/pdfs/sustainability-ratetheraters2020-report.pdf>; <sup>8</sup> *Best ESG Rating Agencies – Who Gets to Grade*, The Impact Investor (Mar. 24, 2022), <https://theimpactinvestor.com/esg-rating-agencies/>.

<sup>9</sup> See Boffo, R. & R. Patalano, *ESG Investing: Practices, Progress and Challenges*, Organisation for Economic Co-operation and Development (2020) at 19, <https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf>.

<sup>10</sup> See Beth Stackpole, *Why sustainable business needs better ESG ratings*, MIT (Dec. 6, 2021), <https://mitsloan.mit.edu/ideas-made-to-matter/why-sustainable-business-needs-better-esg-ratings>; Billy Nauman, *Heavy flows into ESG funds raise questions over ratings*, Financial Times (Mar. 3, 2020), <https://www.ft.com/content/0bd9d2ea-5c15-11ea-8033-fa40a0d65a98>; *Rate the Raters 2020: Investor Survey and Interview Results Report*, SustainAbility (Mar. 2020), <https://www.sustainability.com/globalassets/sustainability.com/thinking/pdfs/sustainability-ratetheraters2020-report.pdf>.

<sup>11</sup> See Boffo, R. & R. Patalano, *ESG Investing: Practices, Progress and Challenges*, Organisation for Economic Co-operation and Development (2020) at 21, <https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf>; see also Beth Stackpole, *Why sustainable business needs better ESG ratings*, MIT (Dec. 6, 2021), <https://mitsloan.mit.edu/ideas-made-to-matter/why-sustainable-business-needs-better-esg-ratings>; *Rate the Raters 2020: Investor Survey and Interview Results Report*, SustainAbility (Mar. 2020), <https://www.sustainability.com/globalassets/sustainability.com/thinking/pdfs/sustainability-ratetheraters2020-report.pdf>; Timothy M. Doyle, *Ratings That Don’t Rate: The Subjective World of ESG Rating Agencies*, American Council for Capital Formation (July 19, 2018), [https://accfcorgov.org/wp-content/uploads/2018/07/ACCF\\_RatingsESGReport.pdf](https://accfcorgov.org/wp-content/uploads/2018/07/ACCF_RatingsESGReport.pdf).

The rated ESG factors themselves tend to differ across providers, though they usually involve at least the following basic assessments:<sup>12</sup>

- Environmental factors, including carbon emissions, energy efficiency, natural resource use, pollution, and sustainability initiatives.
- Social factors, including workforce and labor practices, diversity, supply chain issues, and human rights considerations.
- Governance factors, including corporate ethics and structure—board independence, diversity, etc.—as well as issues like management compensation and corporate ethics.

Different approaches from the major ESG providers “can lead to wide variance in results for individual issuers,” depending on the methodologies used and factors considered by the ESG rater.<sup>13</sup> Nonetheless, despite the methodological differences and approaches by the ESG raters and their often divergent conclusions, the final ratings are used by investors for the same purpose: to identify companies that engage in better ESG practices and to screen investments for ESG-related risk.<sup>14</sup> Investors may elect to assess ESG risk in order to identify financial or reputational risk that has the potential to negatively affect stock price, as a method of signaling adherence to certain values such as protection of the environment or adherence to human rights principles, or some combination of both.<sup>15</sup> Some investors may not be interested in final scores at all, but might

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<sup>12</sup> See *8 Best ESG Rating Agencies – Who Gets to Grade*, The Impact Investor, <https://theimpactinvestor.com/esg-rating-agencies/>; *The Role of ESG Ratings Providers in Assessing ESG Performance and Risks*, Chapman (May 25, 2021), <https://www.chapman.com/publication-ESG-ratings-providers-important-data-point>.

<sup>13</sup> Boffo, R. & R. Patalano, *ESG Investing: Practices, Progress and Challenges*, Organisation for Economic Co-operation and Development (2020) at 27, <https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf>; see also Florian Berg et al., *Aggregate Confusion: The Divergence of ESG Ratings* (August 15, 2019, updated Jan. 14, 2022) at 24, [https://cdn.feem.gag.it/m/events\\_pages/event7-10-2020-rigobon-feem.pdf](https://cdn.feem.gag.it/m/events_pages/event7-10-2020-rigobon-feem.pdf); John Quinn, *How The Lack Of Unified ESG Metrics Creates Litigation Risk*, Forbes (Mar. 15, 2022), <https://www.forbes.com/sites/forbesbusinesscouncil/2022/03/15/how-the-lack-of-unified-esg-metrics-creates-litigation-risk/?sh=f84e0f5522b5>; Beth Stackpole, *Why sustainable business needs better ESG ratings*; MIT (Dec. 6, 2021), <https://mitsloan.mit.edu/ideas-made-to-matter/why-sustainable-business-needs-better-esg-ratings>; James Mackintosh, *Is Tesla or Exxon More Sustainable? It depends on Whom You Ask*, Wall Street Journal (Sept. 17, 2018).

<sup>14</sup> Boffo, R. & R. Patalano, *ESG Investing: Practices, Progress and Challenges*, Organisation for Economic Co-operation and Development (2020) at 21, <https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf>.

<sup>15</sup> See, e.g., Monica Billio et al., *Inside the ESG ratings: (Dis)agreement and performance*, 28 Corporate Social Responsibility and Environmental Management 1426, 1429 (2021); *Rate the Raters 2020 Investor Survey and Interview Results Report*, SustainAbility (Mar. 2020) at 19-21, <https://www.sustainability.com/globalassets/sustainability.com/thinking/pdfs/sustainability->

just look to the underlying data the ESG rater provides in order to supplement the investors' own internal research.<sup>16</sup>

## B. Regulatory Landscape for ESG Raters

By 2025, it is estimated that one-third of the \$140.5 trillion projected global assets under management will be ESG-focused.<sup>17</sup> Morningstar data shows that ESG funds have grown tremendously over the past two years: in 2020, net new assets into ESG funds doubled from 2019 to reach \$51.1 billion, and in 2021, ESG funds attracted almost \$70 billion in new assets.<sup>18</sup> This massive increase in ESG-driven investment has been accompanied by a corresponding increase in regulatory interest on the topic, though much of this regulatory attention has focused on issuers

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ratetheraters2020-report.pdf; *8 Best ESG Rating Agencies – Who Gets to Grade*, The Impact Investor, <https://theimpactinvestor.com/esg-rating-agencies/>.

<sup>16</sup> See, e.g., *Rate the Raters 2020: Investor Survey and Interview Results Report*, SustainAbility (Mar. 2020) at 23-24, 30, <https://www.sustainability.com/globalassets/sustainability.com/thinking/pdfs/sustainability-ratetheraters2020-report.pdf>; Boffo, R. & R. Patalano, *ESG Investing: Practices, Progress and Challenges*, Organisation for Economic Co-operation and Development (2020) at 20, <https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf>.

<sup>17</sup> See Adeline Diab & Gina Martin Adams, *ESG assets may hit \$53 trillion by 2025, a third of global AUM*, Bloomberg (Feb. 23, 2021), <https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum>; see also John Gerard Ruggie et al., *Ten Years After: From UN Guiding Principles to Multi-Fiduciary Obligations*, 6 Bus. & Hum. Rts J. 179, 197 (2021).

<sup>18</sup> Jon Hale, *A Broken Record: Flows for U.S. Sustainable Funds Again Reach New Heights*, Morningstar, Inc. (Jan. 28, 2021), <https://www.morningstar.com/articles/1019195/a-broken-record-flows-for-us-sustainable-funds-again-reach-new-heights>; Alyssa Stankiewicz, *Sustainable Fund Flows Dip for the Quarter but Peak for the Year*, Morningstar, Inc. (Jan. 31, 2022), <https://www.morningstar.com/articles/1076648/sustainable-fund-flows-dip-for-the-quarter-but-peak-for-the-year>; Jon Hale, *Sustainable Funds Landscape - Highlights and Observations*, Morningstar, Inc. (Feb. 18, 2022), <https://www.morningstar.com/articles/1080300/sustainable-funds-landscape-highlights-and-observations>; see also Cathy Curtis, *While green investments are underperforming, investors need to remain patient*, CNBC (Mar. 28 2022), <https://www.cnbc.com/2022/03/28/green-investing-is-underperforming-but-dont-count-it-out-just-yet.html>.

ESG-focused exchange-traded funds and sustainable mutual funds grew 53% in 2021 to \$2.7 trillion, with nearly \$596 billion flowing into the strategy of these funds. See Saijel Kishan, *ESG by the Numbers: Sustainable Investing Set Records in 2021*, Bloomberg (Feb. 3, 2022), <https://www.bloomberg.com/news/articles/2022-02-03/esg-by-the-numbers-sustainable-investing-set-records-in-2021>.

and investment funds,<sup>19</sup> in part due to a recognition that the lack of mandatory ESG reporting standards contributes to inconsistency across ratings.<sup>20</sup>

Despite the fact that there are no regulations governing ESG rating providers currently in force,<sup>21</sup> ratings providers—including Sustainalytics—recognize that eventual regulation of the ESG ratings industry is a near-certainty. Recent discussion around potential regulation has focused primarily on requiring transparency from ESG raters on their methodologies, and preventing potential conflicts of interest between their business lines.<sup>22</sup> In order to better inform both the findings and recommendations of this report, this section discusses potential future regulation of ESG ratings providers, both within the United States and abroad.

### 1. U.S. Regulations

Although it does not currently regulate ESG ratings providers, the U.S. SEC has publicly pointed towards issues providers may face when the industry becomes regulated. Most recently, in July 2021 remarks before the Asset Management Advisory Committee (“AMAC”), SEC Chair Gary Gensler observed that the rise in third-party servicers offering rating tools “raises a number of questions about (1) what data underpin those assertions, (2) whether those service providers are

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<sup>19</sup> See ESG Regulatory Reform, The Harvard Law School Forum on Corporate Governance (Oct. 23, 2021), <https://corpgov.law.harvard.edu/2021/10/23/esg-regulatory-reform/>; Renewed Sustainable Finance Strategy and Implementation of the Action Plan on Financing Sustainable Growth European Commission, European Commission, [https://ec.europa.eu/info/publications/sustainable-finance-renewed-strategy\\_en](https://ec.europa.eu/info/publications/sustainable-finance-renewed-strategy_en); Proposed Rule: The Enhancement and Standardization of Climate-Related Disclosures for Investors, Rel. Nos. 33-11,042; 34-94,478 (May 20, 2020), <https://www.sec.gov/rules/proposed/2022/33-11042.pdf>.

<sup>20</sup> See, e.g., Report by the Expert Panel on Sustainable Finance, Japan Financial Services Agency (2021) at 19, <https://www.fsa.go.jp/en/news/2021/20210618/04.pdf> (explaining that the quality of ESG ratings will be improved by companies improving their ESG disclosures).

<sup>21</sup> As discussed further below, on January 24, 2022, the Securities and Exchange Board of India announced it would regulate ESG ratings providers and requested comments to a proposed regulatory framework. If adopted, India would be the first jurisdiction to impose regulations on ESG data providers. See *Consultation Paper on Environmental, Social and Governance (ESG) Rating Providers for Securities Markets*, Securities and Exchange Board of India (2022), [https://www.sebi.gov.in/reports-and-statistics/reports/jan-2022/consultation-paper-on-environmental-social-and-governance-esg-rating-providers-for-securities-markets\\_55516.html](https://www.sebi.gov.in/reports-and-statistics/reports/jan-2022/consultation-paper-on-environmental-social-and-governance-esg-rating-providers-for-securities-markets_55516.html).

<sup>22</sup> Jean Eaglesham, *Wall Street’s Green Push Exposes New Conflicts of Interest*, Wall Street Journal (Jan. 29, 2022), <https://www.wsj.com/articles/wall-streets-green-push-exposes-new-conflicts-of-interest-11643452202>; *Managing ESG Data and Rating Risk*, Harvard Law Forum on Corporate Governance (July 28, 2021), <https://corpgov.law.harvard.edu/2021/07/28/managing-esg-data-and-rating-risk/>.



providing investment advice, and (3) what advisers’ responsibilities are with respect to their use of such services.”<sup>23</sup> Similarly, in a February 21, 2021 bulletin to investors on ESG Funds, the SEC observed that different providers weigh ESG criteria differently, resulting in “widely different scores” across third-party providers, and noted that third-party ESG scores and ratings can be subjective, unverifiable, or unreliable.<sup>24</sup>

In addition, the SEC has raised concerns around the practices of ESG raters in the context of its responsibility for regulation of credit ratings agencies. In its 2022 report to Congress, the Office of Credit Ratings Staff Report on Nationally Recognized Statistical Ratings Organizations identified (for the first time) ESG ratings practices as a focus area. In particular, it focused on how the growing market for ESG products and services poses a risk to credit ratings agencies and will necessitate review in the future.<sup>25</sup> Specifically, the SEC expressed concern that credit ratings firms are mingling regulated services with newer, unregulated research innovations, and highlighted the need for internal controls to prevent credit ratings agencies from giving favorable ratings to companies subscribing to their newer ESG products.<sup>26</sup> Notably, the report also identified that at

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<sup>23</sup> *Prepared Remarks Before the Asset Management Advisory Committee*, Securities and Exchange Commission (July 7, 2021), <https://www.sec.gov/news/public-statement/gensler-amac-2021-07-07>.

<sup>24</sup> Investor Alerts and Bulletins, Environmental, Social and Governance (ESG) Funds – Investor Bulletin (Feb. 26, 2021), <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-1>. Other SEC bodies have raised similar considerations in other contexts as well. See Recommendation from the Investor-as-Owner Subcommittee of the SEC Investor Advisory Committee Relating to ESG Disclosure (May 14, 2020), <https://www.sec.gov/spotlight/investor-advisory-committee-2012/recommendation-of-the-investor-as-owner-subcommittee-on-esg-disclosure.pdf> (noting that third party ESG data providers “which may not always be reliable, consistent, or necessarily material”); *ESG Disclosure – Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets*, U.S. Securities and Exchange Commission (Mar. 11, 2021), <https://www.sec.gov/news/public-statement/coates-esg-disclosure-keeping-pace-031121> (quoting John Coates, Acting Director, Division of Corporation Finance of the SEC, that “despite an abundance of ESG data, there is often a lack of consistent, comparable, and reliable ESG information available upon which to make informed investment and voting decisions”).

<sup>25</sup> Office of Credit Ratings Staff Report on Nationally Recognized Statistical Ratings Organizations (2022), <https://www.sec.gov/files/2022-ocr-staff-report.pdf>.

<sup>26</sup> Office of Credit Ratings Staff Report on Nationally Recognized Statistical Ratings Organizations (2022) at 8-9, 45, <https://www.sec.gov/files/2022-ocr-staff-report.pdf>; Richard Satran, *SEC Elevates ESG Priority In Credit-Rating Firm Exams, Some Firms Push Back*, Thomson Reuters (Feb. 16, 2022), <https://www.thomsonreuters.com/en-us/posts/investigation-fraud-and-risk/sec-esg-credit-rating-firms/>.

least one credit ratings agency supports conducting ESG risk analyses rather than relying on “subjective value-based ESG scoring rubrics.”<sup>27</sup>

## 2. Proposed Regulations Regarding ESG Raters Outside the United States

Outside the United States, regulators in Asia and Europe are considering regulations of ESG ratings providers as well. India is poised to pass the first set of such regulations. In January 2022, the Securities and Exchange Board of India announced it would regulate ESG ratings providers and requested comments to a proposed regulatory framework.<sup>28</sup> Though the anticipated rules do not yet standardize methodologies or rating scales, they do propose to create accredited ESG raters, to require raters to disclose their rating scales, and to establish a subscriber-pay model for ESG ratings, as opposed to the “issuer-pay model” widespread in the credit ratings industry (where an entity pays to be rated).<sup>29</sup>

Japan’s Financial Services Agency, the country’s financial industry regulator, recognized transparency, fairness of evaluation, governance, and impartiality as some of the challenges facing the ESG rating industry, and expressed the need for the establishment of ideal codes of conduct for ESG rating and data providers.<sup>30</sup> In February 2022, the Financial Services Agency established the “Technical Committee for ESG Rating and Data Providers,” which is tasked with discussing

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<sup>27</sup> Office of Credit Ratings Staff Report on Nationally Recognized Statistical Ratings Organizations (2022) at 45, <https://www.sec.gov/files/2022-ocr-staff-report.pdf>.

<sup>28</sup> *Consultation Paper on Environmental, Social and Governance (ESG) Rating Providers for Securities Markets*, Securities and Exchange Board of India (2022), [https://www.sebi.gov.in/reports-and-statistics/reports/jan-2022/consultation-paper-on-environmental-social-and-governance-esg-rating-providers-for-securities-markets\\_55516.html](https://www.sebi.gov.in/reports-and-statistics/reports/jan-2022/consultation-paper-on-environmental-social-and-governance-esg-rating-providers-for-securities-markets_55516.html).

<sup>29</sup> Khalid Azizuddin, *India Unveils Regulation Plans for ESG Ratings Sector in Global First*, Responsible Investor (Jan. 25, 2022), <https://www.responsible-investor.com/india-unveils-regulation-plans-for-esg-ratings-sector-in-global-first/>; Dhvani Pandya, *India’s Capital Markets Regulator Proposes Tighter ESG Rules*, Bloomberg (Jan. 24, 2022), <https://www.bloomberg.com/news/articles/2022-01-24/india-s-capital-markets-regulator-proposes-tighter-esg-rules>.

<sup>30</sup> Report by the Expert Panel on Sustainable Finance, Japan Financial Services Agency (2021) at 19, <https://www.fsa.go.jp/en/news/2021/20210618/04.pdf> (explaining that the quality of ESG ratings will be improved by companies improving their ESG disclosures).

“issues related to ESG rating and data providers, as well as companies and investors, which also play essential roles in ESG assessment, data provision, and finance.”<sup>31</sup>

Regulators in France and Netherlands have proposed an ad-hoc framework to regulate ESG rating providers, requiring providers to (1) be transparent about exact methodologies employed, (2) establish policies to prevent and manage potential conflicts of interests, and (3) establish governance and internal controls to ensure reliability and quality of products.<sup>32</sup> On February 4, 2022, the European Securities and Markets Authority (ESMA) published a call for evidence on ESG ratings providers in the European Union, such that it can develop an understanding of the landscape.<sup>33</sup> Similarly, the United Kingdom’s Financial Conduct Authority has issued a consultation paper requesting feedback on how to proceed with regulation of the ESG industry, and particularly on whether to encourage voluntary, industry-led adherence to a best practices code or, instead, to regulate the ESG ratings market. A final outcome is expected later this year.<sup>34</sup>

International intergovernmental organizations also have proposed possible regulations for the ESG rater industry. Specifically, in November 2021, the International Organization of

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<sup>31</sup> Establishment of “Technical Committee for ESG Rating and Data Providers, etc.” Japan Financial Services Agency (Feb. 17, 2022), <https://www.fsa.go.jp/en/news/2022/20220217.html>.

<sup>32</sup> *Position Paper: Call for a European Regulation for the provision of ESG data, ratings, and related service*, Autorité des Marchés Financiers (AMF), <https://www.amf-france.org/fr/sites/default/files/private/2020-12/amf-afm-position-paper-call-for-a-european-regulation-for-providers-of-esg-data-ratings-and-related-services.pdf>.

<sup>33</sup> *Call for Evidence: On Market Characteristics for ESG Rating Providers in the EU*, European Securities and Market Authority (Feb. 3, 2022), [https://www.esma.europa.eu/sites/default/files/library/esma80-416-250\\_call\\_for\\_evidence\\_on\\_market\\_characteristics\\_for\\_esg\\_rating\\_providers\\_in\\_the\\_eu.pdf](https://www.esma.europa.eu/sites/default/files/library/esma80-416-250_call_for_evidence_on_market_characteristics_for_esg_rating_providers_in_the_eu.pdf).

<sup>34</sup> Huw Jones, *Financial think-tank calls for regulated ESG ratings in Britain*, Reuters (February 21, 2022), <https://www.reuters.com/markets/europe/financial-think-tank-calls-regulated-esg-ratings-britain-2022-02-21/>; *Consultation Paper: Enhancing Climate-Related Disclosures By Standard Listed Companies and Seeking Views on ESG Topics in Capital Markets*, Financial Conduct Authority (2021) at 39–40, <https://www.fca.org.uk/publication/consultation/cp21-18.pdf>. The International Regulatory Strategy Group, a financial regulatory research body sponsored by the TheCityUK and the City of London Corporation, also has called for regulated ESG ratings to protect investors and standardize data and emphasized a “global approach was needed to avoid fragmentation.” See Huw Jones, *Financial think-tank calls for regulated ESG ratings in Britain*, Reuters (February 21, 2022), <https://www.reuters.com/markets/europe/financial-think-tank-calls-regulated-esg-ratings-britain-2022-02-21/>.

Securities Commissions (“IOSCO”) published a seminal report identifying the absence of regulations over ESG ratings and data products providers globally.<sup>35</sup> The IOSCO consists of regulators from 130 jurisdictions, and the SEC is a member of the IOSCO Board.<sup>36</sup> Morningstar was among the fifty-eight organizations that provided feedback to the IOSCO for the report. The IOSCO proposed the following recommendations for regulators, emphasizing the issues around methodology, transparency, and mitigating potential conflicts of interest:

| Category  | Specific Recommendation   |
|---|---|
| <p><b>Regulation &amp; Development of Standards</b></p> | <ol style="list-style-type: none"> <li>1. Regulators should examine their existing regulatory regimes and determine if there is sufficient oversight of ESG ratings and data products providers.</li> <li>2. Regulators should consider whether there are opportunities to encourage industry participants to develop and follow voluntary common industry standards or codes of conduct, including regarding:               <ol style="list-style-type: none"> <li>a. the identification, management, and mitigation of potential conflicts of interest for ESG ratings and data products providers;</li> <li>b. the integrity, transparency, and independence of ESG ratings and data product methodologies;</li> <li>c. the disclosure of ESG rating and data products terminology to help improve understanding of these terms in the markets.</li> </ol> </li> </ol> |

<sup>35</sup> *Environmental, Social and Governance (ESG) Ratings and Data Products Providers Final Report*, International Organization of Securities Commissions (Nov. 2021), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf>.

<sup>36</sup> *Ordinary Members of IOSCO*, International Organization of Securities Commissions, <https://www.iosco.org/about/?subsection=membership&memid=1>.

| Category                    | Specific Recommendation   |
|-----------------------------|---|
| <b>Methodology</b>          | <ol style="list-style-type: none"> <li>1. Regulators should support voluntary, industry-led development of standardized definitions for the terminology used and referred to by ESG rating and data products providers.</li> <li>2. If regulators have authority over ESG ratings and data products providers, they should consider: <ol style="list-style-type: none"> <li>a. Whether the data and information sources that the provider relies on are publicly disclosed;</li> <li>b. If the provider’s methodologies are publicly disclosed, whether and how the methodologies are defining the individual components being assessed and the measurement methodologies;</li> <li>c. Whether the providers’ ESG ratings and data products are issued in a manner that is internally consistent with the relevant provider’s in-house methodologies;</li> <li>d. Whether the underlying processes and methodologies of the ESG ratings and data products are subject to the provider’s written policies and procedures and/or internal controls designed to help ensure the processes and methodologies are rigorous, systematic, and applied consistently.</li> </ol> </li> </ol> |
| <b>Conflict of Interest</b> | <ol style="list-style-type: none"> <li>1. If regulators have authority over ESG ratings and data products providers, they should consider: <ol style="list-style-type: none"> <li>a. Requiring the provider to identify, disclose and mitigate potential conflicts of interest that may arise between ESG ratings and data product offerings and the provision of ESG consulting services;</li> <li>b. Whether existing corporate governance structures of the provider are sufficient to identify, manage and mitigate any potential conflicts of interest.</li> </ol> </li> </ol>   |
| <b>Oversight</b>            | <p>If regulators have authority over ESG ratings and data products providers, they should consider whether to provide mechanisms for the reporting of complaints or misconduct related to the independence, transparency, or integrity of ESG rating or data products.</p>  |

In particular, advisory services by ESG ratings providers have been flagged as creating the risk of a potential conflict of interest.<sup>37</sup> Sustainalytics, however, is not alone in providing advisory services alongside ESG ratings for issuers.<sup>38</sup>

### 3. Industry Reactions Regarding ESG Raters

Some industry leaders have called for regulation of ESG ratings, critiquing the opacity underlying the data and the methodology used by ESG ratings firms.<sup>39</sup> Others have suggested that increased transparency as an industry practice, rather than through regulation, is necessary to avoid introducing “constraints that would make it hard for raters to keep pace with changes in the market.”<sup>40</sup> Issuers also have objected to regulations, pointing to the high financial burden facing companies in responding to requests from third-party data providers.<sup>41</sup>

In the absence of regulations, some firms have elected to disregard the ESG raters’ algorithms and instead develop their own.<sup>42</sup> For example, Nordic wealth funds have pointed out

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<sup>37</sup> See, e.g., Jean Eaglesham, *Wall Street’s Green Push Exposes New Conflicts of Interest*, Wall Street Journal (Jan. 29, 2022), <https://www.wsj.com/articles/wall-streets-green-push-exposes-new-conflicts-of-interest-11643452202> (“One new set of potential conflicts springs from the widespread practice of selling ESG ratings alongside consulting and other services.”).

<sup>38</sup> See, e.g., *ISS ESG Collaborative Engagement Services*, ISS, <https://www.issgovernance.com/esg/engagement/>; *S&P Global Ratings ESG Evaluation*, S&P Global, <https://www.spglobal.com/ratings/en/products-benefits/products/esg-evaluation>; *Arabesque S-Ray Products and Services*, Arabesque, <https://www.arabesque.com/s-ray/products-and-services/> (describing Arabesque’s “Deep Dive Service” and “Bespoke Solutions”).

<sup>39</sup> Frances Schwartzkopff & Marion Halftermeyer, *Credit Suisse ESG Head Wants ‘More Pressure’ on Rating Firms*, Bloomberg Quint (Sept. 9, 2021), <https://www.bloombergquint.com/onweb/credit-suisse-esg-head-wants-more-pressure-put-on-rating-firms>; Jeroen Bos, *Investors Must Beware of Pitfalls Posed by ESG Ratings*, International Investment (Jan. 30, 2020), <https://www.internationalinvestment.net/opinion/4009801/investors-beware-pitfalls-posed-esg-ratings>; *The ESG Data Challenge*, State Street Global Advisors (March 2019), <https://www.ssga.com/investment-topics/environmental-social-governance/2019/03/esg-data-challenge.pdf>; *Why Sustainable Business Needs Better ESG Ratings*, MIT Management Sloan School (Dec. 6, 2021), <https://mitsloan.mit.edu/ideas-made-to-matter/why-sustainable-business-needs-better-esg-ratings>; Michael Mora, *Can Global Regulators Save the ESG Movements From Itself?*, Foreign Policy (Jan. 10, 2022), <https://foreignpolicy.com/2022/01/10/sustainability-esg-investing-sec-gensler-greenwashing/>.

<sup>40</sup> Frances Schwartzkopff & Marion Halftermeyer, *Credit Suisse ESG Head Wants ‘More Pressure’ on Rating Firms*, Bloomberg Quint (Sept. 9, 2021), <https://www.bloombergquint.com/onweb/credit-suisse-esg-head-wants-more-pressure-put-on-rating-firms>.

<sup>41</sup> Letter from Society for Corporate Governance to U.S. Securities and Exchange Commission Re: Public Input on Climate Disclosure (June 11, 2021), [https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/a8892c7c-6297-4149-b9fc-378577d0b150/UploadedImages/HomePageDocs/Society\\_climate\\_disclosure\\_comment\\_letter\\_to\\_SEC\\_final.pdf](https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/a8892c7c-6297-4149-b9fc-378577d0b150/UploadedImages/HomePageDocs/Society_climate_disclosure_comment_letter_to_SEC_final.pdf).

<sup>42</sup> *The ESG Data Challenge*, State Street Global Advisors (March 2019), <https://www.ssga.com/investment-topics/environmental-social-governance/2019/03/esg-data-challenge.pdf>.

that disparate methodologies employed by different providers result in different scores for the same company, and therefore decided to “de-aggregate” the ESG ratings data, “get underlying data points” from third-party raters, and use them as inputs in an in-house algorithm.<sup>43</sup>

The divergence in ESG assessments for the same company by different ESG rating providers also has garnered skepticism and attention. For example, Tesla’s ESG ratings among three major ratings providers has been described as “wildly different.”<sup>44</sup> Several academic initiatives have emerged in response to these disparities, including MIT Sloan’s “Aggregate Confusion Project.” This project aspires to improve the quality of ESG measurements, which it criticizes as “noisy” and “unreliable.”<sup>45</sup> Though the divergence in ESG ratings among different ESG data and ratings providers receives wide criticism, it should be noted that in and of itself, divergence may not always be problematic, and—so long as the different methodologies and assumptions are explained—could actually present added value to institutional investors seeking multiple, diverse viewpoints on ESG to help them make more informed decisions.<sup>46</sup>

Our review of the volume of commentary around potential future regulations in the ESG ratings industry, and our review of the proposed potential regulations themselves (where available), suggests that there is a consensus forming around three best practices values:

- Embracing transparency as to ratings sources and data products methodology,
- Developing and maintaining internal consistency as to processes, and

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<sup>43</sup> Lars Erik Taraldsen, *ESG Ratings Scores ‘Very Rarely’ Help, Norway Wealth Fund Says*, Bloomberg (Dec. 16, 2021), <https://www.bloomberg.com/news/articles/2021-12-16/esg-ratings-scores-very-rarely-help-norway-wealth-fund-says>.

<sup>44</sup> George Hay, *ESG Ratings’ Big Dogs May Need to Learn New Tricks*, Reuters (Nov. 23, 2021), <https://www.reuters.com/breakingviews/global-markets-regulation-breakingviews-2021-11-23/>.

<sup>45</sup> *The Aggregate Confusion Project*, MIT Management Sloan School, <https://mitsloan.mit.edu/sustainability-initiative/aggregate-confusion-project>; Florian Bing et al., *Aggregate Confusion: The Divergence of ESG Ratings* (updated Jan. 21, 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3438533](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533).

<sup>46</sup> *Managing ESG Data and Rating Risk*, Harvard Law Forum on Corporate Governance (July 28, 2021), <https://corpgov.law.harvard.edu/2021/07/28/managing-esg-data-and-rating-risk/>.

- Ensuring objectivity in research and ratings by implementing governance and structural controls to identify, disclose, and mitigate actual or perceived conflicts of interest.

We conducted this investigation with those best practices in mind and have drafted the recommendations discussed in Section VI below with an eye to these ideals and the potential for a future regulated environment that aligns with these values.

#### **IV. RELEVANT TERMINOLOGY AND LEGAL STANDARDS**

This section defines and discusses key terms and standards relevant to the investigation and provides legal, statutory, and common use definitions where relevant.

##### **A. BDS (Boycott, Divestment, and Sanctions) Definitions**

###### **1. BDS Campaign**

The Boycott, Divestment, Sanctions (“BDS”) campaign is a campaign officially launched in 2005 and coordinated by the Palestinian BDS National Committee.<sup>47</sup> In collaboration with the Palestinian Campaign for the Academic and Cultural Boycott of Israel, the group runs a website—BDSMovement.net—which defines the campaign as “a Palestinian-led movement for freedom, justice and equality.”<sup>48</sup> The BDS movement was founded in response to 170 Palestinian civil society organizations (including unions, political parties, professional associations, and refugee networks) publishing a call for the international community to boycott, divest from, and sanction Israel until the state complies with “with international law and universal principles of human rights.”<sup>49</sup> The BDS movement contends that Israel is in violation of international law, and seeks to pressure Israel through boycotts of and divestment from Israeli products and businesses

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<sup>47</sup> *Palestinian BDS National Committee*, BDS Movement.net, <http://bdsmovement.net/bnc>.

<sup>48</sup> *What is BDS*, BDS Movement.net, <https://bdsmovement.net/what-is-bds>.

<sup>49</sup> Jad Essayli, *Restricting Your Right to Boycott: Free Speech Implications Regarding Legislation Targeting the Boycott, Divestment, and Sanctions (BDS) Movement in the United States and the European Union*, 21 *San Diego Int’l L.J.* 457, 459-60 (2020).



operating in Israel.<sup>50</sup> The BDS campaign seeks (1) an end to the occupation and dismantling the barriers between Israeli territory and the “Occupied Palestinian Territories,” (2) recognition of the equal rights of Arab-Palestinian citizens, and (3) respect for the right of Palestinian refugees to return to their homes.<sup>51</sup> The Anti-Defamation League (“ADL”) has characterized the BDS movement as “a key tactic within the global effort to delegitimize and isolate Israel.” The ADL also charges that “BDS campaigns promote a biased and simplistic approach to the complex Israeli-Palestinian conflict, and present this dispute over territorial and nationalist claims as the fault of only one party—Israel.”<sup>52</sup>

## 2. Boycott

Few pieces of U.S. anti-BDS legislation, including the Illinois anti-BDS statute, 40 Ill. Comp. Stat. Ann. 5/1-110.16, actually define “BDS.” However, the Illinois anti-BDS statute, like most anti-BDS legislation, does define “boycott.” Illinois prohibits the state retirement system pension fund from investing in companies that “boycott Israel,” defined as follows:

“Boycott Israel” means engaging in actions that are politically motivated and are intended to penalize, inflict economic harm on, or otherwise limit commercial relations with the State of Israel or companies based in the State of Israel or in territories controlled by the State of Israel.<sup>53</sup>

Other states’ anti-BDS statutes essentially follow this definition of “boycott.”<sup>54</sup>

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<sup>50</sup> *What is BDS*, BDS Movement.net, <https://bdsmovement.net/what-is-bds>.

<sup>51</sup> Jad Essayli, *Restricting Your Right to Boycott: Free Speech Implications Regarding Legislation Targeting the Boycott, Divestment, and Sanctions (BDS) Movement in the United States and the European Union*, 21 San Diego Int’l L.J. 457, 461-62 (2020). See also BDS, *What is BDS*, <https://bdsmovement.net/what-is-bds>.

<sup>52</sup> *BDS: The Global Campaign to Delegitimize Israel*, Anti-Defamation League, [https://www.adl.org/resources/backgrounders/bds-the-global-campaign-to-delegitimize-israel?gclid=EAlalQobChMI6uDezZG89gIVD-DiCh0uvg18EAAYBCAAEgJgrfD\\_BwE](https://www.adl.org/resources/backgrounders/bds-the-global-campaign-to-delegitimize-israel?gclid=EAlalQobChMI6uDezZG89gIVD-DiCh0uvg18EAAYBCAAEgJgrfD_BwE).

<sup>53</sup> 40 Ill. Comp. Stat. Ann. 5/1-110.16(a).

<sup>54</sup> See, e.g., Fla. Stat. § 215.4725 (“‘Boycott Israel’ or ‘boycott of Israel’ means refusing to deal, terminating business activities, or taking other actions to limit commercial relations with Israel, or persons or entities doing business in Israel or in Israeli-controlled territories, in a discriminatory manner. A statement by a company that it is participating in a boycott of Israel, or that it has initiated a boycott in response to a request for a boycott of Israel or in compliance with, or in furtherance of, calls for a boycott of Israel, may be considered by the State Board of Administration to be evidence that a company is participating in a boycott of Israel....”); Tex. Gov’t Code § 808.001(1) (“‘Boycott Israel’ means refusing to deal with, terminating business activities with, or otherwise taking any action that is intended to penalize, inflict economic harm on, or limit commercial relations specifically with Israel, or

The BDS campaign itself defines “boycott” as “involv[ing] withdrawing support from Israel’s apartheid regime, complicit Israeli sporting, cultural and academic institutions, and from all Israeli and international companies engaged in violations of Palestinian human rights.”<sup>55</sup>

### 3. Divestment

Like many of the other state anti-BDS statutes,<sup>56</sup> the Illinois anti-BDS statute, 40 Ill. Comp. Stat. Ann. 5/1-110.16, does not define “divestment.” The New Jersey anti-BDS statute, N.J. Rev. Stat. § 52:18A-89.14, is an exception—it defines “divestment” as “mean[ing] to sell, redeem, or withdraw all holdings of a company from the investment portfolio of another company or of a governmental entity.”<sup>57</sup> The BDS campaign itself defines “divestment” as “campaigns [that] urge banks, local councils, churches, pension funds and universities to withdraw investments from the State of Israel and all Israeli and international companies that sustain Israeli apartheid.”<sup>58</sup> The United Nations does not define “divestment.”

### 4. Sanctions

Nearly all state anti-BDS statutes leave “sanctions” undefined.<sup>59</sup> Again, only the New Jersey anti-BDS statute, N.J. Rev. Stat. § 52:18A-89.14, defines “sanctions” as “mean[ing] the attempts by national governments, multilateral organizations and other international bodies or their subdivisions to limit or ban trade or other relations with a state or nation.”<sup>60</sup> The BDS campaign

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with a person or entity doing business in Israel or in an Israeli-controlled territory, but does not include an action made for ordinary business purposes.”); N.J. Stat. § 52:18A-89.14 (“As used in this act . . . ‘boycott’ means engaging in actions that are intended to penalize, inflict economic harm on, or otherwise limit commercial relations with another state or nation”).

<sup>55</sup> *What is BDS?*, BDS Movement.net, <https://bdsmovement.net/what-is-bds>.

<sup>56</sup> *See, e.g.*, Fla. Stat. Ann. § 215.4725 (defining boycott and other terms, but not divestment); Ariz. Rev. Stat. Ann. § 35-393 (same); Ark. Code Ann. § 25-1-502 (same); N.C. Gen. Stat. § 147-86.80 (same); Tex. Gov’t. Code § 808.001 (same).

<sup>57</sup> N.J. Rev. Stat. § 52:18A-89.14.

<sup>58</sup> *What is BDS?*, BDS Movement.net, <https://bdsmovement.net/what-is-bds>.

<sup>59</sup> *See, e.g.*, Ark. Code Ann. § 25-1-502 (defining boycott and other terms, but not sanctions or divestment); Nev. Rev. Stat. Ann. § 355.305 (defining boycott but not sanctions or other terms).

<sup>60</sup> N.J. Rev. Stat. § 52:18A-89.14.

defines “sanctions” as “campaigns [that] pressure governments to fulfill their legal obligations to end Israeli apartheid, and not aid or assist its maintenance, by banning business with illegal Israeli settlements, ending military trade and free-trade agreements, as well as suspending Israel’s membership in international forums such as UN bodies and FIFA.”<sup>61</sup>

## **B. BDS Lists**

In addition to a call for boycott of all Israeli companies and products, the BDS campaign also publishes “lists” that target specific companies and products in an attempt to concentrate and maximize economic damage. As of May 2022, the BDS campaign targets the following eight products and brands: (1) fruit, vegetable, and wine labeled as being “produced in Israel,” (2) AXA, (3) Hewlett Packard, (4) Puma, (5) SodaStream, (6) Ahava, (7) Sabra hummus, and (8) Pillsbury.<sup>62</sup> Additionally, the official BDS website counsels those interested in engaging with the movement to “[c]heck with BDS organisations in [their] country for the brands being targeted in [their] community” and provides a drop down menu of various BDS associated organizations around the world.<sup>63</sup>

There are also “unofficial” BDS lists promulgated by sources sympathetic to the BDS movement, with the “BDS Guide” being among the most popular (indeed, it is the top search result for “BDS list” on Google).<sup>64</sup> The list is extensive, as it attempts to name every business, institution, or creative artist with any commercial connection to Israel.<sup>65</sup> Consequently, the list contains thousands of names, brands, companies, and universities.<sup>66</sup> Other BDS lists are more targeted, focusing on companies that conduct business specifically in occupied territories and

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<sup>61</sup> *What is BDS?*, BDS Movement.net, <https://bdsmovement.net/what-is-bds>.

<sup>62</sup> *Know What to Boycott*, BDS Movement.net, <https://bdsmovement.net/get-involved/what-to-boycott>.

<sup>63</sup> *Know What to Boycott*, BDS Movement.net, <https://bdsmovement.net/get-involved/what-to-boycott>.

<sup>64</sup> *BDS List*, BDS Guide, <http://bdsguide.com/bds-list/>.

<sup>65</sup> *BDS List*, BDS Guide, <http://bdsguide.com/bds-list/>.

<sup>66</sup> *BDS List*, BDS Guide, <http://bdsguide.com/bds-list/>.

settlements, or which support the Israeli Defense Force’s military mission there. In February 2020, the UN High Commissioner for Human Rights published a list of 112 companies “that raised particular human rights concerns” associated with “facilitating the construction, expansion or maintenance of Israeli settlements or the demolition of Palestinian housing and property.”<sup>67</sup> The UN High Commissioner’s report itself explicitly states it has no legal standing and does not apply any legal characterization to the businesses listed.<sup>68</sup> However, Israel has condemned the database as a “defamatory blacklist.”<sup>69</sup>

Other human rights and consumer organizations publish their own independent lists. For example, the Ethical Consumer—an independent, nonprofit organization based in Manchester, United Kingdom<sup>70</sup>—publishes shopping guides on a wide-range of issues, including animal testing and climate change,<sup>71</sup> and maintains an ongoing “boycott list” which currently includes eight companies that have supported Israeli settlements in the Israeli/Palestinian conflict areas or the Israeli military (as identified by the BDS movement).<sup>72</sup> Other organizations, such as the Danish NGO Danwatch, investigate various companies involved in the Israeli/Palestinian conflict areas, but do not publish a centralized list.<sup>73</sup>

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<sup>67</sup> Hum. Rts. Council, Ann. rep. of the United Nations High Commissioner for Hum. Rts. and rep. of the Off. of the High Commissioner and the Secretary-Gen. on its Forty-Third Session, UN Doc. A/HRC/43/71 (2020).

<sup>68</sup> Nick Cumming-Bruce, *U.N. Publishes List of Firms Doing Business With Israeli Settlements*, New York Times (Feb. 12, 2020), <https://www.nytimes.com/2020/02/12/world/middleeast/un-israeli-settlements-companies-list.html>.

<sup>69</sup> Nick Cumming-Bruce, *U.N. Publishes List of Firms Doing Business With Israeli Settlements*, New York Times (Feb. 12, 2020), <https://www.nytimes.com/2020/02/12/world/middleeast/un-israeli-settlements-companies-list.html>.

<sup>70</sup> *About Us*, Ethical Consumer, <https://www.ethicalconsumer.org/about-us>.

<sup>71</sup> *Quick Guide*, Ethical Consumer, <https://www.ethicalconsumer.org/quick-guide-ethical-consumer>.

<sup>72</sup> *Boycott List*, Ethical Consumer, <https://www.ethicalconsumer.org/ethicalcampaigns/boycotts>.

<sup>73</sup> See, e.g., Danwatch, *Pension Fund blacklists four companies after Danwatch investigation* (Oct. 10, 2017), <https://danwatch.dk/en/pension-fund-blacklists-four-companies-after-danwatch-investigation/>; Danwatch, *Europe’s Largest Pension Funds Heavily Invested in Illegal Israeli Settlements* (Jan. 31, 2017), <https://danwatch.dk/en/europes-largest-pension-funds-heavily-invested-in-illegal-israeli-settlements/>; Danwatch, *Investment funds invest half a billion in Israeli settlements* (Dec. 19, 2014), <https://danwatch.dk/en/investment-funds-invest-half-a-billion-in-israeli-settlements/>.

## C. Anti-BDS Legislation

### 1. State Anti-BDS Legislation

Currently, thirty-five states have enacted some form of anti-BDS legislation.<sup>74</sup> Despite their similarities, anti-BDS legislation can be classified into three broad types of statutes.<sup>75</sup>

The first type of anti-BDS statute requires that all parties contracting with the state supply a written certification in which the contractor pledges that they will not boycott Israel.<sup>76</sup> States that utilize this type of statute include Florida and California.<sup>77</sup>

The second form of anti-BDS statute requires the state to compile a list of companies boycotting Israel, from which state entities will divest.<sup>78</sup> Usually, the statute will compel the state treasury or retirement board to compile the list for divestment purposes.<sup>79</sup> States that utilize this type of statute include Texas and Arizona.<sup>80</sup>

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<sup>74</sup> Jewish Virtual Library, *Anti-Semitism: State Anti-BDS Legislation*, <https://www.jewishvirtuallibrary.org/anti-bds-legislation>; Palestine Legal, *Legislation targeting advocacy for Palestinian Rights*, <https://legislation.palestinelegal.org/state-legislation/>.

<sup>75</sup> See Jad Essayli, *Restricting Your Right to Boycott: Free Speech Implications Regarding Legislation Targeting the Boycott, Divestment, and Sanctions (BDS) Movement in the United States and the European Union*, 21 San Diego Int'l L.J. 457, 466-67 (2020).

<sup>76</sup> See Jad Essayli, *Restricting Your Right to Boycott: Free Speech Implications Regarding Legislation Targeting the Boycott, Divestment, and Sanctions (BDS) Movement in the United States and the European Union*, 21 San Diego Int'l L.J. 457, 466-67 (2020).

<sup>77</sup> See e.g., Fla. Stat. Ann. § 287.135(2)(a) (“A company is ineligible to, and may not, bid on, submit a proposal for, or enter into or renew a contract with an agency or local governmental entity for goods or services of . . . Any amount if, at the time of bidding on, submitting a proposal for, or entering into or renewing such contract, the company is on the Scrutinized Companies that Boycott Israel List, created pursuant to s. 215.4725, or is engaged in a boycott of Israel . . .”); Cal. Pub. Cont. Code § 2010(c)(1) (“A person that submits a bid or proposal to, or otherwise proposes to enter into or renew a contract with, a state agency with respect to any contract in the amount of one hundred thousand dollars (\$100,000) or more shall certify . . . That any policy that they have against any sovereign nation or peoples recognized by the government of the United States, including, but not limited to, the nation and people of Israel, is not used to discriminate in violation of the Unruh Civil Rights Act . . .”).

<sup>78</sup> See Jad Essayli, *Restricting Your Right to Boycott: Free Speech Implications Regarding Legislation Targeting the Boycott, Divestment, and Sanctions (BDS) Movement in the United States and the European Union*, 21 San Diego Int'l L.J. 457, 466-67 (2020).

<sup>79</sup> See e.g., Tex. Gov't Code Ann. § 808.051(a) (“The comptroller shall prepare and maintain, and provide to each state governmental entity, a list of all companies that boycott Israel.”); Ariz. Rev. Stat. Ann. § 35-393.02E(1) (“Each public fund shall . . . Sell, redeem, divest or withdraw all direct holdings of a restricted company from the assets under its management in an orderly and fiducially responsible manner within three months after preparing the list of restricted companies pursuant to subsection A of this section. On or before August 1 of each year, the state treasurer and each retirement system shall post on their websites a list of investments that are sold, redeemed, divested or withdrawn pursuant to this paragraph.”).

<sup>80</sup> See Tex. Gov't Code Ann. § 808.051(a); Ariz. Rev. Stat. Ann. § 35-393.02E(1).

The final variation of anti-BDS statutes is that of a non-binding resolution.<sup>81</sup> Non-binding resolutions are essentially symbolic condemnations of the BDS movement without enforcement mechanisms.<sup>82</sup> Tennessee and Virginia utilize this type of statute.<sup>83</sup>

Some states have passed more than one type of anti-BDS statute.<sup>84</sup> For example, North Carolina has both a written certification requirement and a company blacklist.<sup>85</sup> To date, twenty eight states have passed laws mandating written certification,<sup>86</sup> thirteen states have passed laws requiring the compilation of company blacklists,<sup>87</sup> and two states have passed only non-binding resolutions.<sup>88</sup>

Illinois has the second type of anti-BDS statute. In 2015, Illinois enacted 40 Ill. Comp. Stat. Ann. 5/1-110.16 which requires the Illinois Investment Policy Board (the “IIPB”) to regulate the investment of public money for state retirement funds. The Illinois statute charged the IIPB with creating and maintaining a quarterly list of businesses who boycott Israel by “engaging in actions that are politically motivated and are intended to penalize, inflict economic harm on, or otherwise limit commercial relations with the State of Israel or companies based in the State of Israel or in territories controlled by the State of Israel.”<sup>89</sup> The consequence of appearing on the

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<sup>81</sup> Jewish Virtual Library, *Anti-Semitism: State Anti-BDS Legislation*, <https://www.jewishvirtuallibrary.org/anti-bds-legislation>.

<sup>82</sup> See *New York State Assembly passes anti-BDS resolution*, World Jewish Congress (June 19, 2015), <https://www.worldjewishcongress.org/en/news/new-york-state-assembly-passes-anti-bds-resolution-6-5-2015>.

<sup>83</sup> S. J. Res. 170, 109th Gen. Assemb., Reg. Sess. (Tenn. 2015); H. J. Res. 177, 2016 Leg., Reg. Sess. (Va. 2016).

<sup>84</sup> See *e.g.*, N.C. Gen. Stat. Ann. § 147-86.81.

<sup>85</sup> N.C. Gen. Stat. Ann. § 147-86.81.

<sup>86</sup> These states are: Alabama, Arizona, California, Colorado, Florida, Georgia, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Missouri, Nevada, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, West Virginia, and Wisconsin.

<sup>87</sup> These states are: Arizona, Arkansas, Colorado, Florida, Illinois, Indiana, Iowa, Mississippi, Nevada, New Jersey, New York, North Carolina, and Texas.

<sup>88</sup> These states are: Tennessee and Virginia.

<sup>89</sup> 40 Ill. Comp. Stat. Ann. 5/1-110.16(a), (b), (d).

list of restricted businesses is that state retirement funds may not be invested in those companies.<sup>90</sup> Under the statute, there is no civil or criminal liability imposed on those listed companies.

## 2. Federal Anti-BDS Legislation

There are two federal anti-BDS laws currently in effect, 19 U.S.C. § 4201 and 19 U.S.C. § 4301, along with an executive order (“EO”) 13899. Passed in conjunction with the Bipartisan Congressional Trade Priorities and Accountability Act of 2015, § 4201 states that in negotiating with foreign countries in the Transatlantic Trade and Investment Partnership (TTIP), it is an objective of the United States to discourage boycotts of Israel.<sup>91</sup> Moreover, § 4201 states that the United States will “seek the elimination of politically motivated nontariff barriers” imposed on goods from Israel or its settlements.<sup>92</sup>

Similarly, 19 U.S.C. § 4301, the Trade Facilitation and Trade Enforcement Act of 2015,<sup>93</sup> contains several anti-boycott measures, including a statement of policy opposing “politically motivated actions” to penalize or limit commercial relations with Israel, such as BDS campaigns. The Trade Facilitation and Trade Enforcement Act states that discouraging boycotts against Israel is a principal U.S. objective in negotiating foreign trade agreements.<sup>94</sup> It directs the President of the United States to report annually on anti-BDS efforts to Congress, including on the specific steps the United States is taking to discourage other countries or international organizations from establishing barriers to trade with Israel or its settlements.<sup>95</sup> The Trade Facilitation and Trade Enforcement Act also bars state and federal courts from recognizing or enforcing foreign

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<sup>90</sup> 40 Ill. Comp. Stat. Ann. 5/1-110.16(a), (b), (d).

<sup>91</sup> 19 U.S.C. § 4201(b)(20) (2015).

<sup>92</sup> 19 U.S.C. § 4201(b)(20) (2015).

<sup>93</sup> 19 U.S.C. § 4301 (2016) *et seq.*

<sup>94</sup> 19 U.S.C. § 4452(b), (c) (2016).

<sup>95</sup> 19 U.S.C. § 4452(d) (2016).

judgments against U.S. persons where the foreign judgment is based on a finding that conducting business in Israel or Israeli-controlled territories violates the law.<sup>96</sup>

Finally, in December 2019, President Trump signed an executive order, EO 13899, which directed government agencies charged with enforcing Title VI of the Civil Rights Act, including the Department of Education, to consider the International Holocaust Remembrance Alliance’s (“IHRA”) definition of antisemitism and its contemporary examples of antisemitism when enforcing the antidiscrimination provisions of the Civil Rights Act.<sup>97</sup> Notably, the IHRA includes two contemporary examples of antisemitism which take aim at BDS rhetoric.<sup>98</sup> Specifically, the IHRA condemns rhetoric that “claim[s] that the existence of a State of Israel is a racist endeavor” or that “appl[ies] double standards [to Israel] by requiring of it a behavior not expected or demanded of any other democratic nation.”<sup>99</sup> Proponents of the BDS movement are often alleged to use such rhetoric against Israel.<sup>100</sup> President Biden has not rescinded this executive order.<sup>101</sup>

Moreover, there are three pending pieces of federal anti-BDS legislation, two sponsored in the Senate, (i) S 1260, SA 1502 (2021) and (ii) S 2119 (2021),<sup>102</sup> and one sponsored in the House.<sup>103</sup> Introduced as an amendment to the Innovation and Competition Act of 2021 and adopted in committee, S 1260, SA 1502 excludes countries that boycott Israel or Israeli settlements

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<sup>96</sup> 19 U.S.C. § 4452(e) (2016).

<sup>97</sup> Proclamation No. 13,899, 84 Fed. Reg. 68,7779 (Dec. 11, 2019).

<sup>98</sup> International Holocaust Remembrance Alliance, *What is antisemitism*, <https://www.holocaustremembrance.com/resources/working-definitions-charters/working-definition-antisemitism>.

<sup>99</sup> International Holocaust Remembrance Alliance, *What is antisemitism*, <https://www.holocaustremembrance.com/resources/working-definitions-charters/working-definition-antisemitism>.

<sup>100</sup> For example, Al Jazeera, a publication noted for its pro-Palestinian and pro-BDS stance, took issue with the IHRA’s contemporary examples of antisemitism. See James Kleinfeld, *IHRA ‘misrepresents’ own definition of anti-Semitism, says report*, Al Jazeera (23 Apr. 2021), <https://www.aljazeera.com/news/2021/4/23/ihra-misrepresents-own-definition-of-anti-semitism-says-report>.

<sup>101</sup> *Legislation targeting advocacy for Palestinian Rights*, Palestine Legal, <https://legislation.palestinelegal.org/state-legislation/>.

<sup>102</sup> *Legislation targeting advocacy for Palestinian Rights*, Palestine Legal, <https://legislation.palestinelegal.org/state-legislation/>; Jewish Virtual Library, *Anti-Semitism: State Anti-BDS Legislation*, <https://www.jewishvirtuallibrary.org/anti-bds-legislation>.

<sup>103</sup> H.R. 6940, 117th Cong. (2022).



from the bill’s \$100 million investment in global technological advancements.<sup>104</sup> S 1260, SA 1502 adopts the definition of boycotts provided in the 2015 Trade Promotion Authority law.<sup>105</sup>

The second proposed bill, S 2119, titled the “Combating BDS Act of 2021,” would authorize state and local legislation prohibiting state investments and contracts with entities that engage in BDS activities against Israel.<sup>106</sup> S 2119 would prevent anti-BDS measures from being preempted by federal law and defines BDS activities to include boycotts of Israel and persons doing business in Israel or its settlements.<sup>107</sup>

Finally, a House bill recently introduced in March 2022 seeks to amend the Export Administration Act of 1979.<sup>108</sup> This bill seeks to protect American companies from being compelled to provide information to international organizations for the purpose of furthering boycotts against Israel, and levies a monetary penalty against individuals who attempt to violate this protection.<sup>109</sup> Additionally, the bill affirms Congress’ opposition to the BDS movement, and also that Congress considers the UN Human Rights Council’s creation of a database of companies doing business in the West Bank, East Jerusalem, and the Golan Heights in March 2016 to be an act supporting the BDS movement.<sup>110</sup>

### 3. Anti-BDS Legislation Outside the United States

Outside the United States, several nations have passed anti-BDS legislation. In Europe and Canada, anti-BDS laws are largely limited to non-binding parliamentary condemnations of the

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<sup>104</sup> S. 1260 S. Am. 1502, 117<sup>th</sup> Cong. (2021).

<sup>105</sup> S. 1260 S. Am. 1502, 117<sup>th</sup> Cong. (2021).

<sup>106</sup> S. 2119, 117<sup>th</sup> Cong. (2021).

<sup>107</sup> S. 2119, 117<sup>th</sup> Cong. (2021).

<sup>108</sup> Press Release, Congressman Lee Zeldin, *Rep. Zeldin Introduces “Israel Anti-Boycott Act” to Combat BDS Movement, Anti-Israel Boycotts* (Mar. 3, 2022), <https://zeldin.house.gov/media-center/press-releases/rep-zeldin-introduces-israel-anti-boycott-act-combat-bds-movement-anti>.

<sup>109</sup> H.R. 6940, 117<sup>th</sup> Cong. (2022).

<sup>110</sup> H.R. 6940, 117<sup>th</sup> Cong. (2022).

BDS movement. For example, the Canadian parliament passed a resolution condemning the BDS movement in 2017, but more stringent anti-boycott laws were defeated in Ontario in 2016 and Vancouver in 2019.<sup>111</sup> Likewise, national legislative bodies in Austria,<sup>112</sup> Germany,<sup>113</sup> and the Czech Republic<sup>114</sup> have condemned BDS in non-binding resolutions.

Nonetheless, laws in the United Kingdom and France have proved significant obstacles to the BDS movement. In response to several city councils passing motions to boycott goods from Israeli settlements, the UK parliament passed a procurement bill in 2016 that prohibits public authorities from boycotts on ethical grounds.<sup>115</sup> In France, the 2003 “Lellouche law” that forbids discrimination based on a number of immutable characteristics, including national origin, has been used to prosecute members of the BDS movement.<sup>116</sup>

Israel itself passed in 2017 a robust anti-BDS measure, Amendment No. 28 to the Entry Into Israel Law, which prohibits the entry into Israel of any foreigner who makes a “public call for boycotting Israel” or “any area under its control.”<sup>117</sup> Based on this law, the Israeli government has refused entry to the representatives of twenty BDS-friendly organizations along with sixteen

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<sup>111</sup> *Ontario anti-BDS bill defeated*, The Times of Israel (May 21, 2016), <https://www.timesofisrael.com/ontario-anti-bds-bill-defeated/>; Maura Forrest, *Cities face pushback over same anti-Semitism definition backed by federal government*, National Post (Nov. 20, 2019), <https://nationalpost.com/news/politics/cities-face-pushback-over-same-anti-semitism-definition-backed-by-federal-government/>; *Canada’s parliament rejects BDS movement*, The Times of Israel (Feb. 23, 2016), <https://www.timesofisrael.com/canadas-parliament-rejects-bds-movement/>.

<sup>112</sup> Benjamin Weinthal, *Austrian Parliament condemns BDS movement as anti-Semitic*, Jerusalem Post (Feb. 29, 2020), <https://www.jpost.com/diaspora/antisemitism/austrian-parliament-condemns-bds-movement-as-antisemitic-619108>.

<sup>113</sup> Joseph Nasr & Riham Alkousaa, *Germany designates BDS Israel boycott movement as anti-Semitic*, Reuters (May 17, 2019), <https://www.reuters.com/article/us-germany-bds-israel/germany-designates-bds-israel-boycott-movement-as-anti-semitic-idUSKCN1SN204>.

<sup>114</sup> Raphael Ahren, *Czech lawmakers pass resolution condemning BDS movement*, The Times of Israel (Oct. 22, 2019), <https://www.timesofisrael.com/czech-lawmakers-pass-resolution-condemning-bds-movement/>.

<sup>115</sup> Jon Stone, *Banning boycotts of Israel will protect Britain’s national security, Government says*, The Independent (Feb. 17, 2016), <https://www.independent.co.uk/news/uk/politics/boycott-israel-ban-bds-illegal-british-government-tories-palestine-procurement-a6879421.html>.

<sup>116</sup> *BDS a Hate Crime? In France, Legal Vigilance Punishes anti-Israel Activists*, Haaretz (Feb. 15, 2014), <https://www.haaretz.com/jewish/the-french-law-that-battles-bds-1.5322519>.

<sup>117</sup> *Israel: Prevention of Entry of Foreign Nationals Promoting Boycott of Israel*, Library of Congress (Mar. 17, 2017), <https://www.loc.gov/item/global-legal-monitor/2017-03-17/israel-prevention-of-entry-of-foreign-nationals-promoting-boycott-of-israel/>.

individuals identified with the movement, including U.S. Congresswomen Rashida Tlaib and Ilhan Omar.<sup>118</sup>

There are no known anti-BDS laws in Africa or Asia.

#### **D. Definitions of Bias**

A common legal definition of “bias” is “[a] mental inclination or tendency; prejudice; predilection.”<sup>119</sup> When used in a litigation context, “bias” is generally used to express a judge, juror, or witness’s feelings in favor of or against another party that sways their judgments on the merits of a controversy.<sup>120</sup> In the evidentiary context, “bias” describes the relationship between a party and a witness that may lead the witness to slant, unconsciously or otherwise, his testimony in favor of or against a party; it may be induced by a witness’ like, dislike, or fear of a party, or by the witness’ self-interest.<sup>121</sup> Legally, “bias” also may be defined as “an unfair act or policy stemming from prejudice.”<sup>122</sup>

Outside of the judicial or juror context, “bias” as a generic term is not defined under Illinois law or statute, nor does the federal case law provide a generic, nonjudicial definition. Nonetheless, the plain meaning of “bias” is “an inclination of temperament or outlook, especially: a personal and sometimes unreasoned judgment.”<sup>123</sup>

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<sup>118</sup> Peter Beaumont, *Israel imposes travel ban on 20 foreign NGOs over boycott movement*, The Guardian (Jan. 7, 2018), <https://www.theguardian.com/world/2018/jan/07/israel-imposes-travel-ban-on-20-foreign-ngos-over-boycott-movement>; *Israel bars Ilhan Omar and Rashida Tlaib from visiting*, BBC News (Aug. 15, 2019), <https://www.bbc.com/news/world-middle-east-49363041>.

<sup>119</sup> *Bias*, Black’s Law Dictionary (11th ed. 2019).

<sup>120</sup> See e.g., *Bias*, Ballentine’s Law Dictionary (3d ed. 2010) (defining “bias” as a “[p]ropension; something that turns the mind and sways the judgment” or “[a] hostile feeling or spirit of ill will toward one of the litigants, or undue friendship or favoritism toward one; involving a mental attitude toward a litigant, not toward the subject matter of the litigation.”).

<sup>121</sup> See, e.g., *United States v. Slough*, 22 F. Supp. 3d 29, 33 (D.D.C. 2014).

<sup>122</sup> *Legal Definitions: Bias*, USLegal.com, <https://definitions.uslegal.com/b/bias/>.

<sup>123</sup> *Bias*, Merriam-Webster Third International Dictionary (11th ed. 2002). This is the dictionary usually cited by U.S. courts when identifying plain meaning or common usage.

In scientific research or technical analysis, bias “is defined as any tendency which prevents unprejudiced consideration of a question.”<sup>124</sup> Bias occurs when “systematic error [is] introduced into sampling or testing by selecting or encouraging one outcome or answer over others.”<sup>125</sup> Importantly, bias need not be intentional, but instead can result from flaws in methodology or process, such as an unknown bias in the selection of inputs, the presence of confounding variables, or the presence of unconscious cognitive shortcuts on the part of the researcher.<sup>126</sup>

**Systemic bias** – Systemic bias, also known as institutional bias, is the inherent tendency of a process to support particular outcomes, particularly in the context of advantaging or disadvantaging a particular social group.<sup>127</sup>

**Implicit Bias** – Implicit bias may be defined as bias that is “not necessarily openly and explicitly expressed, but [is] harbored nonetheless.”<sup>128</sup> Implicit bias is unconscious, not intentional or rooted in malice. “While explicit biases may be shunned and disapproved of in public, implicit biases only strengthen and harden over time, becoming part of one’s core set of beliefs.”<sup>129</sup> Unlike explicit biases, “not all implicit biases take the shape of outward animosity or hatred toward a particular group. One can hold beliefs stemming from seemingly innocuous stereotypes, which then subsequently form cognitive schemas and implicit biases.”<sup>130</sup>

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<sup>124</sup> C. Pannunic, MD & E. Wilkins, MD, MS, *Identifying and Avoiding Bias in Research*, 126(2) *Plast Reconstr. Surg* 619 (2010), <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC2917255/>; see also see also Simundić A. M., *Bias in research*, 23(1) *Biochemia medica* 12 (2013), <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3900086/> (“Bias is any trend or deviation from the truth in data collection, data analysis, interpretation and publication which can cause false conclusions.”).

<sup>125</sup> C. Pannunic, MD & E. Wilkins, MD, MS, *Identifying and Avoiding Bias in Research*, 126(2) *Plast Reconstr. Surg* 619 (2010), <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC2917255/> (quoting Bias, Merriam-Webster Dictionary (2010)).

<sup>126</sup> C. Pannunic, MD & E. Wilkins, MD, MS, *Identifying and Avoiding Bias in Research*, 126(2) *Plast Reconstr. Surg* 619 (2010), <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC2917255/>.

<sup>127</sup> See *Institutional Bias*, Oxford Reference, <https://www.oxfordreference.com/view/10.1093/oi/authority.20110803100005347>; Emily Boudreau, *Uprooting Systemic Bias in Schools*, Harvard Graduate School of Education (Nov. 1, 2019), <https://www.gse.harvard.edu/news/uk/19/11/uprooting-systemic-bias-schools>.

<sup>128</sup> See, e.g., *United States v. Ray*, 803 F.3d 244, 260 n.8 (6th Cir. 2015).

<sup>129</sup> *United States v. Ray*, 803 F.3d 244, 260 n.8 (6th Cir. 2015).

<sup>130</sup> *United States v. Ray*, 803 F.3d 244, 260 n.8 (6th Cir. 2015).

There is no Illinois case law defining the term “implicit bias,” though it is defined in at least one enacted statute. Section 4 of “The Abused and Neglected Child Reporting Act” states, “[a]s used in this subsection, ‘implicit bias’ means the attitudes or internalized stereotypes that affect people’s perceptions, actions, and decisions in an unconscious manner and that exist and often contribute to unequal treatment of people based on race, ethnicity, gender identity, sexual orientation, age, disability, and other characteristics.”<sup>131</sup>

**Confirmation Bias** – Confirmation bias is commonly defined as “a preference for information that is consistent with a hypothesis rather than information which opposes it,”<sup>132</sup> or “the tendency to bolster a hypothesis by seeking consistent evidence while minimizing inconsistent evidence.”<sup>133</sup> The role of confirmation bias in research and the gathering of evidence has been the subject of extensive discussion in academic literature and the law,<sup>134</sup> and even within the context of the Israeli/Palestinian conflict.<sup>135</sup> The primary risk of confirmation bias in the context of factual research and evidence gathering is that researchers will select for information that comports with their world view while either rejecting, minimizing, or re-contextualizing information that is at

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<sup>131</sup> 325 Ill. Comp. Stat. Ann. 5/4.

<sup>132</sup> See, e.g., Scott Plous, *The Psychology of Judgment and Decision Making* 233 (1993).

<sup>133</sup> Barbara O’Brien, *Prime Suspect: An Examination of Factors That Aggravate and Counteract Confirmation Bias in Criminal Investigations*, 15 *Psychol. Pub. Pol’y & L.* 315, 316 (2010).

<sup>134</sup> See, e.g., Daniel Kahneman, *Thinking, Fast and Slow* (2011); Charlan Jeanne Nemeth et al., *Improving Decision Making by Means of Dissent*, 31 *J. Applied Soc. Psychol.* 48, 49 (2001) (“There are literally hundreds of studies documenting how difficult it is for people to seriously question their own judgment, especially when that judgment is bolstered by consensus.”); Andrew Wistich & Jeffrey Rachlinski, *How Lawyers’ Intuitions Prolong Litigation*, Cornell L. Faculty Pubs. Paper 602 (2013) (discussing the role of confirmation bias in discovery); Eyal Peer & Eyal Gamliel, *Heuristics and Biases in Judicial Decisions*, 49 *J. Am. Judges Ass’n* 114 (2013) (discussing confirmation bias by judges).

<sup>135</sup> Shiri Krebs, *Law Wars: Experimental Data on the Impact of Legal Labels on Wartime Event Beliefs*, 11 *Harv. Nat’l Sec. J.* 106, 122-23 (2020) (discussing confirmation bias in context of whether “legal terminology and legal blame influence people’s beliefs about wartime events,” specifically with respect to the Israeli/Palestinian conflict).

odds with it.<sup>136</sup> Confirmation can be a form of “unwitting”—or implicit—bias,<sup>137</sup> and thus can be particularly difficult to identify and counteract.<sup>138</sup>

## V. FACTUAL FINDINGS

### A. Sustainalytics Company History

#### 1. Overview of Company History

In 2009, Sustainalytics was born of a merger between a Dutch company of the same name and Toronto-based Jantzi Research, which was established in 1992 by former Sustainalytics CEO Michael Jantzi.<sup>139</sup> At the time, Triodos Bank, a Dutch bank that provided sustainable financial products, owned 40% of Sustainalytics; APG and PGGM—two Dutch pension funds—owned about 10% each, with Jantzi owning the remainder.<sup>140</sup>

Several years later, in 2015, Morningstar and Sustainalytics began a strategic partnership, through which Morningstar used Sustainalytics’ then-existing ESG Research Ratings product to launch Morningstar’s Sustainability Rating.<sup>141</sup> Not long thereafter, in 2017, Triodos Bank sought

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<sup>136</sup> See generally Richard Posner, *How Judges Think* 111 (2008); Raymond S. Nickerson, *Confirmation Bias: A Ubiquitous Phenomenon in Many Guises*, 2 Rev. Gen. Psychol. 175, 175 (1998) (describing confirmation bias as “unwitting selectivity in the acquisition and use of evidence”).

<sup>137</sup> Raymond S. Nickerson, *Confirmation Bias: A Ubiquitous Phenomenon in Many Guises*, 2 Rev. Gen. Psychol. 175 (1998).

<sup>138</sup> See Lee Ross, Mark R. Lepper & Michael Hubbard, *Perseverance in Self-Perception and Social Perception: Biased Attributional Processes in the Debriefing Paradigm*, 32 J. Personality & Soc. Psychol. 880, 880 (1975) (“Once formed, impressions are remarkably perseverant and unresponsive to new input, even when such input logically negates the original basis for the impressions.”).

<sup>139</sup> Sustainalytics, *About Us*, <https://www.sustainalytics.com/about-us#history>.

<sup>140</sup> Prior to the merger with Jantzi Research, Triodos Bank already had spun out its research team as an independent entity; that independent entity merged with Jantzi Research to create what is now known as Sustainalytics.

<sup>141</sup> News Release, *Morningstar and Sustainalytics Expand Their Sustainability Collaboration* (July 24, 2017), <https://newsroom.morningstar.com/newsroom/news-archive/press-release-details/2017/Morningstar-and-Sustainalytics-Expand-Their-Sustainability-Collaboration/default.aspx>. In 2018, Sustainalytics dismantled the then-existing ESG Research Ratings and created their current flagship ESG rating product, the ESG Risk Rating. The ESG Risk Rating has continued to be incorporated in Morningstar’s Sustainability Rating.

to sell its share of Sustainalytics—Morningstar acquired that share and became a 40% minority shareholder of Sustainalytics.<sup>142</sup>

In 2019, Sustainalytics acquired GES International, a Swedish firm that specialized in providing engagement services, investment screening, and fiduciary voting services to institutional investors.<sup>143</sup> Just over a year later, in April 2020, Morningstar announced that it was purchasing the remaining approximate 60% of Sustainalytics shares.<sup>144</sup> Morningstar completed its acquisition of Sustainalytics in July 2020.<sup>145</sup> Sustainalytics has seventeen offices world-wide; a large portion of its research teams are based in Canada and the Netherlands, but it has additional analysts, research managers, and methodology teams based in Germany, Sweden, Romania, Poland, and the United Kingdom, among other locations.

## 2. Processes for External Inquiries and Feedback

As part of this investigation, White & Case looked at the manner in which Sustainalytics has historically handled external inquiries and feedback, and the relevant processes currently in place. Sustainalytics has formal processes to handle inquiries and feedback from clients and issuers, but no such processes to handle such inquiries and feedback from third parties. According to witnesses interviewed, historically, nearly all such inquiries have come from clients and issuers, as Sustainalytics' research is not generally made available to the public-at-large, making third-party external inquiries rare.

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<sup>142</sup> News Release, *Morningstar and Sustainalytics Expand Their Sustainability Collaboration* (July 24, 2017), <https://newsroom.morningstar.com/newsroom/news-archive/press-release-details/2017/Morningstar-and-Sustainalytics-Expand-Their-Sustainability-Collaboration/default.aspx>.

<sup>143</sup> New Release, *Sustainalytics Acquires GES International* (Jan. 9, 2019), <https://www.sustainalytics.com/esg-news/news-details/2019/01/08/sustainalytics-acquires-ges-international>.

<sup>144</sup> New Release, *Morningstar to Acquire Sustainalytics and Expand Access to ESG Research, Data, and Analytics for Investors Worldwide* (Apr. 21, 2020), <https://newsroom.morningstar.com/newsroom/news-archive/press-release-details/2020/Morningstar-to-Acquire-Sustainalytics-and-Expand-Access-to-ESG-Research-Data-and-Analytics-for-Investors-Worldwide/default.aspx>.

<sup>145</sup> News Release, *Morningstar, Inc. Completes Acquisition of Sustainalytics* (July 6, 2020), <https://newsroom.morningstar.com/newsroom/news-archive/press-release-details/2020/Morningstar-Inc-Completes-Acquisition-of-Sustainalytics/default.aspx>.

Sustainalytics' client inquiries and feedback generally focus on processes, perspectives, or quality. Concerns range from requests for additional features in Sustainalytics products, to identification of research errors or omissions. Sustainalytics addresses complaints through a ticketing system that connects clients with account managers and product managers, who sometimes involve the researchers themselves to provide additional information (through the commercial teams). Sustainalytics has a separate Issuer Relations department to handle inquiries and feedback from issuers.

## B. Relevant Sustainalytics Products

White & Case identified several of Sustainalytics' products as most relevant to this investigation: (1) Controversies Research, (2) Global Standards Screening ("GSS"), (3) Global Standards Engagement ("GSE"),<sup>146</sup> and (4) the Human Rights Radar ("HRR"). As explained further below, Sustainalytics' ESG Risk Rating also is indirectly relevant, as an issuer's Controversy rating contributes to its ESG Risk Rating score. Of these products, the Controversies Research and ESG Risk Ratings methodologies are publicly available through Sustainalytics' website.<sup>147</sup> Information on the methodology and approach of the other products and services identified above are available to Sustainalytics clients. These products are methodologically split

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<sup>146</sup> In addition to GSE, Sustainalytics also offers several other engagement services within its suite of stewardship services, including Material Risk Engagement and Thematic Engagement. Material Risk Engagement links engagement directly to an issuer's ESG Risk Ratings score. Specifically, where a company is given a risk rating score of 32 or greater, it is deemed "high risk" and based on that rating, the company is engaged. Thematic Engagement looks to improve a group of companies on a particular theme or issue, such as climate change, water management, modern slavery and child labor. Thematic engagement identifies companies, including both industry leaders and those that have performed poorly in the particular identified area, and engages those companies in an effort to improve their management of the identified issue. In February 2022, Sustainalytics announced the launch of its "Engagement 360" offering, which "combines all of Sustainalytics' engagement programs in one bundle" available for clients through Sustainalytics' client-facing portal, Global Access. See News Release, *Morningstar Sustainalytics Launches Engagement 360 Solution for Investors* (Feb. 24, 2022), <https://www.sustainalytics.com/esg-news/news-details/2022/02/23/morningstar-sustainalytics-launches-engagement-360-solution-for-investors>.

<sup>147</sup> See *ESG Risk Rating Methodology*, Sustainalytics, [https://connect.sustainalytics.com/controversies-research-methodology?\\_ga=2.55991083.1214062825.1618239466-1283216333.1618239466&\\_gl=1\\*un8liy\\*\\_ga\\*ZTUwNDJjMWItNDk2Mi1lYzExLThmOGYtMDAwZDZhNjRkOWNk\\*\\_ga\\_C8VBPP9KWH\\*MTY1MTYwMDc5Mi4zMC4xLjE2NTE2MDA5MTguNjA](https://connect.sustainalytics.com/esg-risk-ratings-methodology?_gl=1*1cg3ryr*_ga*ZTUwNDJjMWItNDk2Mi1lYzExLThmOGYtMDAwZDZhNjRkOWNk*_ga_C8VBPP9KW H*MTY1MTYwMDc5Mi4zMC4wLjE2NTE2MDA3OTIuNjA; Controversies Research</a>, Sustainalytics, <a href=).



into two groups: ESG Risk Ratings and Controversy products are under the authority of the Methodology & Product Architecture team, while GSS, GSE, and HRR are under the umbrella of a completely separate governing system within the Research Products division.

The following summary of these products is based on the methodology and other internal product guidance documents provided to White & Case in connection with this investigation, as well as information supplied during interviews with Sustainalytics employees. Analysis of the potential bias in any of these products and services is only possible with a granular understanding of the products' methodology and a detailed appreciation for how the products interrelate.

#### 1. Controversies Research

Sustainalytics' Controversies Research assesses business risk, specifically a company's level of exposure in ESG-related incidents and events, and the adequacy of the company's management of these issues. Because involvement in controversies is partially indicative of an issuer's overall ESG performance and risk, it also factors into the ESG Risk Rating product (discussed in Section V(B)(5) below). The location of a company's operations is not a factor considered by the Controversies Research methodology, which as described further below, specifically looks at impact (the negative impact that the incident has caused to the environment and society), risk (the business risk to the company as a result of the incidents), and management (the rated issuer's management systems and response to incidents).

Sustainalytics employees explained that some clients with internal investment policies will use Controversy ratings above a certain ranking to screen their investment portfolios in order to comply with those internal policies. One Sustainalytics employee described the Controversies Research product as a tool to allow clients to distinguish so-called 'smoke from fire' when it comes to negative media attention related to human rights or environmental issues. Sustainalytics

research analysts are able to supply this information to clients because of their expertise in a variety of ESG-related topics (expertise which clients generally do not have internally).

a. Controversy Scoring and Analysis

The Controversy rating score is based on two factors that Sustainalytics refers to as “Incidents” and “Events,” respectively. Incidents are routine company practices that have unintended and/or undesired negative environmental and/or social impact (e.g., the use of child labor in factories) or a single, significant incident related to a company’s operations (e.g., a mine explosion). Events, on the other hand, refer to a series of isolated or related Incidents that pertain to the same ESG issues. For example, a series of employee strikes across different factory locations could collectively constitute an “Event.” These events are categorized into one of several “Event Indicators”—the employee strike example would be categorized under the “Labor Relations” Indicator.

The Incidents team monitors a constant flow of news day to day. Since 2015, Sustainalytics has used LexisNexis as an aggregator to cover approximately 70,000 sources, which is then filtered for the 20,000 companies within Sustainalytics’ coverage universe, ESG relevance, and negativity (searching for negative rather than positive news). Incidents focuses on industries, which are further divided into clusters. Multiple Sustainalytics employees noted the company’s ongoing effort to augment the LexisNexis news sources given the recent increased use of pay walls by media providers. Sustainalytics has compensated for the loss of sources by using Google, NGOs, and smaller media outlets. Sustainalytics also purchased access to the *Financial Times* in 2020, but has not subscribed to other lost news sources. Sustainalytics is currently having a broader conversation about building its own internal media monitoring system. Those discussions are in the early phases, as Sustainalytics is in the process of determining whether the system is capable of being built without interference of paywalls.

The Incidents team employs a system to rank sources based on credibility. NGOs, which the Incidents team recognizes as having a particular perspective, are generally given less weight than other sources. In addition, the Incidents team has a system to identify questionable sources and maintains a list on the Sustainalytics shared drive of tens of thousands of dubious sources. The list contains both a ‘blacklist’ of sources that researchers are not to rely on at all, and a ‘watchlist’ of sources, with which researchers are instructed to exercise caution. There is an annual presentation to the Incidents team regarding the blacklist and watchlist sources, and Incidents analysts are instructed about the list during the onboarding process. The Incidents team does not rate an incident unless it is substantiated by at least two sources. Sustainalytics provides internal guidance for the Incidents team in the form of general and industry specific documents.

Incidents are scored on a scale of 1 – 10 based on criteria designed to assess (1) sustainability impact (i.e., the negative impact of the activity on the environment or society) and (2) the reputational risk to the issuer.

- **Sustainability impact** is assessed based on: (i) the severity of the incident, (ii) the degree of accountability by the issuer, and (iii) degree of exceptionality of the incident (i.e., the degree to which the incident corresponds with patterns of corporate behavior in the relevant industry). Internal guidance exists to inform how analysts should consider and assess each of these factors.
- **Reputational risk** assesses the notoriety and exposure resulting from an incident. Notoriety measures how an incident has been covered by the media. Exposure considers the extent to which a company is exposed to further ESG-related risks through involvement in such incidents. Internal guidance exists to inform how analysts should consider and assess both of these factors.

With respect to reputational risk, the assessment narrative that accompanies a Controversy rating will make note of advocacy campaigns that have targeted a company in connection with a particular incident, or decisions by third parties to divest from the company in relation to that incident. Some Sustainalytics employees explained that this approach is taken not to adopt the

position advanced by the advocacy group or third-party investor, but rather to show external response related to the incident as an indicator of reputational risk.

Ordinarily, an incident factors into the Controversy rating for a period of three years, though long-running, high-impact incidents may continue to inform the Controversy score for more than three years in exceptional cases and are considered until the incident no longer poses a risk to the company.<sup>148</sup> The output from the Incidents team is not a client facing product, but rather is used as a basis for assessing Events, which feed into an issuer's Controversy rating. The Controversies Research team repackages and independently researches Incidents before the information is visible to clients through the Global Access platform.

To assess an Event, analysts look at the entire series of underlying Incidents and make an assessment based on:

- **Impact**, i.e., the negative impact that the incidents have caused to the environment and society,
- **Risk**, i.e., the business risk to the company as a result of the incidents, and
- **Management**, i.e., a company's management systems and response to incidents.

Events are scored on a scale of Category 1 to 5. Category 1 represents an event posing a low impact and posing negligible risks to the company, whereas Category 5 indicates an event with a severe impact and posing serious risks to the company.<sup>149</sup> These scores correspond to the Incident scores (i.e., an Incident score of 1 or 2 corresponds to a Category 1 event, 3 or 4 to a Category 2 event, and so on). An Event, or an aggregation of Events relating to an ESG topic, results in the

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<sup>148</sup> The Incidents team also tracks what is called an "incident chain," which consists of the initial incident plus any incident updates and news updates (i.e., subsequent information published about the incident which does not result in any change in impact and/or risk scores but is essential for reporting on the incident).

<sup>149</sup> Controversies Research Methodology at 2. The specific Category scale for events assessment is as follows: Category 1 (Low), Category 2 (Moderate), Category 3 (Significant), Category 4 (High), and Category 5 (Severe).

issuer's Controversy rating, as the highest Event rating under a controversy indicator automatically becomes the issuer's Controversy rating.

b. Controversies Research Standards of Review and Updates

Sustainalytics analysts review Controversy ratings on an ongoing basis. Sustainalytics has prepared some guidance documents to educate analysts on how to conduct research for the Controversies Research product. New Events with high impact or risk scores or new corporate developments may lead to a change in the Controversy rating. A significant rating change (i.e., an upgrade to or downgrade from Categories 4 or 5) is reviewed and approved by the four-member Events Oversight Committee before being implemented. Although Incidents provide the starting point for a Controversies Research, the research team does not just rely on the Incidents team's research. Instead, Controversies Research analysts conduct their own research, look to best practices in different industries, and work to establish a list of norms by industry.

Sustainalytics analysts carry out a full review of a company's Controversies Research at least every twelve months as part of the annual update to a company's ESG Risk Rating report.

2. Global Standards Screening

The Global Standards Screening ("GSS") product assesses a universe of approximately 20,000 companies<sup>150</sup> for their impact on societal stakeholders and/or the environment, and for the extent to which they cause, contribute to, or are associated with violations of international norms and standards. Specifically, GSS focuses on the international norms guiding corporate conduct, and provides Sustainalytics' opinion as to whether a company is violating, or is at risk of violating, a principle or principles of the United Nations Global Compact ("UNGC") in the areas of human rights, labor rights, the environment, and business ethics. In addition to the UNGC Principles,

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<sup>150</sup> Sustainalytics conducts a quarterly rebalance to identify new companies added to market exchanges and flag them for inclusion in their coverage database. A company is only ever removed if it ceases to exist, such as through acquisition or bankruptcy.

GSS considers other norms and standards, including the OECD Guidelines for Multinational Enterprises (“OECD Guidelines”), the UN Guiding Principles on Business and Human Rights (“UNGPs”), and their numerous underlying conventions and treaties.<sup>151</sup>

Sustainalytics employees explained that some clients have internal investment policies that may require divestment from issuers that partake in certain types of conduct, but also could mandate other actions, such as pausing future investments, or merely monitoring for future developments. Accordingly, Sustainalytics employees acknowledged that some clients may use GSS as a so-called ‘do not invest’ list in order to comply with such internal policies. One employee explained that Sustainalytics’ GSS ratings sometimes function as a de facto divestment list in the Netherlands—i.e., divestment lists published in the Dutch market almost perfectly mirror Sustainalytics’ rankings. Furthermore, some European clients, particularly in Scandinavia, are required by law to divest from companies under particular circumstances. Over the last decade, these sorts of internal investment policies have become common in the United States as well.<sup>152</sup> Notably, this investigation identified no information indicating that Sustainalytics was in any way involved in client decision making as to how they choose to use the GSS product.

a. GSS Analysis and Assessment Process

GSS ratings are determined using a multi-step process, starting with input from the Incidents team (as described above with respect to the Controversies Research product). As noted above, the Incidents team uses a news aggregator to monitor approximately 70,000 media sources

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<sup>151</sup> The specific list is available through Sustainalytics’ client-facing platform, Global Access. Several of these international legal norms are discussed further in this report in § V(C)(5) and Annex II.

<sup>152</sup> See *Global Sustainable Investment Review 2020*, Global Sustainable Investment Alliance (2020) at 10, 12, <http://www.gsi-alliance.org/wp-content/uploads/2021/08/GSIR-20201.pdf>. In particular, U.S.-based investors are increasingly divesting from fossil fuels. See Anne Barnard, *New York’s \$226 Billion Pension Fund Is Dropping Fossil Fuel Stocks*, The New York Times, <https://www.nytimes.com/2020/12/09/nyregion/new-york-pension-fossil-fuels.html>; *Full List*, Global Fossil Fuel Divestment Commitments Database, <https://divestmentdatabase.org/about/> (listing nearly 500 US organizations that have pled to divest from fossil fuels).

on a daily basis to identify incidents. The GSS team first reviews allegations identified by the Incidents team and then assesses the incidents against the GSS assessment criteria to determine whether in-depth research on a particular incident is required.

Second, if additional research is required, the GSS team conducts its own research through external, publicly available sources such as corporate disclosures, government reports, NGO publications, and reports by international and multilateral organizations. At this stage, the GSS team also employs additional insights generated through Sustainalytics' in-house research database, including research findings from other products like the Controversies Research product, Controversial Weapons Radar, or Human Rights Radar. With respect to making determinations based on international law, GSS analysts generally do not seek input from third parties, such as external legal experts, but instead make their own assessments based on decisions by international bodies like the International Court of Justice and the United Nations. For example, GSS's current draft internal guidance document on the Israeli/Palestinian conflict areas references the finding in the International Court of Justice's advisory opinion that the construction of settlements in the Israeli/Palestinian conflict areas violates international law. The same internal guidance document also references the UN Security Council's 2012 fact-finding mission to investigate the effect of the Israeli settlements on Palestinian people.

Third, if—through this additional research—the GSS team identifies information linking a company to a violation that satisfies the GSS methodology criteria, the GSS team prepares an assessment of the violation through the lens of what the GSS team views as the applicable international norms or standards. The analysts then make proposals to the GSS Research Managers regarding the reviewed company's GSS rating.

Fourth, during the research process, the reviewed company will typically be contacted for fact-finding purposes, giving the company an opportunity to explain its position or efforts to address the issue.

Finally, the GSS team will make a proposal regarding a company's GSS status to the Global Standards Oversight Committee ("GSOC"), a committee of approximately ten members, that meets on a weekly basis to consider analysts' proposals, review the sources used in their research, and scrutinize the process by which analysts arrived at their conclusions (including their assessments of the company's management of the issue). Such proposals may suggest changes to the GSS status of a currently rated company, or the assignment of a GSS status to a company for the first time. GSOC has, as a resource, managers and directors who check research content and sources used in the product reports to ensure reliability. The GSOC meetings are attended by of GSS Research Managers, GSS and Global Standards Engagement ("GSE") Product Managers (who attend GSOC meetings to present the GSE perspective), Sustainalytics' Director of Research Content and Leadership, a representative from the Events Oversight Committee (discussed above, in the context of the Controversies Research product), and other members of Sustainalytics' research leadership, including the Executive Director of Research Products, the Director of Engagement Services, and the Director of Product Strategy and Development. All researchers involved in the particular assessment being reviewed by GSOC attend committee meetings as well, though the analysts themselves do not have a vote in the committee's decision.

One Sustainalytics employee described GSOC meetings as long and robust with many people of diverse training and expertise offering their unique perspectives. Analysts recommending specific ratings decisions are called upon to defend their positions to the committee. GSOC decisions are taken seriously because the committee members and analysts



appreciate the consequences of their ratings decisions. GSS ratings decisions are put to majority vote, though employees have explained that consensus will generally be reached during GSOC meetings. If the proposal is approved by GSOC, a written report is drafted in accordance with the GSS guidelines.

Before Sustainalytics publishes a GSS status of Watchlist or Non-Compliant for a particular issue, an additional quality and editorial review is conducted on the report and the sources used. Multiple Sustainalytics employees stressed that consistency and impartiality in GSS statuses is achieved through multiple layers of review, the supervisory role of the GSOC, and by comparing assessments for a particular issuer or industry to previous determinations with similar circumstances.

In making an assessment to determine a company's GSS status, Sustainalytics analyzes the company on several dimensions in relation to the issue, including: (1) severity of impact, (2) company responsibility, and (3) company management. Each one of these factors is analyzed based on additional sub-factors.

- **Severity of Impact** examines: (i) scale of impact (the gravity of the impact and the number of people affected), (ii) scope (the frequency and consequences of the impact), and (iii) "irremediability" (the level of difficulty of restoring the circumstances of those impacted and/or the environment to the prior state). In assessing these components, Sustainalytics looks at relevant norms for a company, as well as expectations for companies operating in an industry. The severity of impact is then determined to be Low, Medium, or High. Relevant figures or numbers on impact, such as the number of people affected, are assessed on a case-by-case basis using prior GSS assessments for guidance (i.e., the "case law" process). There are no fixed thresholds or quantitative rules applied.
- **Company Responsibility** looks at how closely a company is linked to the negative impacts based on: (i) accountability (whether a company has directly or indirectly, knowingly or unknowingly, caused or contributed to the negative impacts through its operations, products, or services), (ii) the systemic nature of the issue (whether a company is responsible due to systematic or systemic violations), and where applicable, (iii) the exceptionality of the issue (the degree to which the issue stands out, relative to relevant industry standards and peers). Other factors, such as the level of a company's

negligence, any recurrence of similar issues involving the same company, and the duration of an issue (how long a company's management should have been aware of the issue) also may be considered in the context of Company Responsibility.

- **Company Management** looks at whether a company is willing and able to address an issue in an appropriate manner, specifically: (i) the quality of the company response in terms of the remedial steps taken and the company's transparency in disclosing relevant information, (ii) the company's management systems (policies and programs for the relevant issue, or lack thereof), and (iii) how effective the company's implementation of those management systems is at preventing a recurrence of the issue. The Company Management factors are primarily assessed based on publicly available information. Company Management is assessed based on whether the GSS team has a Low, Moderate, or High level of confidence in the company's ability to prevent a reoccurrence.

GSS has developed and is continuing to develop subject-specific internal guidelines for research analysts, which instruct researchers and analysts how to assess the severity and exceptionality of particular circumstances and specific types of issuer conduct. This includes guidance on issuers operating in specific geographic regions—including Xinjiang, Myanmar, and the Israeli/Palestinian conflict areas—as well as subject-matter specific guidance on issues like bribery and corruption, human rights implications in supply chains, accounting and taxation, and state-owned enterprises. When there is no internal guidance on a specific issue, GSS researchers consult prior GSS assessments and seek to analogize the situation to similar incidents. Sustainalytics' Director of Product Strategy and Development has proposed a project in which analysts review previous, similar ratings for comparable companies to ensure ratings consistency.

#### b. GSS Status Scoring

A company's GSS status is categorized as either Compliant, Watchlist, or Non-Compliant:

- **Compliant** means that a company has not been found to be causing, contributing to, or at risk of causing or contributing to, severe or systemic and/or systematic violations of international norms and standards. If allegations against an issuer are assessed as Compliant, this means that the alleged issues have been found to not meet the assessment criteria for Watchlist or Non-Compliant status, or do not otherwise meet the requirements of GSS's methodology for Watchlist or Non-Compliant status. However, a Compliant status in GSS does not necessarily mean that a company is in full compliance with all international norms.

- **Watchlist** means that a company has been found to be at risk of contributing to severe or systemic and/or systematic violations of international norms and standards. An issuer is assessed as Watchlist when it is determined to be causing or contributing to severe negative impacts (harm) to stakeholders and/or the environment, but for which not all requirements for a Non-Compliant status could be established. Issuers may also be assessed as Watchlist where the GSS team concludes the issuer is accountable for negative impacts, but there is insufficient information to determine that the company is violating international norms, or where the issuer is linked to a violation of international norms, but the negative impacts are not severe enough to warrant a Non-Compliant status, or the negative impacts are still remediable. Importantly, issuers previously assessed as Non-Compliant may be upgraded to Watchlist status in GSS where it is demonstrated that the issuer is improving its policies and programs to prevent a reoccurrence, but further monitoring is still required, due to pending resolutions or remediation efforts by the issuer.
- **Non-Compliant** means that an issuer has been determined to be causing or contributing to severe systemic and/or systematic violations of international norms (i.e., the company is not acting in accordance with the principles and their associated standards, conventions, and treaties, according to the GSS framework). Companies can be found to be Non-Compliant because they are directly associated with issues causing severe, irreversible impacts that affect stakeholders, the environment, and/or impose a clear cost on society, or because they have an inadequate response to address or remediate such issues. GSS also assesses companies that facilitate third-party human rights violations as Non-Compliant, such as companies involved in the production of landmines, cluster munitions, biological/chemical weapons, and nuclear weapons (outside of the five designated nuclear states).

c. GSS Standards of Review and Updates

Although issuer monitoring is ongoing, Sustainalytics publishes assessment changes in a GSS report on a quarterly basis. The GSS team reviews relevant companies for updates and new developments during this cycle. Each quarter, the GSS team also screens for new incidents and conducts a review of corporate relationships within the universe of issuers covered by GSS.

If GSS researchers conclude that an issuer meets the upgrade criteria, an assessment change to the issuer's status can be proposed for consideration at the weekly GSOC meeting described above. Upgrades are usually based on changes in a variety of factors that indicate a decreased risk of recurrence, including: progress toward remediating the negative impacts caused by the issuer's

activity, new publicly disclosed policies and processes aimed at preventing a recurrence, and lack of new negative developments regarding the issue.

There are two criteria for upgrading a company from Non-Compliant to Watchlist or from Watchlist to Compliant: (1) the violation has ceased; and (2) the company has adopted a responsible course of action. These criteria are defined when the GSS assessment status is initially assigned, and is monitored on a quarterly basis. Issuers are reevaluated against the upgrade criteria on a quarterly basis. If both of these upgrade criteria are fully met, the GSS team may propose that the issuer's status be upgraded to Compliant. If the criteria have been partially fulfilled, the issuer could be upgraded from Non-Compliant to Watchlist. In addition, GSS also may upgrade an issuer from Watchlist to Compliant even in the absence of demonstrated management improvements, where a lack of new incidents over an extended period of time serves as a proxy for the cessation of the violation and prevention of a recurrence. All upgrade decisions are made on a case-by-case basis, and all issuer assessment status changes must be agreed to by the GSOC.

### 3. Global Standards Engagement

Global Standards Engagement ("GSE") is designed to work with companies that are assessed as Watchlist or Non-Compliant by GSS. Importantly, GSE's engagements are based on an internal analysis, in consideration of an issuer's GSS status and a determination of the projected efficacy of engagement—the companies identified for engagement are not based on any external databases or company listings. As described above, GSS seeks to provide an assessment of an issuer's impact on relevant stakeholders and the extent to which an issuer causes, contributes to, or is linked to violations of international norms and standards (based on the UNGC principles). By contrast, GSE works to identify how an issuer addresses the incident that resulted in the GSS Watchlist/Non-Compliant status, and, by corresponding directly with the issuer, attempts to help effectuate change in the issuer's corporate policies and/or processes in order to ensure that the

issuer has systems in place to avoid future reoccurrences and improve its ESG practices. An engagement manager at Sustainalytics explained that the engagement process is intended to assist companies with meeting the ESG standards the companies have set for themselves, either by subscribing to those standards on their website or in public filings, by signing UN and OECD compacts, or by being listed on the New York Stock Exchange or other exchanges that require adherence to certain standards.

In 2019, Sustainalytics acquired a company called GES International. Prior to that acquisition, both companies had international norms-based screening products like GSS, though their respective thresholds and methodologies differed. Before the acquisition of GES, Sustainalytics had no engagement services.<sup>153</sup> Following Sustainalytics' acquisition of GES, changes to both the existing international norms screening products and GES's engagement methodologies were made in order to harmonize the newly merged products. Overall, where there were differences between GES and Sustainalytics methodologies and approaches, it was generally the Sustainalytics' product that was adopted, and GES's existing screening and engagement services were adapted into the newly aligned model.

As mentioned above, Sustainalytics also offers additional engagement services, aside from Global Standards Engagement: Material Risk Engagement and Thematic Engagement. Material Risk Engagement focuses on what Sustainalytics identifies as high-risk companies with the greatest levels of unmanaged ESG risks, specifically companies with ESG Risk Ratings scores of 32 and higher that are among the worst performing half of companies within their industry. Thematic Engagement involves engagement on specific ESG topics, with each topical engagement involving about twenty issuers. Selection of issuers for Thematic Engagement is based on the

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<sup>153</sup> News Release, *Sustainalytics Acquires GES International*, Sustainalytics (Jan. 9, 2019), <https://www.sustainalytics.com/esg-news/news-details/2019/01/08/sustainalytics-acquires-ges-international>.

sector(s) that are specifically implicated or fundamental for developments in the engagement theme.<sup>154</sup> In February 2022, Sustainalytics announced the launch of the “Engagement 360” offering, which compiles all three engagement programs into a single dashboard that is available for clients through Sustainalytics’ client-facing platform, Global Access.<sup>155</sup>

The unique nature of the GSE product makes it hard to generalize client use cases. Although the universe of engagement targets is defined by Sustainalytics’ methodology for the GSS product, the nature of the engagements is driven by the investor-client concerns. In general, use cases are regional and the types of ESG issues clients care about varies dramatically between corporate nationalities. Because of this, as one Sustainalytics employee stated, engagement managers are instructed to remain agnostic as to specific political issues and types of rated conduct. Instead, the focus is on addressing the underlying issues that are creating potential risks for the issuer.

a. Engagement Process and Procedures

GSE follows a four-step process engagement process. First, once a company has been identified by the GSS team as Watchlist or Non-Compliant, the case automatically goes to the GSE team to open the engagement process, at which point the GSE team reviews the company’s current ESG practices as they relate to the reason for the engagement. The GSE team focuses primarily on the company’s response to the findings of the GSS screening analysis, including any indication

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<sup>154</sup> Current Thematic Engagement topics are: child labor in the cocoa supply chain; climate change and the global forest systems; sustainability in food production; workforce composition; localized water management; modern slavery; responsible cleantech; corporate governance and sustainable development goals; and board-level governance in the extractives, financial and pharmaceutical sectors. See *Sustainalytics Global Access – Thematic Engagement*, Sustainalytics, <https://globalaccess.sustainalytics.com/#/research/engagement/thematic>.

<sup>155</sup> See News Release, *Morningstar Sustainalytics Launches Engagement 360 Solution for Investors*, Sustainalytics (Feb. 24, 2022), <https://www.sustainalytics.com/esg-news/news-details/2022/02/23/morningstar-sustainalytics-launches-engagement-360-solution-for-investors>. In addition, Sustainalytics is in the midst of expanding and diversifying its other stewardship offerings. For example, Sustainalytics has invested in its ESG Voting Policy Overlay, a product that advises investor-clients on how to conduct proxy voting in order to achieve the client’s particular ESG vision, including how to vote on corporate management proposals and shareholder resolutions based on Sustainalytics’ ESG research.

that improved corporate policies and procedures could remedy the situation that resulted in the company's GSS status of Watchlist or Non-Compliant. Notably, at least two members of the GSE team interviewed by White & Case suggested that the GSE team relies on the research conducted by GSS, and does not conduct its own research. Only issuers that are screened by GSS as "Non-Compliant" with international norms or considered by GSS to be at risk of violating them ("Watchlist") are candidates for GSE engagement. When a company is being researched by GSS and a proposal to classify that company as Watchlist or Non-Compliant is likely, GSE is notified so that they can conduct a simultaneous review of the company, in order to determine whether engagement is appropriate.

In conducting their initial assessment, engagement managers often will consult with NGOs and local organizations in order to better understand the context of the incident that gave rise to the potential engagement. It is extremely rare for the engagement team to consult with local governments. The GSE team generally does not consult with outside experts on legal issues. A proposal, drafted by one of the engagement managers from GSE, is then submitted to GSOC for a majority vote on whether or not to engage with the company. This is a distinct proposal from the GSS assessment that first identified the issuer as Watchlist or Non-Compliant. However, the GSS and GSE proposals are submitted for GSOC review at the same meeting, and representatives from both products attend the meeting, in order to discuss both the rating (under GSS) and the potential for engagement (by GSE).

Next, the GSE team defines goals for the engagement (the "change objectives"). Change objectives identify what the issuer should do to discontinue the violation, what the issuer can do to address the immediate impacts of the violation, and what the issuer can do to prevent a recurrence. Change objectives are intended to be relevant to the incident that resulted in the

Watchlist/Non-Compliant GSS status, but also feasible for the company to achieve. The change objectives are accessible to Sustainalytics' GSE clients through Global Access and are included in GSE's quarterly reports discussed further below. Members of the GSE team explained to White & Case that the change objectives are not designed to make major changes to issuers' business models, especially where those changes would threaten the company's bottom line. Rather, the intention is to show issuers the unintended, downstream ESG consequences of certain business decisions and to empower them to be more conscious about those decisions.

The GSE team then develops a strategy to direct the course of the engagement and to measure the issuer's progress toward achieving the engagement goals. The engagement strategy includes milestones towards achieving the engagement goals, and a projected timeline. Both the issuer's response to the engagement (i.e., its willingness to listen to investor concerns) and the issuer's progress, are measured on a five-point scale: none, poor, standard, good and excellent.

Finally, Sustainalytics' clients receive real-time updates on issuer progress towards the change objectives and next steps in the engagement. These updates are available to GSE clients in Global Access, which also provides client access to every piece of correspondence between the GSE team and the engaged company, as well as minutes of every meeting and phone call with the company. During the engagement process, there normally are two conference calls per year with the engaged issuer. Clients are invited to join those meetings when possible, but are not permitted to attend if the engaged issuer objects. As needed, the two annual meetings are complemented or substituted by letter and email correspondence and/or in-person meetings.

Where an engaged company does not respond to GSE's communications, or indicates that it is unwilling to participate in the engagement, GSE managers are instructed to encourage the companies to cooperate. Employees working in GSE indicated that the methods by which they



may choose to encourage companies to cooperate are left largely to the discretion of the GSE managers, but one GSE manager stated that it is typical to send letters, co-signed by investors, to the companies, in order to encourage participation in the engagement.

GSE engagement managers are responsible for approximately thirty cases at any given time, and oversee teams of around eight or nine GSE employees. One Sustainalytics employee is in charge of assigning cases to the GSE engagement managers, which is generally done according to the engagement managers' areas of expertise. There is, for example, an engagement manager who specializes in human rights issues and who is assigned all of those cases, including all cases related to the Israeli/Palestinian conflict areas. GSE engagement managers meet informally once a week to discuss the engagement cases. Some GSE engagement managers expressed the view that these open discussions are extremely valuable and enable engagement managers to challenge their beliefs, identify their own unconscious biases about particular issues, and get the perspectives of other engagement managers. GSS analysts and members of the GSE team can share information on important case developments or proposed status changes in connection with a particular issue. However, GSE will not share issuer information learned through engagement with GSS if the issuer designates it as confidential, and such information will only be available to GSE.

Like GSS, all formal GSE status changes are proposed and approved through GSOC at the weekly GSOC committee meetings. However, GSS and GSE differ in the ratings upgrade and downgrade processes. For GSS, as discussed above, in order to upgrade an issuer's status between the Non-Compliant, Watchlist, and Compliant ratings, it is necessary that the issuer make public improvements.<sup>156</sup> By contrast, GSE does not require public action to change an issuer's engagement status, but instead, relies on changes in the issuer's internal procedures. For that

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<sup>156</sup> See *supra* § V(B)(2).

reason, a Sustainalytics employee explained that GSE statuses can change faster than those in GSS, and an issuer can have different GSE and GSS statuses. Furthermore, unlike GSS—which requires publicly available information on the implementation of remedies—GSE also may use a company’s informal statements, provided via email or during conference calls, to assess whether the company is at an advanced level of strategy implementation.

b. Engagement Status

GSE has five possible engagement statuses for engagement: evaluate, engage, disengage, resolved, and archived.

- **Evaluate** status indicates a case with potential systematic incidents or an isolated incident that has severe consequences in relation to the environment or humans, which is presently being verified. Assessing the severity and issuer responsibility takes between three and six months, during which time Sustainalytics contacts the issuer and conducts additional research regarding the company’s responses to the incident and preparedness to address the problem.
- **Engage** status indicates that the issuer has been identified as a case with systematic incidents or an isolated incident that has severe consequences in relation to the environment or society, and the engagement process is underway.
- **Disengage** status signals that there has been poor or no progress on an engagement, and/or poor or no response from the issuer within two years after the start of the engagement. Notably, companies whose business models rely on activities that would not result in productive engagement on those topics are generally listed as disengaged status (for example, state-owned enterprises or companies involved in controversial weapons industries). GSE clients are informed about a decision to disengage, and the rationale for doing so, through the quarterly reporting discussed below. Following disengagement, GSE will still monitor the issuer and will contact them biannually to see if they would be willing to reinitiate dialogue. Positive responses from a company may lead to restarting engagement.
- **Resolved** status means that an issuer’s change objective has been met and that the engagement has concluded.
- **Archived** means that a case has been retired without the need for further engagement.<sup>157</sup>

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<sup>157</sup> After Sustainalytics acquired GES in 2019, several existing GES engagements were archived because the criteria and thresholds used by the screening product changed, and thus those prior GES engagements no longer constituted Watchlist or Non-Compliant under the new GSS methodology.

### c. GSE Deliverables and Updates

GSE reporting delivery coincides with the GSS reporting schedule. GSS and GSE reporting is done quarterly, and is published on the last Friday of February, May, August, and November for GSS, and a working day after for GSE (the following Monday). The GSE quarterly reporting includes a Quarterly Engagement Report that summarizing all updates to cases that occurred during that quarter, and an Offline Excel Report, which is sent to clients (through the client relations team) and includes an overview of all cases and changes marked as new.

An annual engagement report, published every January, provides a summary of GSE activities for the prior year and engagement developments, including engagement statistics and progress on milestones. The annual GSE report also provides a short summary of what happened in the engagement cases during the year, including case statuses as of the preceding December for all engaged cases in that reporting year, and all resolved/archived cases that were previously engaged that year.

As noted above, the history of each engagement and all instances of issuer contact are documented on the GSE section of Global Access, which is updated in real time.

### 4. Human Rights Radar

The Human Rights Radar (“HRR”) seeks to provide information on issuers that are involved in regions of the world where serious human rights violations are allegedly taking place. This includes conflict-affected countries, disputed territories and authoritarian states.

Underlying the HRR is the assumption that issuers operating in what may be considered high-risk countries and disputed territories could face increased legal, regulatory, reputational and financial risks. Through the HRR product, investors can identify and manage exposure to such risks based on information regarding corporate activities in high-risk countries and disputed

territories, as well as information on issuer management of their actual and potential human rights impacts.

Sustainalytics employees familiar with the creation of this product explained that the HRR grew out of bespoke research that Sustainalytics performed prior to 2018. Specifically, a faith-based pension fund and Sustainalytics client commissioned bespoke research into a range of high-risk countries and regions. This client previously had attracted media attention in 2016 for its decision to divest from Israeli banks for their involvement in the Israeli/Palestinian conflict areas. This client drove the methods, set the scope, and identified the targets for this research. An earlier version of HRR specifically stated that it was developed in collaboration with the client. By 2018, Sustainalytics had produced customized reports on various high-risk countries and regions for several different clients, and decided to compile this research into a single product that could be available to all clients. To transform the existing research into a new product, Sustainalytics developed a methodology around the existing HRR research so that it could market the HRR as a stand-alone offering.

One Sustainalytics employee working on HRR stated that they knew, based on discussions with clients, that some clients used HRR to decide whether to divest from or exclude companies from their investment universe. On the other hand, another employee who had previously worked on HRR stated that they did not think clients used HRR to divest from certain companies. The same employee also explained that HRR existed at the time of Sustainalytics' merger with GES, and that post-merger, HRR served an important function when former GES clients complained because certain issuers that previously had been covered by GES's old international norms screening product were now being rated as "Compliant" under the new GSS methodology. According to this employee, Sustainalytics referred those clients to the HRR product because HRR

had lower severity thresholds for issuer conduct than GSS did, and still rated and discussed certain companies that GSS screened as “Compliant.”

Unlike Sustainalytics’ other products, HRR is not currently available on Global Access but is instead delivered directly to clients through a native file on a quarterly basis. HRR is generally sold to clients as a standalone product, but also can be sold in conjunction with other Sustainalytics products. The HRR research team recently increased from four to ten employees, though members of the HRR team observed that HRR still does not have sufficient resources. The HRR product’s methodology is set forth in four documents: a methodology document, a process map, a description of standard operating procedures, and an analyst guidance document.

Multiple Sustainalytics employees remarked on issues faced by the HRR team due to limited resources. For example, the HRR team intended to develop a guidance document to update HRR methodology based on developments in the Israeli/Palestinian conflict areas, but this has not yet happened due to resource constraints. Similarly, the HRR team intended to generate a list of inappropriate research sources, but this resource likewise has not materialized. One employee familiar with the origins of HRR explained that when the product was created, there was no formalized review process, no written methodology, and no analyst guidance similar to what is provided to the GSS and Controversies Research teams. This employee also explained that the underlying issue with HRR was that there were too many deliverables and too few staff.

a. HRR Research Process

The entire HRR product is updated annually, while a quarterly publication addresses recent news and developments. The annual update process has five steps. First, the countries and disputed territories covered by HRR are identified based on the Freedom House annual “Freedom in the World Report.” According to the HRR’s methodology, the product is intended to cover the countries that have the worst aggregated score for political and civil rights in the Freedom House

report, as well as the five lowest-scoring disputed territories in Freedom House’s report. However, of those disputed territories, HRR currently covers only the “Tibet Autonomous Region, Non Self-Governing Territory of Western Sahara, and OPT.”<sup>158</sup>

Both the HRR product brochure—which is publicly available through Sustainalytics’ website—and Sustainalytics’ HRR methodology document, contain the following disclaimer: “the choice of territories is based on client demand. Sustainalytics does not take a position on the definition or politics of disputed territories.”<sup>159</sup> Sustainalytics employees working on HRR explained that when HRR was forced by resource constraints to deviate from its methodology and cover a smaller universe of high-risk territories, the decision of which territories to cover was driven by commercial considerations (i.e., Sustainalytics covered the countries where Sustainalytics believed that their clients were most likely to have more exposure—such as China—and omitted countries where clients were less likely to have investments—such as Tajikistan). Although it is rare to add high-risk locations to HRR’s coverage, that did occur when, based on client interest, Myanmar was added to HRR’s coverage following the February 2021 military coup. Multiple Sustainalytics employees, however, stated that although clients have periodically requested additional country and territory coverage in HRR, those requests are rarely honored.

Once the scope of covered territories has been defined, HRR analysts identify the specific sectors with the highest risk for human rights violations in the covered areas. Criteria used to determine those high-risk sectors include: the strategic importance of a sector to human rights

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<sup>158</sup> Sustainalytics’ website identifies the covered countries as Central African Republic, China, Equatorial Guinea, Eritrea, Libya, Myanmar, North Korea, Saudi Arabia, Somalia, South Sudan, Sudan, Syria, Turkmenistan and Uzbekistan, and the covered disputed territories as “Palestine, Western Sahara and Tibet.” See *Sustainalytics’ Human Rights Radar*, Sustainalytics <https://www.sustainalytics.com/investor-solutions/esg-research/esg-screening/human-rights>. To note, Freedom House report covers the Gaza Strip and the West Bank as separate disputed territories, however a Sustainalytics employee explained that the two were combined into a single classification (the “Occupied Palestinian Territories”) for HRR due to resource constraints. See *West Bank*, Freedom House <https://freedomhouse.org/country/west-bank/freedom-world/2022>; *Gaza Strip*, Freedom House <https://freedomhouse.org/country/gaza-strip>.

<sup>159</sup> *Human Rights Radar*, Sustainalytics, <https://www.sustainalytics.com/investor-solutions/esg-research/esg-screening/human-rights>.

violators, such as authoritarian regimes or rebel groups (for example, the energy and telecommunication sectors); structural links of a sector to human rights abuses (such as aerospace and defense); the type of human rights abuses taking place in a country or territory; and how corporate activity can be linked to those abuses. The assessment is based on Sustainalytics' research, as well as relevant sector and country reports by international organizations and NGOs. The high-risk sectors are then used as a basis for identifying the specific companies that will be covered in HRR. HRR's methodology identifies five high-risk sectors identified for the "Occupied Palestinian Territories": industrials, materials, telecommunication services, financials, and consumer goods.<sup>160</sup> The number of high-risk sectors identified for the other countries and territories covered by HRR range between two and four per territory/country.

Next, HRR analysts identify and assess company involvement for issuers operating in the covered high-risk countries and territories within the past three years. Analysts write assessments for issuers they determine are at risk of being involved in human rights violations based on the issuer's activities in high-risk sectors in high-risk countries/territories. HRR considers issuers "involved" if they have operations, provide services, or have business relationships in a high-risk country/disputed territory, provided that those activities can be linked to an adverse human rights impact.

Subsequently, the HRR team reviews how the identified issuer manages its potential or actual impact on human rights according to the UN Guiding Principles on Business and Human Rights. In making this assessment, analysts take into account corporate documents, as well as other relevant publicly available information. HRR analysts do not directly contact issuers for

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<sup>160</sup> Of the other disputed territories assessed by HRR, the applicable high-risk sectors for Tibet are materials, industrials (transportation), and telecommunication services. For Western Sahara, the applicable high-risk sectors are energy, materials, and industrials (aerospace & defense).

feedback in the scope of the HRR, but may include any relevant issuer feedback received through engagement with those companies by other Sustainalytics teams.

Finally, HRR analysts make an assessment of an issuer's overall complicity in human rights violations based on the applicable high-risk sector, as well as the nature and impact of the issuer's involvement and the level of company management. Issuers are categorized as being at Severe, High, Medium, or Low Risk for complicity in human rights violations within the high-risk country or territory in which the company operates. Numerical scores are assigned to each factor, and the sum of those figures determines the risk category for that country or territory. Sustainalytics employees working on HRR clarified that the term "complicity" is used somewhat colloquially, as criminality is not a factor in the HRR analysis and the use of the term "complicity" is not intended to denote a legal or criminal conclusion. The HRR methodology document states that "[c]ompanies are considered complicit in human rights abuses, if they are implicated in human rights violations conducted by a third party, such as a government, a non-governmental group, a company or an individual."

Currently, HRR does not have a formalized, committee-driven review process of analysts' assessments (like that of the GSS and Controversies Research products), though HRR product and research managers do review of analysts' assessments. However, Sustainalytics employees explained that they are in the process of finalizing the Terms of Reference for a formal HRR Oversight Committee and are developing documentation around a formal review process for HRR. This is an effort to formalize assessment changes for HRR, similar to the role of the GSOC and Events Oversight Committees, and to keep other product lines informed of assessment changes. As compared to some of Sustainalytics' other products, Sustainalytics employees acknowledged that companies could be rated differently in GSS and HRR because the two products have different



severity thresholds and purposes. Although there is some cross-checking of HRR against other Sustainalytics products, that process is informal and unstructured.

b. HRR Analysis of Issuer Involvement

In evaluating an issuer's involvement in activities effecting human rights, the HRR team looks at the nature of the issuer's activity and the impact of that activity in the covered territory/country.

The nature of involvement is largely determined by assessing the issuer's activities for three factors: (1) the proximity of the issuer and/or its services to a repressive human rights regime, such as through special commercial relationships, business relationships with state-owned companies, or research and development partnerships; (2) the extent to which the issuer's products or services can be adapted for use in human rights violations; and (3) evidence of the direct impact of the issuer's operations on human rights.

The impact of involvement is assessed based on four categories:

- **Enforcing** – The issuer is directly involved in or increases the human rights violations through the issuer's operations, services, or products.
- **Expanding** – The issuer's products/operations contribute, directly or indirectly, to the abuse of human rights by creating a benefit for those in power who perpetrate such abuses, or by significantly supporting the perpetrator in maintaining or expanding the human rights abuse.
- **Facilitating** – The issuer's products/operations do create benefits for those in power or support the perpetrator of the human rights abuse in some way that allows for the continuation of the human rights violations.
- **Normalizing** – The issuer's products/operations do not substantially contribute to the human rights conflict, but the products/operations do legitimize the adverse human rights impact (for example, companies operating a factory or retail operation in a high-risk country).

The impact involvement categories each carry a numerical score which then factors into the overall risk assessment discussed below.

c. HRR Analysis of Company Management

In addition to assessing the impact an issuer's activities have on human rights in the covered high-risk territory/country, the HRR team evaluates the company's human rights management, based on the UN Guiding Principles on Business and Human Rights ("UNGPs") as best practice. The company management assessment rates two indicators—the company's human rights policy and company response—on a scale of strong, adequate, and weak.

The HRR team's assessment of an issuer's human rights policy corresponds to specific UNGP requirements. In particular, HRR looks at whether an issuer has committed itself to avoid complicity in human rights abuses by third parties, and to go beyond national legislation where the rule of law is lacking and/or falls short of best practice as defined by the relevant UNGP. HRR's assessment of the issuer's human rights policy also considers any evidence of a sector specific, high-risk approach, such as a freedom of expression policy at a telecommunication company.

With respect to company response, the HRR team reviews whether and how the company (1) acknowledges the relevant issue, (2) conducts human rights due diligence, (3) investigates incidents of human rights abuses, and (4) provides a remedy for victims, such as through a public grievance mechanism. A strong, adequate, or weak company response each translates into a different fixed numerical score that factors into the overall risk assessment discussed below.

d. HRR Risk Assessment

The HRR risk assessment seeks to categorize an issuer's overall risk of being involved in human rights violations in high-risk countries, which is calculated by a scoring algorithm. Higher scores indicate more severe risks of being complicit in human rights violations. The overall HRR risk assessment is determined by the sum of the impact assessment and company response for all of the high-risk countries/territories in which an issuer operates. Overall impact and company

response are also calculated numerically across all of the high-risk countries/territories in which an issuer operates.

## 5. ESG Risk Ratings

The ESG Risk Rating is Sustainalytics' flagship product, and is designed to help investors identify and understand financially material ESG-related risks within their investment portfolios and how those risks may affect issuer performance. The ESG Risk Ratings team is broken up by sector and industry, rather than by geography. Analysts for the ESG Risk Rating focus on the financial materiality and impact of the risks they are analyzing in the short, medium, and long term, in order to determine the likelihood and extent of the financial impact of certain circumstances and events and to reflect that information in the analysis and rating of each company.

An issue is considered to be material within the ESG Risk Rating if its presence or absence in financial reporting is likely to influence the decisions made by a reasonable investor. The assessment of materiality is designed to reflect both the extent to which a company is exposed to material ESG risks and how well the company is managing its exposure. The ESG Risk Rating coverage universes (the "Ratings" and "Ratings Plus" universes) include more than 12,000 companies and cover companies listed on most major global indices.

### a. ESG Ratings Analysis and Scoring

The ESG Risk Rating seeks to measure the magnitude of a company's unmanaged ESG risks. A company's ESG Risk Rating consists of both a quantitative score and a corresponding risk category.

The quantitative score represents units of unmanaged ESG risk on an open-ended scale starting at zero (no risk). Based on their quantitative scores, companies are grouped into one of five risk categories (negligible, low, medium, high, severe). These risk categories are intended to

reflect a comparable degree of unmanaged ESG risk across all subindustries covered by the risk ratings, thus allowing companies to be compared to one another based on ESG risk across industries (for example, comparing a bank with an oil company).

The ESG Risk Rating also accounts for companies' levels of involvement in controversial events that have an impact on the environment or on society, as such involvement may indicate that a company's management systems are not adequate to manage the relevant ESG risks. Each event is categorized from Category 1 (low impact on environment and society, posing negligible risk to the company) to Category 5 (severe impact on the environment and society, posing serious risk to the company). There is overlap between the controversy events that factor into the ESG Risk Rating, and the Controversies Research product discussed above, in Section V(B)(1). The ESG Risk Ratings reports do not directly contain commentary related to controversies, but instead, incorporate the Controversies Research reports as appendices. As noted above, some Controversies Research reports mention advocacy campaigns as an indication of potential reputational risk.

Because Controversies Research is one input that factors into a company's overall ESG Risk Rating, a Controversy rating that accounts for advocacy campaigns as part of an issuer's reputational risk does have the ability to elevate a company's ESG Risk Rating, but that impact is both indirect and limited. In addition, another component of a company's overall ESG Risk Rating is the Country Risk Rating, which accounts for sovereign wealth, educational attainment, and other factors.<sup>161</sup> Notably, Israel has an overall "Low Risk" Country Risk Rating.

Importantly, the ESG Risk Rating is a beta-driven approach; this means that it relies on a regressive statistical model to test the predictive power of its indicator inputs, both individually

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<sup>161</sup> The Country Risk Rating is designed to measure the risk to a country's long-term prosperity and economic development by assessing how sustainably the state manages its wealth.

and in aggregate. Indicators are only included in the model if they have true predictive power—otherwise they are revised or eliminated. Furthermore, each indicator has a dynamic weight that determines its contribution to the final risk score. Sustainalytics employees acknowledged that these indicators sometimes involve normative judgments; for example, collective bargaining (union) agreements can improve a company’s management score, while their absence decreases it. However, the impact of these normative judgments is mitigated by the weight associated with them, which is adjusted to provide the strongest predictive power as to a company’s risk from and management of any given issue.

b. Standards of Review and Updates

The underlying research for the ESG Risk Rating is generally updated on an annual basis. Every year, Sustainalytics reviews the subindustry-specific exposure assessments. The purpose of these assessments, which are independent of individual companies’ assessments, is to validate the selection of material ESG issues for each subindustry. Clients are given advanced notice of upcoming structural changes, like the addition of new data points.

At the company level, the ESG Risk Rating for all companies covered by Sustainalytics are updated annually, as well. The main area of focus for the research analysts is the company’s annual financial disclosures. Researchers on the Standard Ratings Team also review all public disclosures that have been filed since the last update, along with any news items about the company, NGO reports, and the company’s annual sustainability report, where available. If a company does not publish a sustainability report, researchers will consult public documents related to the company to see whether the company has made sustainability related commitments. As a part of the annual update of an issuer’s ESG Risk Ratings report, existing event (controversy) assessments are either confirmed or adjusted. The annual ESG Risk Ratings update involves

several layers of peer review. In addition, as explained above, events (controversies) are also monitored continuously throughout the year.<sup>162</sup>

Based on its investigation, the Standard Ratings Team compiles an initial report, sends that report to the rated company, and welcomes the company to submit any additional information or questions for the Standard Ratings Team to review. This is done in order to gather feedback on the accuracy of the information captured in the draft report, as well as to collect additional and updated information directly from the rated company. One Sustainalytics employee observed that Sustainalytics has seen a large increase in the amount of company feedback recently. That same employee stated that company communications generally do not come from only low-rated companies, but rather, come from the majority of contacted companies, reflecting the tremendous strides that those companies have recently made in the ESG space and their desire to showcase their commitments and accomplishments to investors. Once contacted, companies have two weeks to submit their responses. The Standard Ratings Team then reviews any information received from the companies and decides whether or not to include it in the report. Once the Standard Ratings Team finalizes its research and report, it sends the report to a senior analyst for vetting and, when approved, the report is then sent to the ESG analyst to whom the company has been assigned.

Sustainalytics maintains an internal database, accessible to all employees, which contains separate libraries for each company in the Sustainalytics issuer universe. All of the relevant sources that have been used in the research and ratings processes of that company are stored in those libraries. When an ESG analyst receives the report from the Standard Rating Team, the ESG analyst reviews the findings and, based on that information, writes an analysis of the company's ESG risks. The analysis highlights the main ESG risks that the company is facing and explains

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<sup>162</sup> See § V(B)(1).

the risks and how the company is managing them. When the ESG analysts complete their reports, they are reviewed by a supervisor and then published for investor clients.

#### 6. Bespoke Engagement and Research

In addition to its standard subscription product offerings, Sustainalytics occasionally accepts bespoke assignments from clients. Bespoke assignments are those in which a client requests and pays for Sustainalytics to research and create a report, or to conduct an engagement on a specific issue. A Sustainalytics employee stated that bespoke engagements are rare and generally disfavored by Sustainalytics because of the large amount of resources required and limited profitability of those engagements. At the time of this report, Sustainalytics has conducted about thirty to forty bespoke engagements in total.

One Sustainalytics employee described bespoke research as something akin to custom consulting, where the client's needs fall outside of Sustainalytics' typical screening products and require a deep-dive on a particular ESG issue. Sustainalytics does not have written guidelines around the types of bespoke research it will accept or refuse. One Sustainalytics employee explained that the decision of whether to accept a given bespoke research assignment from a client is a management decision, driven by pragmatic considerations such as resource availability. In addition, although research and product managers often review bespoke research reports before they are delivered to clients, one Sustainalytics employee explained that there is not a standardized or formal process for the review of bespoke research. One employee said that Sustainalytics had recently decided not to accept new bespoke requests for country-related research, though for some existing clients, Sustainalytics continues to carry out existing bespoke research on Sudan, Iran, and Syria.

The information assembled and reviewed in this investigation identified one relevant bespoke research project commissioned from GES in 2018 by a client who had been targeted by a

pro-Palestinian letter writing campaign encouraging it to divest from two specific issuers based on the issuers' alleged involvement in the Israeli/Palestinian conflict areas. The report ultimately concluded that a research and development center operated by one of the issuers in the Israeli/Palestinian conflict areas was not a "strong enough link to the direct facilitation of illegal settlements." This conclusion was the subject of significant criticism from a variety of external observers, including the NGO Who Profits, which took particular issue with the fact that Who Profits had been used as a source in the report that ultimately concluded that the conduct of the issuers was not, on balance, problematic. An update to the report was produced in 2021, this time by Sustainalytics, which had acquired GES since the production of the 2018 report.

The 2021 updated report provided the bespoke client with its requested update on the two issuers' involvement in "OPT" and compatibility with the client's "responsible investment policy," and affirmed the prior conclusion in the 2018 report that GES "did not identify an explicit violation of international human rights and humanitarian law as defined under the scope of its engagement position" with respect to "the involvement of [the issuers] in the Occupied Palestinian Territories ("OPT")."

On at least one occasion several years ago, Sustainalytics declined to perform bespoke research on anti-BDS statutes, despite client interest. One Sustainalytics employee explained that Sustainalytics would no longer accept new bespoke research requests related to the Israeli/Palestinian conflict, and would instead refer the client to the HRR product.

### **C. Sustainalytics' Research Sources, Approaches to the Israeli/Palestinian Conflict Areas, and Use of International Norms**

#### **1. Research Sources Generally**

Multiple Sustainalytics employees explained that for the Controversies Research and GSS products in particular, the assessments and ratings must be supported by multiple sources, and the



sources relied upon are identified to customers on Global Access and in product reports. As discussed above,<sup>163</sup> the Incidents team, which provides the initial starting point for both the Controversies Research and GSS products, ranks sources based on credibility, and also maintains lists of sources that have been watchlisted or blacklisted based on concerns about their reliability. Incidents are not rated unless they are substantiated by at least two sources. Similarly, the Controversies Research team requires that analysts have more than one source to support their assessments. During meetings of the Events Oversight Committee, analysts must provide an explanation of the sources relied upon in their assessments and any other information that is available surrounding the particular controversy. The Controversies Research team also employs a ranking of reputable news sources, which the analysts can use for this purpose. Where a Category 4 or 5 controversy is based on information from an NGO source, which Sustainalytics generally recognizes as having specific points of view, analysts are supposed to identify additional sources to corroborate that information.

With respect to GSS and ratings involving alleged human rights violations in particular, Sustainalytics employees acknowledged the unique challenges that such research presents, and explained that, in order to meet those challenges, GSS analysts substantiate all allegations with multiple, credible sources. GSS researchers explained that in addition to NGO sources like Human Rights Watch and Amnesty International, the sources that are used most often are the United Nations, international governmental organizations like the European Union, *The Washington Post*, and *The New York Times*. Sustainalytics employees familiar with GSS practices also explained that GSS researchers do not maintain a list of prohibited sources. As noted above, Sustainalytics employees who worked on HRR stated that there was no list of prohibited sources used by the

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<sup>163</sup> See *supra* § V(B)(1).

HRR team (although they thought it would have been useful to have such a list), and that HRR analysts primarily rely on institutional sources like the United Nations, European Union, and OECD, as well as larger NGOs such as Freedom Watch and Amnesty International.

## 2. Sources Related to the Israeli/Palestinian Conflict Areas

Several Sustainalytics employees provided information about the use of the NGO Who Profits as a source relied upon by the Controversies Research, GSS, GSE, and HRR teams in the context of research involving the Israeli/Palestinian conflict areas. Who Profits describes itself as “an independent research center dedicated to exposing the commercial involvement of Israeli and international corporations in the ongoing Israeli occupation of Palestinian and Syrian lands.”<sup>164</sup> Sustainalytics employees expressed contrasting views on the use of Who Profits by the research teams. Some employees indicated that Who Profits was used primarily for background information, and was consistently balanced against other sources. Other Sustainalytics employees explained that research analysts often rely upon Who Profits for what they view as unique, boots-on-the-ground research regarding corporate involvement in the region, in part because Who Profits is one of the few organizations that actually operates on the ground in the Israeli/Palestinian conflict areas. One Sustainalytics employee described the relationship with Who Profits as being somewhat distinct from other NGO sources, as Sustainalytics is familiar with Who Profits’ research approach, and thus analysts will sometimes contact Who Profits directly to ask clarifying questions or obtain additional information. The same employee also explained that Sustainalytics has a similar relationship with other organizations for research regarding other regions or issues, such as Justice for Myanmar, PAX (which focuses on weapon deliveries), and the Australian Strategic Policy Institute’s work on Xinjiang, China.

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<sup>164</sup> See *Who Profits Research Center*, Who Profits, <https://www.whoprofits.org/about-who-profits/>.

Communications between Sustainalytics employees and representatives of Who Profits suggest that the relationship between the entities is close, relative to Sustainalytics' relationships with other organizations. For example, in at least two instances Who Profits raised complaints to Sustainalytics (and GES, prior to its 2019 acquisition by Sustainalytics) about certain business practices, specifically once when Sustainalytics sent a representative to an ESG conference in Israel, and, as noted above, once when Sustainalytics published a bespoke research report that cited Who Profits and ultimately concluded the issuers in question had not violated international norms. On both occasions, GES and Sustainalytics sought to meet with representatives of Who Profits and address their concerns. In neither case, however, did Sustainalytics alter its ratings based on Who Profits' complaints.

As described above, Sustainalytics' Incidents team screens the news media for negative ESG occurrences, which Sustainalytics calls incidents, based on various sources such as news publications, NGO reports, or any other publicly available information alleging negative ESG activity.<sup>165</sup> The Incidents team maintains a list of sources determined to be unreliable. The spreadsheet has several lists including a list of sources categorized as "unreliable" and two lists of "removed" sources. In early 2019, the Incidents team decided to stop using certain sources related to the Israeli/Palestinian conflict areas that the team determined were unreliable. These sources included *Electronic Intifada* and BDSMovement.net, both of which appear on the source spreadsheet as "removed." The 2020 JLens allegations prompted Sustainalytics to conduct what Sustainalytics viewed as a safety check on its sources related to the Israeli/Palestinian conflict areas. This check revealed approximately twenty references in Controversies Research to BDS Movement.net and *Electronic Intifada* from 2012 to 2018 that inadvertently had not been removed.

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<sup>165</sup> See *supra* § V(B)(1).

Sustainalytics then took steps to ensure that all such references had been removed. In January 2021, Sustainalytics located some remaining references to *Electronic Intifada* that persisted due to a technical issue and manually eliminated these references. In mid-February 2021, the Controversies Research team also sought removal of two additional sources that might be considered biased against Israel: TelesurTv.net, which is sponsored by the government of Venezuela, and *Iran Daily*, which is owned by the government of Iran. *The Jerusalem Post* and NGO Monitor, two notable pro-Israeli sources, are not on this list of unreliable sources.<sup>166</sup>

Separately, on February 28, 2020, the UN High Commissioner for Human Rights published a report on businesses located in the Israeli/Palestinian conflict areas.<sup>167</sup> The report focused on “business enterprises involved in certain activities relating to settlements in the Occupied Palestinian Territory,” in response to a specific request by the UN Human Rights Council, contained in a March 2016 resolution, that mandated the Office to produce a database of business enterprises involved in such activities.<sup>168</sup>

Sustainalytics received various inquiries from clients following publication of the UN High Commissioner for Human Rights February 2020 report. The research teams for GSS and HRR reviewed the February 2020 report, and ultimately determined that Sustainalytics would mention the report in some ratings narratives but would not change any of its rating decisions based on the report. This was partly due to the fact that the vast majority of the 112 entities included on the UN High Commissioner’s list fell outside Sustainalytics’ covered universe of issuers. In addition,

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<sup>166</sup> In addition, White & Case identified instances where Sustainalytics Controversy Research reports cite to *The Jerusalem Post*.

<sup>167</sup> High Commissioner for Human Rights, Database of All Business Enterprises Involved in the Activities Detailed in Paragraph 96 of the Independent International Fact-Finding Mission to Investigate the Implications of the Israeli Settlements on the Civil, Political, Economic, Social and Cultural Rights of the Palestinian People Throughout the Occupied Palestinian Territory, Including East Jerusalem, U.N. Doc. A/HRC/43/71 (2020).

<sup>168</sup> See Press Release, Office of the United Nations High Commissioner for Human Rights, UN Rights Office Issues Report on Business Activities Related to Settlements in the OPT, U.N. Press Release (Feb. 12, 2020) <https://www.ohchr.org/en/press-releases/2020/02/un-rights-office-issues-report-business-activities-related-settlements>.

Sustainalytics employees criticized the UN High Commissioner’s report; they claimed that it did not meet the standards of Sustainalytics research and methodologies, which Sustainalytics viewed as more closely aligned to international law and standards. Numerous witnesses at Sustainalytics emphasized that its methodologies are designed to provide objective analysis and engagements while avoiding political bias.

With respect to GSS statutes in particular, the GSS team determined that it would not automatically downgrade the companies covered by Sustainalytics that were included in the UN High Commissioner’s report to “Watchlist” or “Non-Compliant” status without other corroborating sources and application of the GSS methodology. GSS researchers also noted that although the UN High Commissioner’s report may be used as a reference by GSS analysts, the GSS product criteria differs greatly from the High Commissioner’s approach, and thus the situation for almost all of the companies listed in the High Commissioner’s report was not considered severe enough to be classified as “Watchlist” or “Non-Complaint” by GSS. Of the 112 business enterprises included in the High Commissioner’s report, GSS listed only one company as “Watchlist.” That rating dates back to 2011. The Controversies Research product, however, does cite to a company’s presence on the UN High Commissioner’s list as a source of potential legal and/or reputational risk for that particular issuer. The treatment of the UN High Commissioner’s list appears to be consistent with Sustainalytics’ general approach that each of the product teams’ assessments are based on Sustainalytics’ methodology and application of Sustainalytics’ internal criteria; multiple Sustainalytics employees reiterated that Sustainalytics does not blindly adopt a position or reach a determination based on a single external source’s conclusions.

Sustainalytics also does not use any UN resolutions as a basis for downgrading Controversy ratings or GSS assessments. Notably, it specifically does not use any resolutions from the UN

Human Rights Council as a basis for downgrade.<sup>169</sup> Sustainalytics is aware that the UN Human Rights Council is a political body composed of representatives of five countries, and that the perspectives of those countries will affect the viewpoint of the Council. Instead, Sustainalytics analysts use UN resolutions as a signal to investigate a particular situation further. UN resolutions are mentioned in Controversies Research assessments and in HRR reports to show reputational risk that flows from the existence of the resolution (regardless of whether the resolution is justified or not). One Sustainalytics employee stated that, because reports from UN Rapporteurs and UN-commissioned investigations rarely mention individual companies, they would not be used by most of Sustainalytics' products. If a company were to be mentioned in a UN-commissioned investigation, however, an analyst would only use that information as a starting point to conduct further research.

### 3. Sustainalytics' Approach to Exclusionary Lists and Client Divestment Decisions

Sustainalytics employees were emphatic that none of their research is intended to serve as a “blacklist”—i.e., an exclusionary list of companies in which clients must avoid investing, or must divest from if already an owner. However, employees also acknowledged that at least some clients may use their ESG products in this manner (particularly the GSS and Controversies Research products). When asked whether Sustainalytics ever recommended divestment, Sustainalytics employees emphatically denied that the company made such recommendations. One employee even characterized the GSE engagement service as the opposite of divestment, as it consists of a dialogue with the engaged company that is designed to improve relationships between the investor-client and engaged issuer, rather than to punish the issuer. Our independent

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<sup>169</sup> Notably, certain client communications, such as the Global Standards Screening and Engagement: Approach to Assessing Human Rights and Forced Labour Allegations Linked to Companies Operating in China from June 2021, explain that Sustainalytics “does not use UN resolutions or sanction lists as stand-alone sources unless details on the actions of a company are provided,” and that Sustainalytics “will always conduct further analysis” with respect to “UN resolutions or sanction lists.”

review of documents in this investigation confirms that Sustainalytics has a known and understood policy among its employees that Sustainalytics does not recommend divestment. Ultimately, as Sustainalytics leadership and employees have recognized, Sustainalytics does not direct the manner in which its clients use its research and—although Sustainalytics sometimes receives signals about divestment actions through client communications or public filings—Sustainalytics does not know and does not seek to direct the precise manner in which its products are utilized.

In addition, Sustainalytics has thought carefully and strategically about the decision not to provide bona fide investment recommendations. Sustainalytics’ leadership explained that clients generally prefer to use Sustainalytics’ research as an input to their internal decision models rather than outsourcing investment/divestment decisions entirely. Indeed, many of Sustainalytics’ larger clients have complex investment models into which Sustainalytics’ ratings serve as one input (sometimes in combination with ESG ratings data from other providers, such as MSCI). These models can select for very different criteria; some clients, for example, prioritize reputational risk as a component of their decision-making—particularly investment funds located in regions that tend to receive a great deal of external pressure from NGOs. Other clients are interested in avoiding specific ESG risk areas, such as controversial weapons. These decisions are sometimes purely financial (i.e., resulting from concerns about financial risk), sometimes purely ethical (i.e., divorced from any financial considerations), and sometimes a mix of both.

#### 4. Terminology and Guidance Related to the Israeli/Palestinian Conflict Areas

##### a. Terminology Usage

As a general matter, Sustainalytics uses the term “Occupied Palestinian Territories” (or “OPT”) to refer to the disputed territories implicated in the Israeli/Palestinian conflict. The terminology for the implicated territories was the subject of discussion among Sustainalytics employees in mid-2020. Sustainalytics employees observed that, at that time, the territory was

being referred to by multiple terms in various Sustainalytics products. At that time, the HRR and GSS teams used several different terms: “Disputed Territories: Palestine,” “Disputed Territory of Palestine,” “Occupied Palestinian Territories,” “Occupied Territories of Palestine,” “Palestine,” and “Palestinian territories.” GSE used “Palestinian Authority” and “Occupied Palestinian Territories” or “OPT.”<sup>170</sup> One explanation for this apparent inconsistency was a technical one; some product platforms and report formats required shorter terminology to make them readable and user-friendly.

Sustainalytics employees involved in the discussion, including members of the GSS, GSE, and HRR teams and leadership in Sustainalytics research, agreed that it would be advisable to adopt a single term to use consistently across all Sustainalytics products. They ultimately decided that the term “Occupied Palestinian Territories (OPT)” was the best option, in part because of its use by the UN. The group also agreed to use the full term in the first instance on all documents, and then to refer to the territory simply as “OPT” in all subsequent references.

This approach to terminology has been integrated into the proposed internal guidance materials for GSS analysts, which specifically states that the term “Occupied Palestinian Territories” has been widely used in official positions of multilateral organizations, including the UN and the European Union. The proposed GSS internal guidance states that the UN uses the term “Occupied Palestinian Territories” (OPT) in reference to West Bank, East Jerusalem, the Gaza Strip, and the Golan Heights, and that the term Occupied Territories is also widely used by news organizations such as *The New York Times*. Similarly, the “Occupied Territories Guidance” employed by the Incidents team points to the UN’s use of the term “Occupied Territories” to refer to the West Bank, East Jerusalem, the Gaza Strip, and the Golan Heights. This guidance document

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<sup>170</sup> As of the time of this report, GSE still uses “Palestinian Authority” in both Global Access and in its annual and quarterly reports to identify the location of the underlying conduct for which a company is engaged.



used by the Incidents team also discusses other disputed territories, including Western Sahara and Tibet, and provides guidance on to how to assess and score incidents in each of the various occupied and disputed territories. Sustainalytics does not currently employ a style guide that specifically covers use of terminology across the various product lines.

b. Research Approach to the Israeli/Palestinian Conflict Areas

As noted above, both GSS and the Incidents team have specific guidance for analysts regarding how to assess corporate conduct related to the Israeli/Palestinian conflict areas, within the framework of their respective products. The Controversies Research product itself does not have specific guidance on this issue, though the Controversies Research model is discussed briefly in the Incidents team's guidance. As of the time of this report, there is no specific guidance document on the Israeli/Palestinian conflict areas for analysts working on the HRR product.

(A) GSS/GSE

As discussed above in Section V(B)(3), following the acquisition of GES by Sustainalytics in 2019, the two companies harmonized their individual screening products to create GSS, with Sustainalytics' methodologies being the primary methodologies used. Sustainalytics' prior international norms screening product had higher severity thresholds than did GES's prior product, which meant that many cases that would have qualified for engagement based on the GES rating no longer qualified under the new GSS ratings standards. A Sustainalytics specialist on human rights issues, together with a team of analysts, worked to apply the GSS ratings model to the GES list of engaged companies. The result was that approximately 100 GES engagement cases were archived. This included eight Israeli companies, including five banks and two natural resources companies. Only two companies continued to meet the new GSS rating criteria for screening and engagement solely based on their involvement in the Israeli/Palestinian conflict areas. Two others

also remained eligible for screening and engagement on issues related to the Israeli/Palestinian conflict area, but were engaged, in part, due to activities in other regions.<sup>171</sup>

Sustainalytics employees who were extensively involved in this process explained that, prior to the integration with Sustainalytics, GES had a much broader view of what constituted a violation of international law standards in the Israeli/Palestinian conflict areas than did Sustainalytics. Specifically, GES's rationale was that the settlements in the Israeli/Palestinian conflict areas violated international law, and therefore, any company that was involved with or supported the settlements in any way contributed to violations of international law. GES's stance on issues related to the Israeli/Palestinian conflict areas was set forth in policy papers that had been reviewed by external advisory boards and included information from external consultants. These policy documents provided background on the Israeli/Palestinian conflict with reference to relevant UN resolutions, international humanitarian law, and the Fourth Geneva Convention. In addition, the policy documents described, by industry, the impact of settlements on local communities.

Because the GSS rating standards diverged from those of GES, GSS could not use the GES policy papers on this issue. As a result, Sustainalytics employees specializing in human rights issues had to develop new guidelines for GSS analysts on how to apply the screening analysis to the Israeli/Palestinian conflict areas and other conflict regions. In formulating these guidance documents, the Sustainalytics analyst in charge of the project reviewed prior GSS ratings to ensure consistency within the GSS product and consulted with representatives from the GSE and HRR teams to make sure the instructions were consistent across products.

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<sup>171</sup> The list of companies screened by GSS does not overlap with the public targets of the official BDS movement, which encourages consumer boycotts of the following eight products and brands: (1) fruit, vegetable, and wine labeled as being "produced in Israel," (2) AXA, (3) Hewlett Packard, (4) Puma, (5) SodaStream, (6) Ahava, (7) Sabra hummus, and (8) Pillsbury. See *Know What to Boycott*, BDS, <https://bdsmovement.net/get-involved/what-to-boycott>.

In July 2020, the proposed guidelines for companies operating in Israeli/Palestinian conflict areas were presented to the executive team and then to the GSOC. The guidance was accepted by both groups and was implemented by GSS. Under the GSS guidance, only companies that participate in one of the four enumerated activities, and whose participation in those activities meet the requisite “high impact and moderate management” thresholds, are to be classified as “Watchlist” in GSS. The activities for “Watchlist” classification are (1) surveillance/security for the checkpoints or walls, (2) equipment/services for the demolition of housing and property, (3) large infrastructure projects, and (4) the supply of arms. Sustainalytics does not screen Israeli banks in GSS for providing mortgages for the construction of settlements because those banks are required by Israeli law to provide these mortgages.

To be classified as “Non-Compliant” under the GSS model, a company must participate in one of the same four enumerated activities. However, if the company is alleged to participate in the provision of equipment or services for demolition of housing or property, the company must be *knowingly* engaging in that activity, and if the company is alleged to be participating in large infrastructure projects, their participation must be of “exceptional scale and impact.” Furthermore, for a company to be classified as “Non-Compliant,” the allegation must be supported by multiple sources, the impact of the activity must be severe, the company’s management of the incident must be weak, and there must be no company response to the allegations.

Sustainalytics communicated the clarified GSS/GSE approach for analyzing companies operating in the Israeli/Palestinian conflict areas to clients in September 2020.

## (B) Incidents

As explained above, the Incidents team screening provides the initial starting point for both the Controversies Research and GSS products.<sup>172</sup> The guidance document on “Occupied Territories” cover the Israeli/Palestinian conflict areas as well as other occupied / disputed territories including Western Sahara, Tibet, Puntland-Somaliland, the South China Sea, Yemen, and the territories involved in the Guyana-Venezuela conflict. The guidance document states at its outset that for all high risk and disputed areas, including “OPT,” the Incidents team applies a standard framework whereby analysts focus on the fundamental human rights at risk of violation, rather than on political grievances. The document’s position is that in occupied territories where human rights are being systematically violated, any business activity in that region is connected to the violations in some direct or indirect way.

The Incident team classifies corporate involvement in occupied / disputed territories into three categories: normalization, expansion, and enforcement. Business activities that may appear neutral but that, by virtue of their presence in the occupied territory, indirectly support or enable the occupation, are classified as “normalizing” behavior. Companies that enable an occupying force to expand its power—such as by providing construction or telecommunication services—are classified as “expansion” behavior. Finally, companies are classified as “enforcing” the occupation if they provide technology for the security or surveillance power of the occupying party.

As a separate component of its analysis, the Incident team looks at the risks to which companies operating in the occupied / disputed territories have exposed themselves. These risks also fall into three categories: human rights risks, reputational risks, and legal/regulatory risks.

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<sup>172</sup> See *supra* §§ V(B)(1)-(2).

When the Incident team is assessing an issuer that has been operating in occupied / disputed territories, the first step of their analysis is to determine the nature of the issuer’s involvement. The Incident team’s guidance outlines four types of activities for companies operating in those territories: (1) minor economic activities and sales, (2) activities benefiting perpetrators or exacerbating grievances, (3) provision of tailored products or services, and (4) direct violations of human rights. Analysts are instructed to classify each case based on consideration of the proximity of the company’s activities to the violations of human rights, the degree to which the company’s products or services can be adapted to violate human rights, and the evidence of the direct impact that the company’s activities on the human rights of the local population. Each of the four types of activities, in turn, correlates with a level of risk that the company faces: minor economic activities are deemed low to moderate risks, provision of tailored products and services is deemed a moderate to significant risk, activities benefiting perpetrators are deemed significant to high risks, and direct violations of human rights constitute high to severe risks.

Those risk classifications also correlate with the one-through-five ratings that the company would likely receive under the Controversy rating model. Low to moderate risks will usually be given a level one Controversy rating, moderate to significant risks will most often translate to levels two or three, significant to high risks will be given levels three or four, and high to severe risks will receive level five under this model.

#### 5. Use of International Norms by Sustainalytics

This section contains findings describing how Sustainalytics uses and applies international norms, guidelines, and principles in several of its products—in particular, GSS, GSE, HRR, and Controversies Research. Many of these norms such as the UN Global Compact (“UNGC”) Principles, the UN Guiding Principles on Business and Human Rights (“UNGPs”), OECD

Guidelines for Multinational Enterprises Chapters (“OECD Guidelines”) are widely accepted.<sup>173</sup>

A more detailed description of these and other international human rights norms are provided in Annex II. In addition, this section distinguishes Sustainalytics’ use of these norms compared to how it treats resolutions and decisions from the UN’s more politicized bodies.

Notably, none of the norms or guidelines relied upon by Sustainalytics, except for applicable EU regulations, are legally binding over companies, nor are they intended to be so. Rather, guidelines such as the UNGC Principles, the UNGPs, and the OECD guidelines, are intended to be voluntary and to provide a framework and guidance as to how companies should implement certain principles. Certain language in Sustainalytics’ assessments, however, particularly from the GSS team, which characterizes company conduct in terms of “non-compliance” and “violations,” may imply legal obligation where none exists.

Nonetheless, though Sustainalytics’ assessments of company conduct cannot be considered a legal determination, the approach of using international norms, guidelines, or even conventions, traditionally only applicable to countries, in order to establish standards of conduct for businesses, is gaining regulatory traction. Particularly in Europe, there is a growing body of legislation that references international norms as setting standards of conduct required for corporations. For example, in February 2022, the European Commission issued the Proposal for a Directive on Corporate Sustainability Due Diligence,<sup>174</sup> which would make mandatory certain human rights and environmental due diligence requirements and essentially impose legal obligations on companies to comply with certain international norms. Similarly, in June 2021, the German

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<sup>173</sup> See Annex II; see also United Nations Global Compact 20th Anniversary Campaign Overview Presentation, UN Global Compact (2020), <https://d306pr3pise04h.cloudfront.net/docs/publications%2FUN-Global-Compact-20th-Anniversary-Campaign-Infosheet.pdf> (explaining that, as of 2020, over 10,000 companies had committed to the UNGC Principles); *About - Organisation for Economic Co-operation and Development*, Organisation for Economic Co-operation and Development, <https://mneguidelines.oecd.org/about/> (Showing that Israel is one of 46 countries that have adopted the guidelines).

<sup>174</sup> *Proposal for a Directive on Corporate Sustainability Due Diligence*, European Commission (Feb. 23, 2022), [https://ec.europa.eu/info/publications/proposal-directive-corporate-sustainable-due-diligence-and-annex\\_en](https://ec.europa.eu/info/publications/proposal-directive-corporate-sustainable-due-diligence-and-annex_en).

Parliament published the Supply Chain Due Diligence Act, which will—starting in 2023—impose due diligence obligations on companies to prevent a broad range of human rights and environmental violations in their supply chains. The legislation is notable in that it incorporates into domestic law several international norms listed in the annex of the law, including International Labour Organization conventions, the Minamata Convention on Mercury, the Stockholm Convention on Persistent Organic Pollutants, and the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal.<sup>175</sup> These new regulations illustrate that Sustainalytics’ approach of assessing company conduct based on international norms is not too far afield from where national regulations (at least in Europe) may be headed.

a. GSS

As discussed in Section V,<sup>176</sup> GSS (1) assesses how a company’s conduct is causing, contributing, or linked to violations of international norms and standards; and (2) provides Sustainalytics’ opinion on whether a company is violating or at risk of violating principles of the UN Global Compact. Sustainalytics uses GSS to assign a status to a company: “Non-Compliant,” “Watchlist,” or “Compliant.”

Of Sustainalytics’ products, GSS most heavily references and relies upon international norms and standards, including the UN Global Compact (“UNGC”) Principles, the UN Guiding Principles on Business and Human Rights (“UNGPs”), and the OECD Guidelines for Multinational Enterprises (“OECD Guidelines”), as well as their underlying conventions, treaties, and instruments. The GSS research team also monitors developments in international norms and

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<sup>175</sup>See *Act on Corporate Due Diligence Obligations in Supply Chains*, Federal Ministry of Labour and Social Affairs (Aug. 18 2021), <https://www.bmas.de/EN/Services/Press/recent-publications/2021/act-on-corporate-due-diligence-in-supply-chains.html>; see also *Germany Introduces Due Diligence Obligations for Global Supply Chains of Large Companies*, HKTDC Research (Aug. 9, 2021), <https://research.hktdc.com/en/article/ODIxOTkzMzk0>.

<sup>176</sup> See *supra* § V(B)(2).

attempts to incorporate new international standards and treaties into its assessments. GSS assessments categorize company conduct under one of four UNGC issue categories (human rights, labor, environment, and anti-corruption).<sup>177</sup> Under the GSS methodology, GSS views a company's conduct through the lens of the UNGC principles, and—within those assessments—offer evaluations of how the company's conduct aligns with relevant sections of the UNGPs, the OECD Guidelines, and underlying conventions and treaties.

b. GSE

GSE also indirectly relies on international norms and guidelines insofar as it uses GSS assessments as the trigger for a GSE engagement.<sup>178</sup> GSE, by design, engages companies that are assessed as “Watchlist” or “Non-Compliant” by GSS—its aim is to address the GSS violation and prevent recurrence by effectuating change in a company's relevant ESG practices, policies, and programs. In addition, the GSE team includes companies' statistics related to UN Principles for Responsible Investment (“PRI”) in its annual engagements reports to clients, so clients can use those statistics in their annual UN PRI reporting.

Sustainalytics has developed specific guidance for GSS and GSE that governs their approach to different regions. With respect to the Israeli/Palestinian conflict areas, GSE notes that it considers “international norms and responsible investment practices derived from contemporary international standards and guidelines, which are applicable to investors looking to fulfill their responsibilities to conduct due diligence on their investee companies.” Sustainalytics notes that, though it considers “relevant jurisprudence and court decisions,” its research process “inherently involves an independent and methodologically sound assessment.”

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<sup>177</sup> See *The Ten Principles*, UN Global Compact, <https://www.unglobalcompact.org/what-is-gc/mission/principles>.

<sup>178</sup> See *supra* § V(B)(3).



For example, with respect to Myanmar, the GSS and GSE approach is to consider the report from the 2019 UN Fact Finding Mission on Myanmar, as well as the UNGC, the UNGP, and OECD Guidelines. With respect to China, the GSS and GSE approach clarifies that it considers UN reports as a source only if a report gives “specific details on the involvement of a company,” and further notes that it “does not use UN resolutions or sanction lists as stand-alone sources unless details on the actions of a company are provided and will always conduct further analysis aimed at corroborating sources.”

c. HRR

Human Rights Radar also relies on international norms. The HRR product provides information on companies that are “involved in the most volatile regions in the world where grave human rights violations are taking place.” This includes conflict-affected countries, disputed territories and authoritarian states. HRR is intended to support investors in identifying and managing exposure to such risks.<sup>179</sup>

The HRR’s use of the UNGPs is primarily focused on company management of the risks of operating in these so-called “high-risk territories and countries,” and, in particular, on whether a company has developed a human rights policy, engages in human rights due diligence, and has a remediation framework.

d. Incidents, Controversies Research, and ESG Risk Rating

As discussed above in Section V(B)(1), the Sustainalytics Incidents team screens the news and creates incidents reports for Sustainalytics’ various product teams. The Incidents team has developed a guidance document specifically for occupied territories.<sup>180</sup> That document explains

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<sup>179</sup> See *supra* § V(B)(4).

<sup>180</sup> See *supra* § V(C)(4).

the Incidents team’s methodology for scoring incidents related to conflict-affected areas and disputed territories, and the risks associated with companies’ operations in such areas.<sup>181</sup> With respect to the Israeli/Palestinian conflict areas, the guidance asserts that the “United Nations Security Council has found the Israeli occupation to impede the rights” of Palestinians. The document also notes that the United Nations has condemned the barriers constructed between Israel and the “Occupied Palestinian Territories.”

Research from the Incidents team feeds directly into the Controversies Research product,<sup>182</sup> and indirectly to the ESG Risk Ratings product, as a company’s Controversy score factors into the ESG Risk Rating product, which is Sustainalytics’ flagship product.<sup>183</sup> The GSS product also uses research gathered by the Incidents team as its starting point. Sustainalytics employees explained that the Incidents team’s research and the incidents they categorize are not blindly accepted by GSS analysts. Instead, analysts conduct their own, independent research of reports they receive from the Incidents team. Nevertheless, the Incidents team’s guidance on occupied / disputed territories informs what incidents related to the Israeli/Palestinian conflict areas will be flagged in the first instance, and consequently, which will be passed along to the product teams for further research and assessments.

#### **D. Research Outcomes in Sustainalytics’ Treatment of Human Rights Issues**

As part of the independent investigation, White & Case analyzed Sustainalytics’ products for evidence of comparative bias in research outcomes related to the Israeli/Palestinian conflict. To do this, White & Case built a model of Sustainalytics’ research data from the products most relevant to the investigation (Controversies Research, GSS, GSE, HRR, and ESG Risk Ratings)

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<sup>181</sup> See *supra* § V(C)(4).

<sup>182</sup> See *supra* § V(B)(1).

<sup>183</sup> See *supra* § V(B)(5).

by loading, cross-referencing, and tagging company entries in Microsoft Excel. This allowed the White & Case team to focus on Sustainalytics’ treatment of human rights issues—including issues related to the Israeli/Palestinian conflict—both within and across Sustainalytics’ products.

### 1. Analysis Methodology and Assumptions

The data for the Controversies Research, GSS, GSE, and ESG Risk Ratings products were downloaded directly from the Sustainalytics Global Access portal via its reporting functionality.<sup>184</sup> The analysis summarized in this report was performed on data current through May 10, 2022, with the exception of data from HRR; HRR data was pulled from Q4 2021 HRR report, which was the most recent data available to White & Case as of May 2022.

#### a. Research Universe

The set of companies rated by Sustainalytics differs between products; internally, these sets are referred to as “universes.” Because the Compliance products—which include GSS and Controversies Research—were a focal point of the investigation, our research outcomes analysis focused on the “Compliance Universe.”<sup>185</sup> In some situations (typically involving subsidiaries), Sustainalytics determines that “an issuer is equivalent from an ESG perspective to another issuer” and rates the two entities identically, with the primary entity as a “research entity” and the secondary entity as a “coverage entity.” Therefore, the research outcomes analysis was further filtered to focus only on research entities.<sup>186</sup> As of May 10, 2022, the Compliance Universe provided data on 22,013 research entities.<sup>187</sup> The Q4 2021 Human Rights Radar report consisted

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<sup>184</sup> White & Case lawyers were provided access to Sustainalytics products via accounts in the Global Access platform.

<sup>185</sup> The Compliance Universe—also called the “Global Compliance Base” Universe—was identified by selecting the “Global Compliance Base” from the “Universe” drop-down in the Global Access reporting tool. The Compliance Universe is significantly larger than, but includes all companies within, the Ratings Universe.

<sup>186</sup> A company was treated as a Research Entity where ‘Research Entity ID’ = ‘Entity ID’.

<sup>187</sup> When not filtered for Universe and research entity status, Global Access includes data on 29,596 entities and HRR includes data on 155 entities.

of 145 Compliance Universe research entities.<sup>188</sup> Some companies were rated in HRR for involvement in up to five different high-risk territories/countries; unless otherwise indicated, the HRR analysis focused on the primary (i.e., “Country 1” in the HRR deliverable) high-risk territory/country of involvement.

b. Territory/Country Tagging

GSS and Controversies Research were manually tagged for entries that mentioned a particular high-risk territory/country. For example, narratives were searched for variations of the words “Israel,” “Palestine,” “Occupied Territories,” “Occupied Palestinian Territories,” and “OPT,” and search hits were confirmed through manual review. In the Controversies Research product, companies were tagged for involvement in the Israeli/Palestinian conflict areas (based on the word search and manual follow-up) only if they had a Category 3, 4, or 5 Controversy rating in the “Society – Human Rights” event indicator.

2. HRR

Involvement in the “Disputed territory of Palestine” is the most common reason companies are listed in the HRR, and by a significant margin. 29% of entities—forty-two total<sup>189</sup>—are rated primarily for involvement in the “Disputed territory of Palestine,” over 10% more than the next runner-up (“Disputed territory of Western Sahara,” at 17%).<sup>190</sup> One Sustainalytics employee emphasized the increased volume of corporate activity in Israel resulting in part from the fact that the Israeli economy is more developed, suggesting that the denominator of companies exposed to

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<sup>188</sup> Three companies IDs listed in HRR are not in the “Global Compliance Base” Universe as reported in the Global Access portal. These companies were excluded from the analysis because of the Compliance Universe filter. Of these, one company was rated in HRR for involvement in the “Disputed territory of Palestine.”

<sup>189</sup> The total number of companies rated in HRR for involvement in the “Disputed territory of Palestine” is forty-three if the product is not filtered to match the Compliance Universe and forty-four if including all high-risk territory/country involvements (i.e., not just “Country 1”).

<sup>190</sup> When all involvements are weighed equally (i.e., the analysis is not filtered to focus only on “Country 1”), “Disputed territory of Palestine” is still the most-cited territory/country of involvement.

ratings related to the Israeli/Palestinian conflict is therefore larger. Ideally, an analysis of HRR ratings would look at the frequency of rating relative to the number of companies involved in a particular high-risk territory/country, but data on high-risk territory/country involvement by companies that are not covered in HRR was unavailable. Nonetheless, some of the data on other territories/countries covered in HRR undercuts the rationalization that there are more companies rated in HRR for involvement in the Israeli/Palestinian conflict areas simply because Israel has a more developed economy. For example, involvement in the Tibet Autonomous Region—in which Chinese companies, among others, might be rated as involved—represented only 3% of HRR ratings, and involvement in Saudi Arabia—a country with a GDP nearly 75% larger than Israel’s GDP<sup>191</sup>—represented only 7% of HRR ratings.

Additional data analyzed by White & Case further suggests that ratings related to the Israeli/Palestinian conflict are overrepresented in HRR relative to other Sustainalytics research products. It is not possible to compare ratings one-to-one across different Sustainalytics products because each Sustainalytics product serves a fundamentally different purpose.<sup>192</sup> This lack of one-to-one correspondence does not mean, however, that cross-product comparison is impossible, as there are areas of methodological overlap where consistency would logically be expected. For example, it would be expected that companies rated in HRR also have human rights-related Controversy ratings, and that companies with severe human rights-related Controversy ratings for conduct involving an HRR-covered territory/country likewise would be rated in HRR. This was

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<sup>191</sup> The 2020 GDP of Israel was 407.1 billion USD, while the 2020 GDP of Saudi Arabia was 700.1 billion USD. *See* The World Bank: Open Data, <https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=IL> (Israel) and <https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=SA> (Saudi Arabia).

<sup>192</sup> For example, HRR—a product ostensibly designed to assess the degree of a company’s involvement in a predefined list of high-risk countries and territories—has a much lower “severity threshold” than GSS, which is designed to capture only the most egregious violations of international norms. HRR would therefore be expected to rate many more entities than GSS, and for different types of involvement.

not always the case. Of companies rated for issues related to the Israeli/Palestinian conflict areas in HRR, only 29% have human rights-related Controversy ratings of Category 3 or higher,<sup>193</sup> and 40% have no human rights-related Controversy ratings at all.

By contrast, companies rated in HRR for involvement related to the Israeli/Palestinian conflict areas were not more likely to have a GSS rating of “Watchlist” or “Non-Compliant,” as compared to the GSS status of the other companies rated in HRR for involvement in other high-risk countries/territories. Nonetheless, the number of companies rated in HRR for involvement in the Israeli/Palestinian conflict as compared to the other covered territories/countries, as well as the fact that 40% of the companies rated in HRR for issues related to the Israeli/Palestinian conflict have no corresponding human-rights related rating in the Controversies Research product, suggest that HRR focuses disproportionately on the Israeli/Palestinian conflict.

### 3. ESG Risk Ratings and Controversies Research

The ESG Risk Ratings do not directly reference particular geopolitical conflicts. One way to test for bias in the ESG Risk Ratings is by checking to see if the ESG Risk Ratings for companies rated for reasons related to the Israeli/Palestinian conflict in other products—such as HRR—are statistically better (lower) or worse (higher) than industry peers. Of the companies rated for in HRR for involvement related to the Israeli/Palestinian conflict, the average ESG Risk Rating for those same companies was actually lower than it was for almost any other high-risk country or territory covered in HRR, and also was lower than the average ESG Risk Rating for the entirety of the Ratings Plus Universe. This was generally true even when the analysis controlled for

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<sup>193</sup> As discussed in Section V(B)(1), the events assessment scale indicates that Category 3 events are considered “significant,” Category 4 events “high,” and Category 5 “severe.” *See supra* § V(B)(1).

confounding variables such as company industry and subindustry, which are substantial factors in a company's ESG Risk Rating.

With respect to Controversies Research, sixty research entities are rated for a human rights-related controversy of Category 3 or higher.<sup>194</sup> Of those sixty companies, twenty-one companies had a rating of Category 3 or higher that was at least partially related to the Israeli/Palestinian conflict areas. Of those twenty-one companies, eighteen companies had a Category 3 human rights-related rating and three had a Category 4 human rights-related rating. There were no Category 5 ratings related to the Israeli/Palestinian conflict.

In addition, within the sixty companies rated for a human rights-related controversy of Category 3 or higher, 50% of those ratings—that is, thirty—featured an incident involving what Sustainalytics tags as “Occupied Territories / Disputed Regions.”<sup>195</sup> Among those thirty ratings with “Occupied Territories / Disputed Regions” incidents, the Israeli/Palestinian conflict is a factor in 70%—that is, twenty-one—of those ratings.<sup>196</sup> The remaining 30% of these ratings reference involvement in Sudan, Western Sahara, Hong Kong, Somalia, Kurdistan, Yemen, Syria, and Myanmar. This suggests that the Israeli/Palestinian conflict is responsible for a majority of the Occupied Territories / Disputed Regions incidents that led to a human-rights related Controversy rating of Category 3 or higher. However, there are justifiable, non-biased explanations for this focus, such as the Israeli/Palestinian conflict receiving a disproportionate amount of media attention. Furthermore, on average, Controversy ratings involving the Israeli/Palestinian conflict

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<sup>194</sup> This is the total number of Category 3, Category 4, and Category 5 Controversy ratings under the “Society – Human Rights” event indicator, within the Compliance Universe of companies, as of April 26, 2022.

<sup>195</sup> Specifically, of the sixty companies with either a Category 3, 4, or 5 Controversy rating in “Society – Human Rights” event indicator, 50% of those ratings involved an incident tagged under “Society – Occupied Territories / Disputed Regions – Answer Category.”

<sup>196</sup> Of all companies with either a Category 3, 4, or 5 Controversy rating in the “Society – Human Rights” event indicator and a rating in the “Society – Occupied Territories / Disputed Regions – Answer Category,” 63% had a narrative reference to the Israeli/Palestinian conflict.

were less severe than for other conflict zones. For example, there were no Category 5 Controversy ratings related to the Israeli/Palestinian conflict areas, but 13% of the sixty “Society – Human Rights” Controversy ratings were a Category 5. On balance, our analysis did not reveal clear evidence of biased outcomes related to the Israeli/Palestinian conflict in the Controversies Research or ESG Risk Ratings products.

#### 4. GSS and GSE

With respect to GSS, White & Case focused this part of its analysis on companies that were rated in GSS based on Principle 2 of the UN Global Compact (“UNGC”). As discussed further in Annex II, Principle 2 advises that companies “make sure that they are not complicit in human rights abuses.”<sup>197</sup> In GSS, 122 entities are rated as Watchlist or Non-Compliant for violations of Principle 2.<sup>198</sup> GSS is not limited by geographic location or a list of high-risk territories or countries (like HRR), but instead rates a company’s risk of violating a UNGC principle without geographic limitation. Most of these ratings based on Principle 2 do not mention a single, specific territory/country territory where the alleged violations occurred. Instead, they refer generally to high-risk or conflict-affected countries, or they list multiple countries and regions. Where a country is mentioned in GSS in connection with a potential Principle 2 violation, those countries were generally from a small list: China, India, Myanmar, Saudi Arabia, Iran, Syria, the “Occupied Palestinian Territories,” Egypt, South Sudan, Pakistan, and the Western Sahara.<sup>199</sup> Most of these geographic locations were mentioned only a handful of times (fewer than five).

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<sup>197</sup> See *The Ten Principles*, UN Global Compact (2022), <https://www.unglobalcompact.org/what-is-gc/mission/principles>; see also Annex II(A).

<sup>198</sup> Of these, eighty-eight are research entities, and forty-eight are research entities in the Compliance Universe. One entity is rated for violations of both Principles 2 and 7, while the rest are rated solely for violations of Principle 2.

<sup>199</sup> Additionally, North Korea, Australia, and Egypt each had one mention in a GSS Principle 2 narrative.



Overall, the percentage of companies rated in GSS for alleged violations of Principle 2 related to the Israeli/Palestinian conflict areas is comparable to ratings for other high-risk countries/territories. GSS screens only four companies as “Watchlist”—and zero as “Non-Compliant”—for conduct related, at least in part, to the Israeli/Palestinian conflict. That is roughly on par with the number of Principle 2 Watchlist ratings involving Pakistan, Saudi Arabia, and the Western Sahara (which are implicated in Watchlist/Non-Compliant statuses for two or three Principle 2 violations), and significantly fewer than China (which is implicated in thirteen Watchlist/Non-Compliant statuses for Principle 2 violations). Similarly, the volume of GSE engagements with companies related to the Israeli/Palestinian conflict areas did not substantively differ from the number engagements with companies operating in China, Myanmar, Russia, Saudi Arabia, and Western Sahara.<sup>200</sup> Our analysis did not reveal evidence of statistically disproportionate treatment of the Israeli/Palestinian conflict in the GSS or GSE products.

## **VI. RECOMMENDATIONS**

Sustainalytics has already made significant strides reflecting a commitment to providing transparent, consistent, and objective ratings and research products to its customers. For example, within the GSS product team, a guidance document for assessing corporate conduct in the context of the Israeli/Palestinian conflict has been developed and submitted to the GSOC, and Controversies Research and the Incidents team are each in the process of formulating research guidance on a variety of topics, recognizing the importance of providing clear, consistent direction to Sustainalytics research analysts. Sustainalytics leaders also have intuitively recognized the importance of teaching the professional research staff how to navigate the landscape of the

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<sup>200</sup> Sustainalytics employees described twenty-five GSE engagements regarding companies’ alleged “Involvement with Entities Violating Human Rights,” which included nine from China, three from Myanmar, three from Russia, two from Saudi Arabia, and two from Western Sahara.

Israeli/Palestinian conflict, which inevitably gives rise to source bias. The Incidents team has commendably developed a specific system to identify and eliminate research sources that are false and inaccurate, as well as a scoring system to prioritize the most accurate, reliable, and balanced sources.

In addition, Sustainalytics' processes across various products are designed to promote discourse and debate among analysts with diverse viewpoints. For example, for GSS researchers to screen a company as "Watchlist" or "Non-Compliant," or to change the assessment of a company, they are required to present their research to the GSOC, which engages in an open discussion about the findings before putting the research analysts' recommendation to a formal vote. Across the board, Sustainalytics employees describe these discussions as an open exchange of ideas among researchers with a variety of backgrounds and viewpoints. Sustainalytics employees consistently expressed confidence in the existing system of checks and balances on research and ratings assessments that assist Sustainalytics in analyzing issues appropriately, particularly in areas such as the Israeli/Palestinian conflict, and every research analyst interviewed in the course of our investigation approached the reflection mandated by this process eager to eliminate any existence or perception of potential bias in their ratings or research.

Each of the following recommendations is informed by those conversations and by the likelihood of a regulated future for the ESG ratings provider industry. White & Case recommends that Morningstar take the following steps within its ESG research and ratings products and services in order to ensure that all of its products satisfy the highest standards of embracing transparency, maintaining consistency, and ensuring objectivity, in order to avoid the possibility—or even the appearance—of bias within its ESG research and ratings products, particularly with respect to the Israeli/Palestinian conflict. We have reviewed the products, policies, and procedures in place as

thoroughly as possible, and make these recommendations based on factual findings informed by extensive independent research as to the existing legislative and regulatory landscape, while noting that Morningstar and Sustainalytics are in the best position to determine how best to implement these recommendations.

**A. *Embrace Transparency: Mitigate Risk of Bias by Embracing Transparency as to Research Sources and Ratings Methodology***

**1. Clearly State Underlying Assumptions and Review Language Usage in Sustainalytics Reports**

To enhance transparency and help reduce any risk of bias with respect to Sustainalytics' research and ratings on this subject, Morningstar and Sustainalytics should develop and include additional language in Sustainalytics' research reports regarding the products' baseline assumptions and positions on issues related to the Israeli/Palestinian conflict areas where relevant.

As several responsible Sustainalytics employees acknowledged, Sustainalytics does make qualitative judgments within several of its processes (applying those judgments to the GSS, HRR, and Controversies Research products). Indeed, as one employee explained, clients are paying Sustainalytics for its expertise and judgment, including on complex human rights issues.

Specifically, Sustainalytics should add prominent, clear language in its reports (where applicable) that:

- Describes the specific assumptions made in the context of research and ratings related to the Israeli/Palestinian conflict areas, including the assumption that the territories are “occupied” and that the settlements violate international law;
- Clearly identifies the source of the position being adopted in each of these assumptions, with the explicit caveat that many international law principles typically apply to states, not private corporate actors, and that these principles are being used as international law guidelines rather than legal requirements;
- Expressly states that Sustainalytics' ratings and products are not designed to be used either as a tool to advance the BDS movement and other advocacy campaigns, or as a tool to comply with anti-BDS legislation, and are not a recommendation to divest from any company;

- Clearly explains how certain information—such as the existence of advocacy campaigns against a particular issuer or on a specific topic, and prior divestment decisions by third parties—factors into Sustainalytics’ assessments for Controversies Research and GSS in particular (i.e., the position that the advocacy campaign or divestment by third parties represents a reputational risk for a company, regardless of the validity of those campaigns or third-party divestment decisions);
- More clearly explains Sustainalytics’ current approach of considering UN sources but not completely adopting the perspective of those sources (for example, Sustainalytics’ decision not to make ratings changes based on the February 2020 report by the UN High Commissioner for Human Rights on companies doing business in the Israeli/Palestinian conflict areas).

Sustainalytics already has worked to develop some of these explanations, including in the context of discussions with internal stakeholders. However, these baseline assumptions and positions are not always evident in Sustainalytics’ research and reports. In addition, although Sustainalytics has some limited disclaimers that it is not making legal assessments of a company’s conduct,<sup>201</sup> the terminology used in various products, GSS and HRR in particular, do not align with that stance. In particular, the use of words “comply,” “violate,” and “complicit” have legal connotations, which consumers of Sustainalytics’ research could confuse as indicating a conclusive legal assessment.

More neutral language, such as “Aligned” and “Not Aligned,” better describes the nature of Sustainalytics’ ratings. One Sustainalytics analyst trained as an attorney shared her recommendation of this approach with others at Sustainalytics, and also recognized that the UN Global Compact and OECD guidelines are not binding on companies, and that international conventions and treaties are only binding on the states that ratified them. We recommend that Sustainalytics add statements to its research reports that transparently identify and acknowledge

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<sup>201</sup> See, e.g., ESG Spotlight: Race, Ethnicity and Public Equity: A Global Snapshot (July 14, 2021) at 9, <https://connect.sustainalytics.com/esg-spotlight-race-ethnicity-and-public-equity> (“Sustainalytics does not assess any issuer’s compliance with (local) legislation, but only provides an indication of the expected impact the reported allegations may have for businesses.”).

qualitative judgments that are being made, including on issues related to the Israeli/Palestinian conflict, to assure actual objectivity and preserve the appearance of objectivity.

2. Promote Accuracy and Protect Transparency and Objectivity of Sustainalytics Sources

To assure source transparency and objectivity, Sustainalytics should take steps to: (1) disclose all sources in all products; (2) expand sources to include more diverse perspectives where possible; (3) provide routine information updates to all research analysts regarding sources that have been determined to be false and inaccurate; (4) provide training to all analysts about how to uncover bias in sources; and (5) regularly review the Incidents list of unreliable sources to ensure that sources are eliminated for propagating false or patently biased information.

Sustainalytics products—other than HRR—generally already consistently disclose the underlying sources used. Where possible, Sustainalytics researchers should look to expand sources covering issues related to the Israeli/Palestinian conflict areas in order to ensure the research captures the spectrum of diverse perspectives. Sustainalytics also should recognize and specifically confront the challenges its research analysts face when conducting research related to the Israeli/Palestinian conflict areas. Sustainalytics research analysts described the high volume of sources voicing strong opinions on the Israeli/Palestinian conflict. Examples include *Electronic Intifada* and BDSMovement.net, sources that Sustainalytics deemed so extreme and partial with respect to information regarding these issues that Sustainalytics removed them from its research products and prohibited analysts from using the sources in the future. Sustainalytics employees familiar with this issue caution, however, that it is not prudent to try to eliminate all sources that have a viewpoint on the Israeli/Palestinian conflict, as doing so would effectively result in having few—if any—sources on this issue. Sustainalytics analysts should be specifically trained on how to conduct their research with a sensitivity towards identifying and weighing source bias, and

preventing source bias from affecting their conclusions. This already is done to a degree in the Incidents team's approach to weighing specific sources when assessing and scoring a particular incident. We note that Sustainalytics does cite to publications that might be considered pro-Israel, including *The Jerusalem Post*.

Certain sources, such as Who Profits, have a pro-Palestinian viewpoint and are still used as a source across several products. Sustainalytics researchers explained that they think critically about the information gathered from Who Profits because of the organization's known perspective on the Israeli/Palestinian conflict. However, they expressed reluctance to disregard Who Profits as a source entirely, in part because it provides a boots-on-the-ground perspective regarding the Israeli/Palestinian conflict areas due to its physical presence there; this perspective would otherwise be absent from Sustainalytics research. Several Sustainalytics employees made this observation about the value of information provided by Who Profits and the ability of the experienced Sustainalytics research team to weigh Who Profits' perspective on these issues in considering the information Who Profits provides.

One Sustainalytics employee explained that the Incidents team keeps a running list of watchlist and blacklisted sources. Similar lists for the HRR and GSS products have been discussed, but not completed. To the extent that sources are eliminated because they report objectively false information, keeping track of those types of sources is sound policy and should be communicated formally to all research teams to promote coordination and consistency in source usage across products. That said, Sustainalytics should not necessarily eliminate sources merely for having a perspective. Rather, Sustainalytics should train analysts from every product group on the use of biased sources and educate them on the biases other researchers have previously identified.

We recommend that Sustainalytics take steps to preserve the objectivity and transparency of its sources by ensuring source disclosure, by regularly expanding the universe of the sources being considered, eliminate false, extreme, and inaccurate sources across all product lines, and by routinely training its research analysts on how to conduct objective, reliable research against the backdrop of potential source bias.

**B. *Maintain Consistency: Adjust Processes to Enforce and Monitor Internal Consistency and Adherence to Methodology***

1. Consolidate Methodology for All Sustainalytics Products Under a Unified, Metrics-Driven Methodology Department

Sustainalytics should bring oversight for GSS and GSE methodologies under Sustainalytics' Methodology and Product Architecture team (the "Methodology team").<sup>202</sup> A rigorous, data-driven, tested, and transparent research methodology is Sustainalytics' best defense against accusations of bias. This is already built out within the dedicated Methodology team, which develops, tests, and publishes the methodology for the ESG Risk Ratings, as well as specific processes within the Controversies Research.

Currently, GSS, GSE, HRR, and Bespoke Research operate outside of Sustainalytics' Methodology team. These products also are much more qualitative in terms of the approach, their methodologies are generally not driven by quantitative data, and their outcomes are not statistically tested. Sustainalytics employees already anticipate that the Methodology team will eventually oversee methodology for all Sustainalytics products. Sustainalytics employees have explained that the process of onboarding additional products into the Methodology team will take time and resources, and that the innovation (new product development) side of the Methodology team

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<sup>202</sup> Other Sustainalytics products—including ESG Risk Ratings and the Controversies Research product—are a collaboration between the Methodology and Product Architecture team and the Research team. The Methodology and Product Architecture team sets the overall structure and methodological considerations for the product, while the Research team designs the individual indicators and conducts the research. Indicators are tested by the Methodology team, but the Research team owns the actual ratings deliberation and output.

currently demands a great deal of the department's resources. Nevertheless, given the importance of Sustainalytics maintaining transparent, objective, analytics-based processes for all of its products, we recommend that Sustainalytics allocate additional resources to the Methodology team to allow this important restructuring to occur as expeditiously as possible.

After the Methodology team determines the analytical frameworks, Sustainalytics research leaders are responsible for filling in the methodology framework with the research content for their respective products, and already make some content-related methodological decisions. Accordingly, it also may be necessary to allocate additional resources to the research teams in order to allow them to work cooperatively with the Methodology team to animate the methodology frameworks for the products brought within the Methodology team's oversight. We recommend creating a role within the Methodology team to oversee GSS, GSE, HRR and Bespoke Research (if Sustainalytics continues to offer these products), and any other future products involving qualitative judgments, to ensure that Sustainalytics products meet standards of transparency, objectivity, and analytics-based ratings assessments.

## 2. Develop a Style Guide and Research Guidance on Issues Related to the Israeli/Palestinian Conflict Areas

Morningstar and Sustainalytics should focus efforts and resources on formulating a style guide and research/ratings guidance for analysts, particularly in connection with issues related to the Israeli/Palestinian conflict areas, to ensure that the language in its research products avoids even the appearance of bias or a lack of objectivity. Sustainalytics should develop the style guide with assistance from experts on different sides of the Israeli/Palestinian debate and should leverage Sustainalytics' analysts with relevant experience and expertise. Such guidance should include an examination of the language used in describing issues related to the Israeli/Palestinian conflict areas. In particular, Sustainalytics should carefully consider the terminology used to refer to the



region in question with particular attention to avoiding confirmation bias and the projection or perception of bias. Where possible, it could refer to specific regions by their geographic names (i.e., the West Bank, Gaza, East Jerusalem, etc.). Where territories are necessarily referred to as “occupied” or “disputed” territories, the label should be annotated with an explicit explanation as to why and from what source Sustainalytics has adopted that particular term, as opposed to presenting the modifier as an independent or qualitative judgment. Sustainalytics should develop mechanisms to enforce the most consistent possible use of territory-labeling language, including by promulgating an expanded style guide. The style guide should assist Sustainalytics in discussing regions with greater precision and sensitivity (for example, by not referring to the Golan Heights as being part of the Israel/Palestinian conflict when that particular location is subject to a dispute between Israel and Syria—not the Palestinian populations), thus reducing the presentation or appearance of bias.<sup>203</sup>

In addition, Sustainalytics should devise formal written research/ratings guidance for analyzing issues relating to the Israeli/Palestinian conflict areas. Many Sustainalytics employees stated that Sustainalytics could benefit from more formal written guidance in general and on issues related to the Israeli/Palestinian conflict areas specifically, in particular for Controversies Research and GSS. Sustainalytics, to its credit, already has developed some formal written guidance. As discussed, the Incidents team has guidance for scoring incidents related to Israeli/Palestinian conflict areas and other disputed territories. In addition, GSS currently provides internal guidance for research analysts that instructs them in how to assess the severity and exceptionality of

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<sup>203</sup> See, e.g., Maayan Lubell, *Explainer: What is the significance of the Golan Heights*, Reuters (Mar. 21, 2019), <https://www.reuters.com/article/us-usa-israel-golanheights-explainer/explainer-what-is-the-significance-of-the-golan-heights-idUSKCN1R22IR>.

particular circumstances and issuer conduct in the Israeli/Palestinian conflict areas.<sup>204</sup> Sustainalytics should complete the process of supplying every research team with formal written guidance on issues related to the Israeli/Palestinian conflict areas, and develop a comprehensive style guide to use to ensure uniformity in the language used to discuss this conflict.

### 3. Substantially Revise or Eliminate the Human Rights Radar Product

Sustainalytics should substantially revise or eliminate the HRR product. As discussed in detail in Section V(B)(4) above, HRR is a direct deliverable that is updated quarterly and distributed to clients in a native file. The product currently lacks an independently developed methodology as well as procedural safeguards needed to ensure transparency and objectivity. This could result in third parties viewing HRR as impaired by value judgments or bias favoring one side in the Israeli/Palestinian conflict. HRR also focuses on only a few geographic regions and was found to have a latent, disproportionate focus on the Israeli/Palestinian conflict which results in biased outcomes disfavoring companies doing business in Israel.

The origin of HRR and the genesis of its methodology are problematic from a bias perspective. HRR grew out of bespoke research reports commissioned primarily by a single client. The client drove the methods and controlled the scope and targets of the original research.<sup>205</sup> HRR eventually evolved into a product available to a broader client base, but the methodology for the broader product formed around pre-existing research rather than de novo. HRR is unique in this aspect among Sustainalytics products, as Sustainalytics developed its other products from the

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<sup>204</sup> This also includes guidance on geographic regions like Xinjiang, and Myanmar as well as subject-matter guidance on topic such as bribery/corruption and human rights implications in supply chain issues.

<sup>205</sup> An early version of HRR even stated that it was developed in collaboration with the Sustainalytics client, though that reference was later eliminated.

ground up, building the methodologies and research processes and protocols from original work product.

Notably, HRR focuses disproportionately on the Israeli/Palestinian conflict areas relative to other “high-risk” countries and conflict areas covered by the product.<sup>206</sup> As discussed above, Sustainalytics identifies the countries and territories covered in HRR based on the Freedom House annual “Freedom in the World Report,” and analyzes companies operating in the countries with the worst aggregated score for political and civil rights (according to the Freedom House report), as well the five lowest-scoring disputed territories.<sup>207</sup> After identifying the covered countries and territories, HRR analysts then identify the specific sectors with the highest risk of violating human rights in those countries and territories, and from there identify the specific companies covered in HRR.<sup>208</sup> HRR’s methodology identifies five high-risk sectors for the “Occupied Palestinian Territories,”<sup>209</sup> while the number of high-risk sectors identified for the other countries and territories covered by HRR range between two and four per territory/country. A comparative review of companies rated by HRR in Q4 2021 also reveals that 29% of entities—forty-two total—are rated primarily for involvement in the “Disputed territory of Palestine,” nearly 10% more than the next covered territory (“Disputed territory of Western Sahara,” at 18%).<sup>210</sup> Even when

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<sup>206</sup> See *supra* § V(D)(2).

<sup>207</sup> As stated above, with respect to the covered disputed territories, HRR currently only includes the “Tibet Autonomous Region, Non Self-Governing Territory of Western Sahara, and OPT,” notwithstanding the approach articulated in the product’s methodology. See *supra* § V(B)(4). Thus, HRR has not yet fulfilled its commitment with respect to the covered disputed territories. Notably, Sustainalytics employees who have worked on HRR stated that clients have asked Sustainalytics to cover additional high-risk regions, but Sustainalytics has generally refused, with the exception of adding Myanmar. See *supra* § V(B)(4).

To note, the Freedom House report actually covers Gaza and the West Bank as separate disputed territories, however a Sustainalytics employee explained that the two were combined into a single classification (the Occupied Palestinian Territories) for HRR due to resource constraints.

<sup>208</sup> These sectors are industrials, materials, telecommunication services, financials, and consumer goods. See *supra* § V(B)(4).

<sup>209</sup> Of the other disputed territories assessed by HRR, the applicable high-risk sectors for Tibet are materials, industrials (transportation), and telecommunication services. For Western Sahara, the applicable high-risk sectors are energy, materials, and industrials (aerospace & defense).

<sup>210</sup> See *supra* § V(D)(2). Data reflects the filtering described *supra* § V(D)(1).

considering *all* HRR ratings, and not just the primary (i.e., “Country 1”) ratings, the “Disputed territory of Palestine” is still the most-cited location.

In addition, HRR sometimes uses inflammatory language and fails to clearly and consistently provide sourcing attribution. For example, in one HRR report from the fourth quarter of 2021, HRR used language that Israel’s military intelligence unit has “in-house technology for coercive spying tactics.” This statement makes an apparent value judgment as to the Israeli military without source attribution, adding to the perception that the product’s evaluative process is impacted by confirmation bias.

By way of further example, another HRR report from the fourth quarter of 2021 stated that the Israeli Navy’s protection of oil fields is associated with “severe human rights violations . . . as well as the violation of the right to livelihood through making the Palestinian fishing waters inaccessible to fisherman.” Again, this statement was offered without source attribution or reference to an applicable international norm, and gives rise to the perception that it reflects an evaluative judgment made with confirmation bias.

We interviewed Sustainalytics employees and executives about the HRR product. Uniformly, the employees desired more guidance and training in research and methodologies. Importantly, none of the Sustainalytics employees familiar with HRR expressed personal bias or even any viewpoint on the Israeli/Palestinian conflict. In fact, Sustainalytics employees with HRR responsibilities often sought added resources to make HRR a better product. Nevertheless, as those who worked on HRR acknowledged, Sustainalytics does not currently robustly or rigorously test the conclusions reached by its HRR analysts. Unlike other Sustainalytics products, HRR currently lacks an oversight body and has no formal checks and balances to ensure the accuracy and

objectivity of HRR's conclusions. HRR also lacks any mechanism to ensure consistency between the facts and conclusions in HRR and other Sustainalytics products.

Multiple Sustainalytics employees described the lack of quality control functions in HRR, including the lack of formal review process and analyst guidance. This was primarily due to lack of resources; HRR has reportedly historically had too many deliverables and too few staff. Although HRR managers are working to develop a formal HRR oversight committee and formal review processes for the product, those mechanisms have not yet been implemented. One Sustainalytics employee familiar with HRR stated that certain HRR guidance documents that had been promised had not been provided yet because they had not been created due to time constraints. The same employee stated that HRR analysts do not use existing Sustainalytics guidance regarding the Israeli/Palestinian conflict from other products as references.

To avoid biased outcomes in the product, substantial improvements to the HRR product are necessary to revise problematic language, address absent sourcing, increase the range of regions covered by the product, and provide formalized guidance documents. As currently configured, the product was found to have a latent, disproportionate focus on the Israeli/Palestinian conflict which results in biased outcomes disfavoring companies doing business in Israel, and suffers from foundational methodological problems not present in any other Sustainalytics products which result in diminished objectivity and transparency as compared to all other Sustainalytics products. Our recommendation therefore is to either substantially revise or discontinue the HRR product.

#### 4. Eliminate Bespoke Research

We recommend that Sustainalytics eliminate the bespoke research offering. Bespoke research is commissioned by individual clients on issues identified by the client for either an hourly or a flat fee.<sup>211</sup>

We have not been able to identify any formal guidelines for Sustainalytics' acceptance or rejection of bespoke research requests. Nor have we found there to be any standardization of guidelines for bespoke research or any formal review of bespoke assignments. One Sustainalytics employee familiar with bespoke research stated that the decision to accept a bespoke assignment was a management decision, but could not point to any clear policies or guidelines that applied. The same employee stated that she thought that management generally checked bespoke research reports before they were delivered to the client, but was not sure that was always true and agreed there was no formal guidance for bespoke research projects (which may not even be practical given the sui generis nature of the variety of potential inquiries). This lack of formal criteria and processes around the selection of bespoke projects, and the execution of those projects, allows for a lack of objectivity and consistency in bespoke research.

Anticipation of a regulated ESG environment in the future also weighs in favor of the elimination of bespoke research. As an initial matter, bespoke research can create an appearance of a conflict of interest and lack of objectivity, as the research is conducted according to the client's individual goals and requirements. Further, accepting bespoke research assignments could put Sustainalytics in the position (to the extent the client requesting the bespoke research is a rated company) of accepting funds from a company in its ratings universe to opine on specific topics. Indeed, as discussed above, the issue of why ESG ratings deviate systematically and whether there

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<sup>211</sup> See *supra* § V(B)(6).

are economic incentives to adjust ratings already is an area of critique within the industry.<sup>212</sup> The existence of paid, custom work for a ratings client implicates this concern and may create the appearance of a conflict of interest.

We considered suggesting revisions to the bespoke research product to formulate guidelines for the acceptance and rejection of this type of research and to institute a formal review process. However, bespoke research may disproportionately implicate conflict regions, may be more often requested by clients who have a perspective on heavily politicized issues, and can create the appearance of conflict in accepting funds from rated clients, even if the bespoke research services are successfully screened from the ratings services. The specific parameters of bespoke research work could also be difficult to reconcile with a universally consistent set of internal controls and processes. Because these factors cause bespoke research to fail to meet standards of transparency, consistency, and objectivity, our recommendation is to eliminate bespoke research.

**C. *Ensure Objectivity: Implement Robust Structural and Procedural Controls to Identify, Disclose, and Mitigate Actual or Perceived Conflicts of Interest***

1. Establish Appropriate Screening Mechanisms between Engagement Services and Ratings Decisions

Given the potential of a conflict of interest between engagement and Sustainalytics' ratings decisions, as described further below, we considered recommending that Sustainalytics cease offering GSE. Eliminating engagement services would neutralize any future allegations of bias with respect to Sustainalytics' selection of engaged companies, and would ensure that there could be no criticism of Sustainalytics' ratings decisions based on potential conflicts with engagement services. We have determined, however, that a compliance department-enforced screen, consisting

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<sup>212</sup> See, e.g., Florian Bing et al., *Aggregate Confusion: The Divergence of ESG Ratings*, SSRN (updated Apr. 15, 2022) at 20, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3438533](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533).

of robust procedural and structural controls between engagement services and ratings decisions, is sufficient to address concerns as to ratings objectivity.

Therefore, to the extent Morningstar decides to continue offering engagement and other stewardship services, we recommend that GSE and the other Sustainalytics engagement services be screened from ratings decisions through a set of robust procedural and structural controls. Currently, Sustainalytics engagement services include GSE, Material Risk Engagement, and Thematic Engagement. As discussed in Section V(B)(3) above, GSE is Sustainalytics' stewardship-based engagement product, in which GSE engagement managers reach out to companies that have GSS ratings of Watchlist or Non-Compliant and consult directly with the companies to improve the practices that gave rise those GSS ratings. For Material Risk Engagement, company engagement is based on an issuer's poor ESG Risk Rating, relative to that issuer's subindustry peers. In Thematic Engagement, engagement managers conduct engagement with groups of companies that share certain thematic issues, such as child labor in the cocoa industry supply chain, based on the sector(s) that are specifically implicated or are central to developments in the engagement theme.

Our investigation focused on the GSE product because it was the engagement service that included analysis of human rights issues related to company operations in the Israeli/Palestinian conflict areas. However, we understand that Sustainalytics is in the midst of expanding and diversifying its other stewardship offerings.<sup>213</sup> Furthermore, articles on Sustainalytics' website actively promote positive developments from engagement leading to risk ratings improvements.<sup>214</sup>

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<sup>213</sup> See *supra* § V(B)(3).

<sup>214</sup> See, e.g., *What Happens When Companies are Receptive to Investor Feedback on ESG?* dated Feb. 10, 2022, <https://www.sustainalytics.com/esg-research/resource/investors-esg-blog/material-risk-engagement-for-esg-impact> (“Our proactive approach generates better risk management systems . . . and reduces the exposure to negative impacts for ESG and brand reputation. What’s more, these results are measurable using our ESG ratings research.”).



Allowing engagement progress (or lack thereof) to impact an issuer’s ratings in other Sustainalytics products could give rise to a potential conflict of interest, or at the very least, the appearance of conflict and lack of objectivity. Accordingly, Sustainalytics should develop structural and procedural screens that ‘wall off’ information generated by GSE and the other engagement services from Sustainalytics ratings decisions in other products. Sustainalytics needs to implement robust procedural and structural controls that (1) prevent the flow of information (or, indeed, the appearance that information can flow) from the engagement services to ratings products; (2) strictly control the receipt, storage, and distribution of material nonpublic information (“MNPI”) obtained by Sustainalytics in the course of an engagement; and (3) control or eliminate any incentives in the ratings products that depend on issuer performance in the engagement services, and vice-versa.

We have not identified methodological problems with the GSE product that demonstrate a lack of objectivity. GSE does not engage with companies based on any BDS lists or other externally generated criteria. GSE has a formalized oversight and review process<sup>215</sup> and is funded by investor-clients rather than the companies with which Sustainalytics engages. Processes in place for GSE include weekly meetings of GSE engagement managers in which the engagement managers discuss their cases and share their diverse perspectives on the issues they are confronting.<sup>216</sup> The discussions were described by many as spirited and productive, involving employees with diverse areas of expertise and perspectives. The engagement managers we spoke with appreciated the complexity of issues related to the Israeli/Palestinian conflict areas, and none demonstrated personal bias on either side of the conflict. One engagement manager stated that

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<sup>215</sup> See *supra* § V(B)(3).

<sup>216</sup> See *supra* § V(B)(3).

when she joined Sustainalytics, she was explicitly told as part of the onboarding process that there was no room for activism in performing her job.

GSE's objectivity in working with engaged companies regarding the Israeli/Palestinian conflict areas is enhanced by the fact that, in many instances, GSE is not required to determine the human rights standards and commitments that apply to companies with which they engage. Rather, GSE engagement managers explained that engagement often focused only on working with the companies to meet the standards they themselves have signed onto publicly, through corporate statements on their website or in other public documents, or by virtue of commitments they make in order to be listed on the New York Stock Exchange or other exchanges.

There also are only a handful of companies (four, total) for which there is currently GSE engagement based on issues related to the Israeli/Palestinian conflict areas. GSS rates all four of these companies "Watchlist." None are rated "Non-Compliant." This is out of a total of 519 total companies that GSS rates "Watchlist" and "Non-Compliant" in GSS overall, and 122 total companies rated either "Watchlist" or "Non-Compliant" with respect to Principle 2 of the UNGC.<sup>217</sup> Of those four companies, two have a GSS status and GSE engagement based largely on human rights issues other than the Israeli/Palestinian conflict (such as mining concerns in Myanmar). Further, as noted above, our statistical comparison revealed that the volume of GSE engagements for issues related to the Israeli/Palestinian conflict areas is comparable to the number of engagements involving human rights issues with companies operating in China, Myanmar, Russia, Saudi Arabia, and Western Sahara.<sup>218</sup> Overall, we did not identify any methodological

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<sup>217</sup> Under Principle 2 of the UNGC, businesses should make sure that they are not complicit in human rights abuses. *See The Ten Principles*, UN Global Compact, <https://www.unglobalcompact.org/what-is-gc/mission/principles>.

<sup>218</sup> *See supra* § V(D)(4).

problems with the GSE product that suggest a bias in its approach to issues related to the Israeli/Palestinian conflict areas, or in its outcome.

Based on interviews with engagement managers, Sustainalytics' overall approach to engagements related to the Israeli/Palestinian conflict areas is measured and pragmatic. One engagement manager stated that, in dealing with these issues, his goal was to find a way to engage with the companies that provided the companies with meaningful options for how to change conduct deemed to present human rights issues, instead of ignoring or refusing to work with such companies. With one of the Watchlisted companies, for example—whose heavy machinery was alleged to have been adapted post-sale to be used to demolish homes in the West Bank and to facilitate jade mining in Myanmar—Sustainalytics did not advocate that the company relinquish opportunities to sell its products, but rather encouraged the company to put pressure on some of its larger dealers with respect to scrutinizing their buyers (“Know-Your-Customer” processes). This approach is nuanced and practical, and evidences Sustainalytics' understanding of the company and its business.

Nevertheless, the nature of the GSE engagement managers' work with engaged companies could create the appearance of a lack of objectivity in Sustainalytics' ratings products for those same engaged companies. This issue applies to Sustainalytics' other engagement products as well. To ensure transparency and objectivity in GSE and in Sustainalytics ratings products, and to avoid potential conflicts of interest, Sustainalytics should screen GSE and the other engagement products from Morningstar and Sustainalytics ratings decisions as well as from all client-facing, paid ESG compliance services.

Some Sustainalytics employees spoke about the existence of a so-called ‘wall’ between engagement and ratings services, while others denied that such a wall exists. To the extent that a

wall exists as a matter of ad hoc procedure currently, it appears to be focused on protecting material non-public or confidential information provided by the rated issuers in the context of the GSE engagement (e.g., by making sure that information did not make it into Sustainalytics' research products on Global Access and in client-facing reports). Sustainalytics employees familiar with GSE explained that if an issuer designates information provided to GSE as confidential, then the information is only available to GSE. The 'wall' that currently exists between GSS and GSE falls short of fulfilling the screening we recommend. However, the fact that GSE and GSS already have processes in place to screen confidential information provided to GSE from GSS provides strong indication that a true information screening process that blocks information generated in engagement from being used in ratings decisions could be successfully adopted.

Currently there is a significant amount of coordination between GSS and GSE, and GSS and GSE analysts frequently collaborate on ratings decisions for companies. Several Sustainalytics employees have stated that GSE does not perform its own research, but relies on GSS research. Furthermore, many decisions for the two products are made by the same committee (GSOC), and representatives of GSS and GSE, as well as representatives from the Controversies Research product, who also sit on the Events Oversight Committee, regularly attend these meetings. Public Sustainalytics materials also acknowledged the close relationship between GSE and GSS. For example, the Sustainalytics' client publication from September 2020, "Global Standards Screening and Engagement Approach to Analyzing Companies Operating in Occupied Palestinian Territories (OPT)," mentions the close connection between the GSS product and the GSE product: "Sustainalytics' Global Standards Screening (GSS) forms the basis of our Global Standards Engagement (GSE) service, where we engage with Non-Compliant and Watchlist companies on behalf of investors. Since the launch of these two enhanced products in Q3 2019,

we have been working on bringing them into full methodological alignment for the benefit of our clients.” Such public statements suggest that there has been no historical independence between GSS and GSE.

The recommendation to screen GSE and the other engagement services from Sustainalytics’ ratings decisions is not necessarily one to abolish all coordination between GSS and GSE. There is no reason, for example why they could not continue to share research or meet in the GSOC committee. However, to assure actual objectivity, as well as the appearance of objectivity, between engagement with and ratings of the same companies, GSS ratings decisions must be screened from GSE engagement information.

Setting up a screening process between GSE and the other engagement products, and GSS and Sustainalytics’ other rating products has the benefit of preparing Morningstar and Sustainalytics to function in a future regulated environment. Academics studying the ESG rater industry already have discussed the “Rater Effect” (or “Halo Effect”), whereby ratings are skewed when performance of a company in one category influences perceived performance of the company in other categories.<sup>219</sup> GSE engagement with companies rated by GSS, combined with the substantial overlap between the GSS and GSE teams, may be viewed as exacerbating the possibility of a perception of biased results due to the Rater Effect. Furthermore, potential ESG regulation may involve requirements related to conflicts of interests, which could impact the future provision of engagement services and interaction with ratings products.

In addition, we have identified steps that Sustainalytics should take to standardize engagement practices, in order to avoid reputational risk. Currently, if issuers decline to participate in the engagement with GSE, Sustainalytics engagement managers may draft letters for client-

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<sup>219</sup> See Florian Bing et al., *Aggregate Confusion: The Divergence of ESG Ratings*, SSRN (updated Apr. 15, 2022) at 18, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3438533](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533).

investors to co-sign stating how important it is for the company to cooperate with GSE, and may follow up with an additional letter drafted for the signature of multiple investor-clients if the issuer continues not to cooperate. The practice of drafting such statements on behalf of investors and sending to companies on investor letterhead is not likely to survive post-regulation and suggests insufficient governance focused on maintaining objectivity. It may also run afoul of the intent of certain anti-BDS legislation in the United States.

In order to conduct stewardship services while avoiding the risk of actual or perceived bias, the content of engagement correspondence should also be monitored. We understand that GSE has a template letter used to inform issuers that GSE will be issuing an engagement status of “disengage” with respect to that issuer due to poor or no progress on an engagement, or poor or no response from the issuer after two years after the start of the engagement.<sup>220</sup> However, some of the engagement managers with whom we spoke described diverging approaches to correspondence with an engaged company regarding the company’s lack of cooperation, or in the few instances in which a company’s continued lack of cooperation makes it necessary for Sustainalytics to disengage with the company. One engagement manager said the general practice was to send at least one or two communications to a company to notify the company that it was not making progress in the engagement. Another engagement manager stated that if, after a first letter from investors, a company remained uncooperative, he would send a second letter signed by three investors stating that if a company was designated as “disengaged” by Sustainalytics, it could result in divestment by Sustainalytics’ client-investors.

Engagement services can be provided without demonstrating bias or enhancing the perception of bias, however, to do so, Sustainalytics should promulgate and enforce specific

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<sup>220</sup> See *supra* § V(B)(3).

guidelines for engagement managers about the process of corresponding with issuers that are not cooperating in the engagement, or with which Sustainalytics is disengaging. This should include consistent use of a standard letter and a process by which the client-investor signatories take greater ownership of the content of the letter. Sustainalytics should also develop specific guidance for the language engagement managers use with uncooperative companies. Specifically, to ensure that Sustainalytics does not run afoul of anti-BDS legislation, Sustainalytics must prohibit engagement managers from including language in oral or written correspondence with an issuer that suggests disengagement could lead to divestment by Sustainalytics' investor-client.

Standard procedures for communicating with engaged companies, particularly uncooperative companies and those with which Sustainalytics is disengaging, are all the more critical because Sustainalytics commendably already provides all written correspondence and summaries of oral correspondence between the Sustainalytics engagement team and the engaged issuers is available through Global Access. If not meticulously scripted and crafted, this correspondence could be accessed and used by critics to argue that Sustainalytics was counseling divestment by the investor-client. Sustainalytics also should recognize that even after it has protected itself from any suggestion that it is advancing divestment, critics on different sides of the Israeli/Palestinian conflict may use correspondence with engaged companies to argue either that Sustainalytics is too aggressive or not aggressive enough with human rights issues related to the Israeli/Palestinian conflict areas.

We do not recommend changes to GSE methodology (with the exception of formalization of company correspondence noted above) as we have found no indication of biased outcomes or lack of formal processes in relation to the Israeli/Palestinian conflict areas, that cause the product to fall short of standards of transparency and objectivity. Our recommendation is to screen GSE

and other engagement services from ratings decisions, which will better position Sustainalytics to avoid appearances of conflict of interest and prepare for the possibility of future regulation.

2. Retain an Ombudsperson Responsible for Responding to External Inquiries from Non-Client, Non-Issuer Third Parties

Sustainalytics should allocate the resources to designate an ombudsperson who is tasked with investigating and responding to third-party inquiries and feedback. The Sustainalytics process for such external inquiries has historically been informal and relied heavily on a few individuals. As Sustainalytics expands, this ad hoc, informal approach to complaints from third parties that are neither clients nor issuers is no longer viable.<sup>221</sup> The role of the ombudsperson could be structured to fit within the existing compliance framework, with a direct reporting line through Morningstar's Global Chief Compliance Officer to Morningstar's Board of Directors.<sup>222</sup>

Multiple Sustainalytics employees described formalized procedures for client complaints and relations, as well as the more recently developed issuer relations processes. However, no such formal process exists for receiving and addressing external complaints from non-client, non-issuer third parties. An ombudsperson who operates independently of the research and commercial teams and is given broad, protected investigative powers will promote early identification of, and intervention in external concerns, reducing the risk of escalation and improving the management of external communications. That individual should be provided with the issue-specific documents and guidance discussed above, and should be introduced to the Sustainalytics employees with the

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<sup>221</sup> See Office of the UN High Commissioner on Human Rights, UN Guiding Principles on Business and Human Rights, Principle 31 & cmt. (h), U.N. Doc. HR/PUB/11/04 (2011) (explaining that “a business enterprise cannot, with legitimacy, both be the subject of complaints and unilaterally determine their outcome” and describing criteria for effective non-judicial grievance mechanisms, including accessibility, transparency, and consultation with relevant stakeholders).

<sup>222</sup> See Standards of Practice §§ 2.1-2.2, International Ombuds Association (Mar. 17, 2022), [https://ioa.memberclicks.net/assets/docs/SOP-COE/IOA\\_Standards\\_of\\_Practice\\_English.pdf](https://ioa.memberclicks.net/assets/docs/SOP-COE/IOA_Standards_of_Practice_English.pdf) (“The Ombuds operates independently of line and staff reporting structures and without influence from other functions or entities within the organization. The Ombuds program reports to the highest authority possible within the organization. In executing the Ombuds’ role and responsibilities, the Ombuds does not report programmatically to any function that affects, or is perceived as affecting, the Ombuds’ independence.”).



most experience in the relevant subjects. This individual should also be tasked with coordinating with Morningstar's and Sustainalytics' communications teams on any third party complaints, and involved with the Morningstar / Sustainalytics' joint response. We recommend that the ombudsperson oversee the ultimate response to third party complaints.

## **VII. CONCLUSION**

White & Case has concluded its investigation and presents the findings and recommendations herein to Morningstar's Board of Directors. Morningstar's commendable decision to devote substantial resources, time, and energy to a process that would open their ESG research, ratings products, and services to external scrutiny reflects the company's genuine commitment to industry leadership in an uncertain regulatory environment. The findings and recommendations herein reflect the independent work product and judgment of White & Case LLP.

## ANNEXES

### I. GLOSSARY OF ACRONYMS USED IN THIS REPORT

| <b>Term</b> | <b>Definition</b>                                    |
|-------------|--|
| ADL         | Anti-Defamation League                               |
| AMAC        | Asset Management Advisory Company                    |
| BDS         | Boycott, Divestment, Sanctions                       |
| BPPG        | Best Practice Principles Group                       |
| EO          | Executive Order                                      |
| EOC         | Events Oversight Committee                           |
| ESG         | Environmental, Social, and Governance                |
| FCA         | United Kingdom Financial Conduct Authority           |
| FSB         | Financial Stability Board                            |
| GSE         | Global Standards Engagement                          |
| GSOC        | Global Standards Oversight Committee                 |
| GSS         | Global Standards Screening                           |
| HRR         | Human Rights Radar                                   |
| ICA         | Investment Company Act of 1940                       |
| IFRS        | International Financial Reporting Standards          |
| IHRA        | International Holocaust Remembrance Alliance         |
| IIPB        | Illinois Investment Policy Board                     |
| IOSCO       | International Organization of Securities Commissions |
| ISSB        | International Sustainability Standards Board         |

|                 |   |
|-----------------|---|
| MNPI            | Material Nonpublic Information                            |
| OECD Guidelines | OECD Guidelines for Multinational Enterprises<br>Chapters |
| OHCHR           | Office of the High Commissioner for Human Rights          |
| SASB            | Sustainability Accounting Standards Board                 |
| SEC             | Securities and Exchange Commission                        |
| SFDR            | Sustainable Finance Disclosure Regulation                 |
| UN              | United Nations  |
| UNGC            | United Nations Global Compact                             |
| UNHRC           | United Nations Human Rights Council                       |
| UNGPs           | UN Guiding Principles on Business and Human<br>Rights     |
| UN PRI          | UN Principles for Responsible Investment                  |

## II. INTERNATIONAL NORMS, GUIDELINES, AND REGULATIONS INFORMING SUSTAINALYTICS' RESEARCH PRODUCTS AND METHODOLOGIES

### A. United Nations Global Compact (“UNGC”) Principles

The UNGC is a non-binding, voluntary United Nations pact designed to encourage businesses and firms to embrace socially responsible policies. The UNGC launched in 2000 by former UN Secretary-General Kofi Annan “with commitments from 44 global companies, two labour organizations, 12 civil society representatives and six business associations.”<sup>223</sup> More than twenty years later, over 10,000 companies have committed to upholding the principles of the UNGC.<sup>224</sup> The UNGC is embodied in a set of ten Principles derived from the Universal Declaration of Human Rights, the International Labour Organization’s Declaration on Fundamental Principles and Rights at Work, the Rio Declaration on Environment and Development, and the United Nations Convention Against Corruption.<sup>225</sup> These principles fall into four categories: human rights, labor, environment, and anti-corruption.<sup>226</sup> GSS’ assessments of companies operating in the Israeli/Palestinian conflict areas are most often linked to the Human Rights Principles (specifically, to Principle 2).

Below is the list of UNGC Principles and the categories to which they correspond:

- Human Rights: Principles 1-2
  - Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights, and
  - Principle 2: make sure that they are not complicit in human rights abuses.

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<sup>223</sup> United Nations Global Compact 20th Anniversary Campaign Overview Presentation, UN Global Compact (2020), <https://d306pr3pise04h.cloudfront.net/docs/publications%2FUN-Global-Compact-20th-Anniversary-Campaign-Infosheet.pdf>.

<sup>224</sup> United Nations Global Compact 20th Anniversary Campaign Overview Presentation, UN Global Compact (2020), <https://d306pr3pise04h.cloudfront.net/docs/publications%2FUN-Global-Compact-20th-Anniversary-Campaign-Infosheet.pdf>.

<sup>225</sup> See *The Ten Principles*, UN Global Compact, <https://www.unglobalcompact.org/what-is-gc/mission/principles>.

<sup>226</sup> See *The Ten Principles*, UN Global Compact, <https://www.unglobalcompact.org/what-is-gc/mission/principles>.

- Labour: Principles 3-6
  - Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;
  - Principle 4: the elimination of all forms of forced and compulsory labor;
  - Principle 5: the effective abolition of child labor; and
  - Principle 6: the elimination of discrimination in respect of employment and occupation.
- Environment: Principles 7-9
  - Principle 7: Businesses should support a precautionary approach to environmental challenges;
  - Principle 8: undertake initiatives to promote greater environmental responsibility; and
  - Principle 9: encourage the development and diffusion of environmentally friendly technologies.
- Anti-Corruption: Principle 10
  - Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery.

Membership in the UNGC is entirely voluntary.<sup>227</sup> Applicants to the UNGC send a Letter of Commitment to the UN Secretary-General, wherein they commit to implement the UNGC Principles and report annually on their progress.<sup>228</sup> Companies participating in the UN Global Compact span countries across the globe, and are involved in a variety of business sectors and industries.<sup>229</sup> Sustainalytics has been a participant in the UNGC since 2013.<sup>230</sup> Morningstar has been a participant since July 2021.<sup>231</sup>

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<sup>227</sup> See *Frequently Asked Questions*, UN Global Compact, <https://www.unglobalcompact.org/about/faq>.

<sup>228</sup> See *Joining Policy*, UN Global Compact, [https://ungc-communications-assets.s3.amazonaws.com/docs/about\\_the\\_gc/PDF\\_Joining%20Policy\\_01.12.2022.pdf](https://ungc-communications-assets.s3.amazonaws.com/docs/about_the_gc/PDF_Joining%20Policy_01.12.2022.pdf).

<sup>229</sup> See *Our Participants*, UN Global Compact, <https://www.unglobalcompact.org/what-is-gc/participants>.

<sup>230</sup> See *Sustainalytics*, UN Global Compact, <https://www.unglobalcompact.org/what-is-gc/participants/19296-Sustainalytics>.

<sup>231</sup> See *Morningstar, Inc.*, UN Global Compact, <https://www.unglobalcompact.org/what-is-gc/participants/147224-Morningstar-Inc>.

The UN Global Compact is not a “compliance or monitoring body.”<sup>232</sup> There is generally no legal consequence for breaching any of the UNGC Principles. Rather, the only “enforcement” mechanism derives from the Compact’s ability to “delist” participating companies—this happens primarily for integrity reasons, such as for failure to report on progress or failure to engage in dialogue.<sup>233</sup> As of April 2022, the number of companies delisted for failure to communicate progress is 14,653, whereas the number of active participants is 13,889.<sup>234</sup>

### **B. UN Guiding Principles on Business and Human Rights (“UNGPs”)**

The UNGPs are guidelines for States and companies to address human rights abuses. They are based on three pillars: (1) the state duty to protect human rights; (2) the corporate responsibility to respect human rights; and (3) access to remedy for victims of business-related abuses.<sup>235</sup> With respect to the second pillar of corporate responsibility, companies are expected to have a human rights policy statement, make continuous efforts at human rights due diligence, and maintain a structure for remediation in the event of conduct adversely affecting human rights.<sup>236</sup> With respect to international norms, the HRR product is particularly concerned with the corporate responsibility component of the UNGPs.

The framework upon which the UNGPs are based – three pillars focused on protect, respect, and remedy – was developed by Harvard Professor John Ruggie, who was appointed in

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<sup>232</sup>See *Joining Policy*, UN Global Compact, [https://ungc-communications-assets.s3.amazonaws.com/docs/about\\_the\\_gc/PDF\\_Joining%20Policy\\_01.12.2022.pdf](https://ungc-communications-assets.s3.amazonaws.com/docs/about_the_gc/PDF_Joining%20Policy_01.12.2022.pdf).

<sup>233</sup> See *De-listing and Re-joining Policy*, UN Global Compact, [https://ungc-communications-assets.s3.amazonaws.com/docs/about\\_the\\_gc/PDF\\_De-listing\\_and\\_re-joining\\_policy\\_01.12.2022.pdf](https://ungc-communications-assets.s3.amazonaws.com/docs/about_the_gc/PDF_De-listing_and_re-joining_policy_01.12.2022.pdf).

<sup>234</sup> *Compare Our Participants*, UN Global Compact, [https://www.unglobalcompact.org/what-is-gc/participants/search?utf8=%E2%9C%93&search%5Bkeywords%5D=&search%5Bengagement\\_tiers%5D%5B%5D=2&search%5Breporting\\_status%5D%5B%5D=active&search%5Bper\\_page%5D=10&search%5Bsort\\_field%5D=&search%5Bsort\\_direction%5D=asc](https://www.unglobalcompact.org/what-is-gc/participants/search?utf8=%E2%9C%93&search%5Bkeywords%5D=&search%5Bengagement_tiers%5D%5B%5D=2&search%5Breporting_status%5D%5B%5D=active&search%5Bper_page%5D=10&search%5Bsort_field%5D=&search%5Bsort_direction%5D=asc) (with filters “Active” and Participant), *with De-Listed Participants*, UN Global Compact, <https://www.unglobalcompact.org/participation/report/cop/create-and-submit/expelled>.

<sup>235</sup> See *UN Guiding Principles on Business and Human Rights*, Office of the High Commissioner for Human Rights [https://www.ohchr.org/sites/default/files/Documents/Publications/GuidingPrinciplesBusinessHR\\_EN.pdf](https://www.ohchr.org/sites/default/files/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf).

<sup>236</sup> See *UN Guiding Principles on Business and Human Rights*, Office of the High Commissioner for Human Rights [https://www.ohchr.org/sites/default/files/Documents/Publications/GuidingPrinciplesBusinessHR\\_EN.pdf](https://www.ohchr.org/sites/default/files/Documents/Publications/GuidingPrinciplesBusinessHR_EN.pdf).

2005 as a Special Representative by the UN Secretary-General to assist in drafting human rights norms in relation to businesses.<sup>237</sup> Prior to Professor Ruggie’s appointment, the Sub-commission of the predecessor to the UN Human Rights Council, the UN Commission on Human Rights, had developed draft norms in 2004 that were widely opposed by businesses because the norms sought to impose on companies binding obligations and duties under international human rights law that states have themselves.<sup>238</sup> The Commission on Human Rights (later the UN Human Rights Council) decided not to adopt the draft norms, and requested that the UN Secretary General appoint a Special Representative “with the goal of moving beyond the stalemate and clarifying the roles and responsibilities of states, companies and other social actors in the business and human rights sphere.”<sup>239</sup> After years of research and discussions with governments, businesses, and other stakeholders on five continents, Professor Ruggie developed and presented the “Protect, Respect and Remedy” Framework to the Human Rights Council in 2008.<sup>240</sup> The framework was well received by various stakeholders, and the adoption of that framework led to the development of the UNGPs.<sup>241</sup> The UN Human Rights Council unanimously endorsed the UNGPs in 2011.<sup>242</sup>

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<sup>237</sup> *The UN “Protect, Respect and Remedy” Framework for Business and Human Rights*, Business & Human Rights Centre <https://media.business-humanrights.org/media/documents/files/reports-and-materials/Ruggie-protect-respect-remedy-framework.pdf>; John Ruggie, *UN Guiding Principles*, Harvard University, <https://scholar.harvard.edu/john-ruggie/un-guiding-principles>.

<sup>238</sup> *The UN “Protect, Respect and Remedy” Framework for Business and Human Rights*, Business & Human Rights Centre <https://media.business-humanrights.org/media/documents/files/reports-and-materials/Ruggie-protect-respect-remedy-framework.pdf>; John Ruggie, *UN Guiding Principles*, Harvard University, <https://scholar.harvard.edu/john-ruggie/un-guiding-principles>.

<sup>239</sup> *The UN “Protect, Respect and Remedy” Framework for Business and Human Rights*, Business & Human Rights Centre, <https://media.business-humanrights.org/media/documents/files/reports-and-materials/Ruggie-protect-respect-remedy-framework.pdf>.

<sup>240</sup> *The UN “Protect, Respect and Remedy” Framework for Business and Human Rights*, Business & Human Rights Centre <https://media.business-humanrights.org/media/documents/files/reports-and-materials/Ruggie-protect-respect-remedy-framework.pdf>; John Ruggie, *UN Guiding Principles*, Harvard University, <https://scholar.harvard.edu/john-ruggie/un-guiding-principles>.

<sup>241</sup> *The UN “Protect, Respect and Remedy” Framework for Business and Human Rights*, Business & Human Rights Centre <https://media.business-humanrights.org/media/documents/files/reports-and-materials/Ruggie-protect-respect-remedy-framework.pdf>.

<sup>242</sup> See *OHCHR and Business and Human Rights*, Office of the High Commissioner for Human Rights, <https://www.ohchr.org/en/business>.

The UNGPs are not legally binding on companies or States and do not “create new legal obligations,” but rather they elaborate on existing standards of international human rights and provide guidance on how to implement them.<sup>243</sup>

### **C. OECD Guidelines for Multinational Enterprises Chapters (“OECD Guidelines”)**

The OECD Guidelines are “non-binding principles and standards for responsible business conduct.”<sup>244</sup> They are recommendations promoted by governments to “multinational enterprises operating in or from adhering countries.”<sup>245</sup> Israel is one of thirty-four OECD countries (forty-six countries total) that have adopted the guidelines.<sup>246</sup> The guidelines are not legally enforceable and observance of them is entirely voluntary.<sup>247</sup>

### **D. European Union Regulations**

The EU Sustainable Finance Action Plan<sup>248</sup> contains a set of regulations focused on ESG investing. Some of these regulations include the EU Taxonomy Regulation,<sup>249</sup> which provides a list of “environmentally sustainable economic activities,” and the EU Sustainable Finance Disclosure Regulation,<sup>250</sup> which seeks to promote transparency and prevent greenwashing.<sup>251</sup>

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<sup>243</sup> See *FAQs on UN Guiding Principles*, Office of the High Commissioner for Human Rights, [https://www.ohchr.org/Documents/Publications/FAQ\\_PrinciplesBusinessHR.pdf](https://www.ohchr.org/Documents/Publications/FAQ_PrinciplesBusinessHR.pdf).

<sup>244</sup> See *OECD Guidelines*, Organisation for Economic Co-operation and Development, <https://www.oecd.org/daf/inv/mne/48004323.pdf>.

<sup>245</sup> See *OECD Guidelines*, Organisation for Economic Co-operation and Development, <https://www.oecd.org/daf/inv/mne/48004323.pdf>.

<sup>246</sup> *About - Organisation for Economic Co-operation and Development*, Organisation for Economic Co-operation and Development, <https://mneguidelines.oecd.org/about/>.

<sup>247</sup> See *OECD Guidelines*, Organisation for Economic Co-operation and Development, <https://www.oecd.org/daf/inv/mne/48004323.pdf>.

<sup>248</sup> *EU Sustainable Finance Action Plan*, Business-HumanRights.org, <https://www.business-humanrights.org/en/latest-news/eu-commission-action-plan-on-sustainable-finance/>.

<sup>249</sup> *EU Taxonomy Regulation*, European Commission, [https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities\\_en](https://ec.europa.eu/info/business-economy-euro/banking-and-finance/sustainable-finance/eu-taxonomy-sustainable-activities_en).

<sup>250</sup> *EU Sustainable Finance Disclosure Regulation*, eurosif.org, <https://www.eurosif.org/policies/sfdr/#:~:text=The%20Sustainable%20Finance%20Disclosure%20Regulation,made%20by%20financial%20market%20participants>.

<sup>251</sup> “Greenwashing” refers to corporate marketing that is based on exaggerated or misleading claims of environmental or social responsibility. See de Freitas Netto, S.V. et al., *Concepts and Forms of Greenwashing: A Systematic Review*, 32 *Env’t Sci. Eur.* 1-2 (2020).



Sustainalytics seeks to help its clients comply with regulatory requirements emanating from these EU regulations. For example, Sustainalytics' EU Taxonomy Solution helps investors incorporate the EU Taxonomy criteria in their investment decisions and report on progress.<sup>252</sup> Sustainalytics' service for the EU's Sustainable Finance Disclosure Regulation helps clients comply with the regulation's requirements to "incorporate and disclose sustainability risks and factors."<sup>253</sup>

### **E. UN Principles for Responsible Investment ("UN PRI")**

The UN PRI is a network of investors that encourages sustainable investments that incorporate ESG considerations into investment decisions.<sup>254</sup> The UN PRI prides itself on being "truly independent"; it "does not operate for its own profit," is not affiliated with any particular government, and "is supported by, but not part of, the United Nations."<sup>255</sup>

The UN PRI developed six principles that "offer a menu of possible actions for incorporating ESG issues into investment practice."<sup>256</sup> The six principles investors agree to abide by include:

- Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.
- Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.
- Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

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<sup>252</sup> *EU Sustainable Finance Action Plan Solutions*, Sustainalytics, <https://www.sustainalytics.com/investor-solutions/esg-research/eu-sustainable-finance-action-plan-solutions>.

<sup>253</sup> *EU Sustainable Finance Action Plan Solutions*, Sustainalytics, <https://www.sustainalytics.com/investor-solutions/esg-research/eu-sustainable-finance-action-plan-solutions>.

<sup>254</sup> *About the PRI*, United Nations Principles for Responsible Investment, <https://www.unpri.org/about-us/about-the-pri>.

<sup>255</sup> *About the PRI*, United Nations Principles for Responsible Investment, <https://www.unpri.org/about-us/about-the-pri>.

<sup>256</sup> *What are the Principles for Responsible Investment?*, United Nations Principles for Responsible Investment, <https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment>.

- Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.
- Principle 5: We will work together to enhance our effectiveness in implementing the Principles.
- Principle 6: We will each report on our activities and progress towards implementing the Principles.

The principles are “voluntary and aspirational,” but investors can exhibit a commitment to them by becoming a signatory to the UN PRI principles.<sup>257</sup> Sustainalytics has been a signatory to the PRI principles since 2008.<sup>258</sup> Morningstar has been a signatory since 2016.<sup>259</sup>

#### **F. Best Practice Principles for Providers of Shareholder Voting Research & Analysis 2019**

The 2019 Best Practice Principles for Providers of Shareholder Voting Research & Analysis (“Principles”) are a set of three principles concerned with encouraging “sound practices in the shareholder voting research and analysis industry that serve the needs of investors.”<sup>260</sup> The Principles were developed by Best Practice Principles Group (“BPPG”), an EU group formed in 2013.<sup>261</sup> The BPPG invites all organizations that assist investors in complying with stewardship or corporate governance responsibilities to become a signatory to the Principles.<sup>262</sup> The three Principles are:<sup>263</sup>

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<sup>257</sup> *What are the Principles for Responsible Investment?*, United Nations Principles for Responsible Investment, <https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment>.

<sup>258</sup> *Sustainalytics Signatory Profile*, United Nations Principles for Responsible Investment, <https://www.unpri.org/signatory-directory/Sustainalytics/2601.article>.

<sup>259</sup> *Morningstar, Inc. Signatory Profile*, United Nations Principles for Responsible Investment, <https://www.unpri.org/signatory-directory/Morningstar-inc/2416.article>.

<sup>260</sup> *2019 Best Practice Principles for Providers of Shareholder Voting Research & Analysis*, Best Practice Principles Group, at 4, <https://bppgrp.info/wp-content/uploads/2019/07/2019-Best-Practice-Principles-for-Shareholder-Voting-Research-Analysis.pdf>.

<sup>261</sup> *Best Practice Principles for Shareholder Voting Research*, Best Practice Principles Group, <https://bppgrp.info/>.

<sup>262</sup> *Best Practice Principles for Shareholder Voting Research*, Best Practice Principles Group, <https://bppgrp.info/>.

<sup>263</sup> *2019 Best Practice Principles for Providers of Shareholder Voting Research & Analysis*, Best Practice Principles Group, at 10-11, <https://bppgrp.info/wp-content/uploads/2019/07/2019-Best-Practice-Principles-for-Shareholder-Voting-Research-Analysis.pdf>.

- Principle One: Service Quality, which encourages the public disclosure of research methodologies and “house” voting policies.
- Principle Two: Conflicts-of-Interest Avoidance or Management, which encourages the public disclosure of a conflicts-of-interest policy and the disclosure of conflicts of interest to clients without delay.
- Principle Three: Communications Policy, which encourages open communication with clients about methodology, developing a policy for communicating with issuers and other stakeholders, making clients aware of this dialogue, and providing clients ample time to review research or analysis before a vote deadline.

Neither Sustainalytics nor Morningstar is a signatory to the Principles.<sup>264</sup> However, Sustainalytics does rely on the Principles to inform its approach in meeting requirements applicable to proxy advisors.<sup>265</sup> As part of its Stewardship Services, Sustainalytics’ ESG Voting Policy Overlay provides voting recommendations to clients based on ESG principles, ESG topics with strong support among investors, information gathered through engagement processes with issuers, and clients’ goals related to their individual ESG priorities.<sup>266</sup>

Sustainalytics distilled the Principles and other requirements for proxy advisors into three basic requirements: (1) “[d]isclosure of research methodology and an applicable ‘in-house’ voting policy”; (2) “[p]olicy regarding the prevention and management of potential conflicts of interest”; and (3) proxy advisor communications with companies that are the object of Sustainalytics’ research, advice, or voting recommendations, as well as with the stakeholders of those companies.<sup>267</sup> In line with the Principles, Sustainalytics developed internal documents to clarify

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<sup>264</sup> *Signatory Statements*, Best Practice Principles Group, <https://bppgrp.info/signatory-statements/> (only six companies, including ISS, are listed as signatories to the principles).

<sup>265</sup> *Sustainalytics approach to industry requirements*, Sustainalytics, <https://connect.sustainalytics.com/hubfs/INV/Stewardship/ESG%20Voting%20Policy%20Overlay/Sustainalytics%20approach%20to%20industry%20requirements.pdf>.

<sup>266</sup> *ESG Voting Policy Overlay*, Sustainalytics, <https://www.sustainalytics.com/investor-solutions/stewardship-services/esg-voting-policy-overlay#:~:text=Sustainalytics'%20ESG%20Voting%20Policy%20Overlay%20is%20intended%20to%20work%20in,third%2Dparty%20policy%20and%20provider.>

<sup>267</sup> *Sustainalytics approach to industry requirements*, Sustainalytics, <https://connect.sustainalytics.com/hubfs/INV/Stewardship/ESG%20Voting%20Policy%20Overlay/Sustainalytics%20approach%20to%20industry%20requirements.pdf>.

its methodology and processes, including for making updates following feedback from issuers. These documents included its Code of Ethics, Key Business Principles and Practices, ESG Voting Policy Overlay and related methodology, and Policy on managing institutional conflicts of interest (Abstract).<sup>268</sup> Sustainalytics also developed disclosure systems for disclosing conflicts of interest in voting recommendations.<sup>269</sup>

### **G. Stewardship Codes**

In the last three decades, there has been a growth of corporate governance regulation including more than 40 stewardship codes.<sup>270</sup> These codes requires institutional investors and their service providers to be transparent about their processes, monitoring the investee companies and improving accountability to both companies and their own beneficiaries and clients.<sup>271</sup> The European Corporate Governance Institute hosts copies of many such codes.<sup>272</sup>

Sustainalytics is a signatory to the UK Stewardship Code 2020, which was published by the UK Financial Reporting Council “to set high stewardship standards for asset owners and asset managers, and for service providers that support them.”<sup>273</sup>

The UK Stewardship Code comprises two sets of “apply and explain” principles, one for asset managers and owners and the other for service providers (such as Sustainalytics). As with many such codes, the principles are not prescriptive as to a single approach. The code recognizes that service providers undertaking to support their clients’ stewardship may include activities such

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<sup>268</sup> *Sustainalytics approach to industry requirements*, Sustainalytics, <https://connect.sustainalytics.com/hubfs/INV/Stewardship/ESG%20Voting%20Policy%20Overlay/Sustainalytics%20approach%20to%20industry%20requirements.pdf>.

<sup>269</sup> *Sustainalytics approach to industry requirements*, Sustainalytics, <https://connect.sustainalytics.com/hubfs/INV/Stewardship/ESG%20Voting%20Policy%20Overlay/Sustainalytics%20approach%20to%20industry%20requirements.pdf>.

<sup>270</sup> D. Katelouzou & M Siems, *The Global Diffusion of Stewardship Codes*, 4 (Eur. Corp. Governance Inst., Working Paper No. 526, 2020), [http://ssrn.com/abstract\\_id=3616798](http://ssrn.com/abstract_id=3616798).

<sup>271</sup> See, e.g., Dionysia Katelouzou & Konstantinos Sergakis, *Shareholder Stewardship Enforcement*, 3 (Eur. Corp. Governance Inst., Working Paper No. 514, 2020), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3564266](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3564266).

<sup>272</sup> *Codes Database*, European Corporate Governance Institute, <https://ecgi.global/content/codes>.

<sup>273</sup> *UK Stewardship Code 2020*, Financial Reporting Council (2020), [https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code\\_Dec-19-Final-Corrected.pdf](https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf)

as engagement, voting recommendations and execution, providing data and research, advising and providing reporting frameworks and standards.

The UK Stewardship Code Principles for Service Providers are:

- Principle 1: Signatories' purpose, strategy, and culture enable them to promote effective stewardship.
- Principle 2: Signatories' governance, workforce, resources, and incentives enable them to promote effective stewardship.
- Principle 3: Signatories identify and manage conflicts of interest and put the best interests of clients first.
- Principle 4: Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system.
- Principle 5: Signatories support clients' integration of stewardship and investment, taking into account, material environmental, social and governance issues, and communicating what activities they have undertaken.
- Principle 6: Signatories review their policies and assure their processes.

The Code itself recognizes that its status is currently voluntary, and sets a standard that is higher than the minimum UK regulatory requirements. Signatories may choose to report the steps they have taken meet the requirements of the Code and disclose information to meet other stewardship-related UK regulatory requirements or international stewardship codes. However, the Financial Reporting Council does not provide assurance against all other requirements in assessing reporting against the Code.

After application and assessments, organizations approved as signatories to the Code must continue to meet the Code requirements to maintain their status by annually submitting a report to the Financial Reporting Council.<sup>274</sup>

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<sup>274</sup> *UK Stewardship Code 2020 Application and Assessment*, Financial Reporting Council (2020), <https://www.frc.org.uk/getattachment/Investors/UK-Stewardship-Code/UK-Stewardship-Code-%E2%80%93-How-to-apply/Stewardship-Code-Application-and-Assessment-March-2022.pdf>.

Sustainalytics issued its most recent Stewardship Code report in March 2021<sup>275</sup> setting out the steps it has taken to respect the Principles. The report acknowledges the acquisition of Sustainalytics by Morningstar, but does not present Morningstar as a signatory, save that it notes that Sustainalytics has set up a public policy committee to support Morningstar's public policy team on public consultations that have an important ESG dimension.

In the thirty eight-page report, Sustainalytics sets out its practices in relation to each principle. For example, in relation to conflicts of interest, Sustainalytics reports that:

In the ordinary course of Sustainalytics' business spanning numerous relationships with clients, business partners, vendors, shareholders and the like, **the potential exists for business conflicts to arise.** These situations are subject to Sustainalytics' policies and business practices, which include specific conflict management procedures. Sustainalytics' management and directors are responsible for setting those policies, amending them from time to time and further communicating them to personnel. **Sustainalytics uses a combination of conflict management policies, procedures and organisational and technical measures to ensure that potential conflicts of interest do not become real conflicts.** Ultimately, our goal is to protect the interests of clients and key stakeholders. Our robust conflict management framework specifically addresses the need for analyst independence, consistency of process, structural separation of commercial and research (and engagement) teams, data protection and systems separation. **At Sustainalytics we structurally separate and independently manage our various Research, Engagement and Sales teams, as per the above organisational chart (Figures 1 & 2 in section 2.3).** Each of these teams operates separately and is managed by a different executive with a separate and distinct senior management layer. **Commercial personnel are prohibited from discussing client or prospect relationship details with research analysts.** Furthermore, our commercial data systems are completely separated from the systems used by our various Research and Engagement teams to perform their company assessments and produce client deliverables. Specific rules regarding the structural separation and communication across the different teams at Sustainalytics are detailed in our different operating policies.

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<sup>275</sup> *Sustainalytics Report of Compliance with the Principles for Service Providers Reporting Period: January 1, 2020 through December 31, 2020*, Financial Reporting Council (2020), [https://www.frc.org.uk/getattachment/272c792a-ce62-475c-9102-99352a9a2a4a/Sustainalytics-UK-Stewardship-Code-Report\\_March-2021\\_Final.pdf](https://www.frc.org.uk/getattachment/272c792a-ce62-475c-9102-99352a9a2a4a/Sustainalytics-UK-Stewardship-Code-Report_March-2021_Final.pdf) (emphasis added).