Global Research Unlocked

ESG is evolving, but not going away; new EU rules to have broad impact

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ESG
United States

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Key takeaways

- BofA Global Research analysts join the podcast to discuss emerging risks, opportunities, and growth themes in global markets
- US ESG funds had a challenging 2023. Monitoring regulatory landscape is important for material risks and sector opportunities
- Lawyer Michael Littenberg walks us through some of latest ESG regulatory initiatives and implications for ESG investors

ESG topics still impacting stocks and there's more to come

US ESG funds faced a challenging 2023, seeing net outflows of around $7.1 billion, but strong markets meant that assets under management grew strongly. In the US, ESG regulations have historically been market driven, unlike the specific directives in the EU, but more recently the regulatory landscape in the US has seen a flurry of initiatives. For investors, there is state legislation that seeks to penalize managers who boycott fossil fuels and firearms manufacturers and legislation in other states that seeks to keep pensions from investing in fossil fuels and firearms. There have been legal challenges to California's legislation but changes coming from the EU will still be relevant for global companies regardless of the California outcomes. The SEC will vote on the long-awaited climate disclosure rule later today. Dimple Gosai hosts Michael Littenberg of law firm Ropes & Gray to discuss the evolving ESG regulatory landscape and which regulations may impact ESG investors. *Global Research Unlocked can now be found on public podcast platforms, including Spotify, Apple Podcasts, Google Podcasts, and Amazon Music. These podcasts are first released to clients and then to the platforms.*

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Full Podcast Transcript

T.J. Thornton, Head of Product Marketing: Hello, and welcome to Global Research Unlocked, where we discuss what's rising from growth industries to rising risks and opportunities in global markets. I'm T.J. Thornton, Head of Product Marketing at BofA Global Research, and we're recording this episode on Friday, February 16, 2024.

US ESG funds actually faced a very challenging year where they saw net outflows of around $7.1 billion in 2023, which was the worst flow performance in the fund's history after five consecutive years of inflows, but that being said, it's not all dismal. Total US ESG AUMs (assets under management) still grew by 24% in 2023, and fun fact is we actually saw the number of US ESG funds grow by 9% last year, so I do think specific themes are still gaining traction.

Dimple Gosai, CFA

Investor interest and views on ESG have evolved quite a bit over the last couple of years. Today we're privileged to be joined by Michael Littenberg, Partner at Ropes & Gray and Dimple Gosai, Head of US ESG and Cleantech Analyst at BofA Global Research. They'll shed some light on these ESG topics and some more. A true expert on this topic, Dimple will host, and I'll be here to take notes. Thanks Michael and Dimple for joining us today.

Dimple Gosai, Head of US ESG Strategy and Cleantech Analyst: Thank you, T.J. Thank you, Michael.

Michael Littenberg, Partner at Ropes & Gray: Thank you for having me here today. It's a pleasure to be with you.

Dimple Gosai: Michael, I'm really glad you could have joined us today. I guess in the US, ESG regulations have historically been market driven, unlike EU specific directives, but more recently the regulatory landscape in the US has seen a flurry of initiatives. Michael, this is really your domain. What are the main ESG regulations investors really should be focusing on?

Michael Littenberg: There's really two categories of regulation in the United States that investors need to be aware of as they relate specifically to ESG. There's a category of regulation that's specific to investors, and then there's the category of regulation that's specific to investee companies. Starting with regulation that's applicable specifically to investors, I think you could break that down largely into state level regulation, what's often referred to as legislation that's pro ESG or anti ESG, and so it's legislation that seeks to define investment practices, typically, when investing in state pension funds on the pro ESG side of it, its legislation that, for example, seeks to limit investment in fossil fuels and firearm assets. And on the anti ESG side, it's legislation that, for example, seeks to penalize managers who boycott fossil fuels and firearms are perceived to be doing that, as well as to penalize managers that are taking ESG into account when it's not viewed as being financially relevant, and there's literally hundreds of different pieces of legislation, both at the adopted and proposing stage in the states. And although not specific to managers, I'll just also mention that there is a big body of anti-fraud legislation. Since there've been several ESG related enforcement actions involving managers, and that's an area that the SEC is still focused on. On the investee side, managers are focused in particular on climate related disclosure legislation. And there's three pieces of legislation that were recently adopted in California that provide for disclosure on greenhouse gas emissions, on climate risk, and then also on net zero and similar sorts of claims. There's also a proposal from the SEC for climate disclosure that would apply to public companies. But then at the state level, there's also proposals that recently have come out of Illinois and New York that are somewhat similar to California legislation. Those are the big areas, but one other I'll just mention, the investee company side that I think is getting more attention is the Uyghur Force Labor Prevention Act and that deals with products that are imported into the United States that have inputs from the Xinjiang region of China. And that's an area where we've been seeing a lot more enforcement as recently as the other day. I think that's something that's also on a lot of investors' radar screens with respect to the companies that they're investing in. There's of course many other legislative proposals beyond these at the Federal and the State level. But I think it was probably premature generally to spend time on those, either because passage of the legislation is unlikely, or the legislation will probably change significantly before it ultimately gets adopted. And the last point I'll just make is the items that I've highlighted, those are on the US side, but there's also a lot of developments on the international side as well.

Dimple Gosai: You made a really interesting point. We have seen a wave of anti ESG bills in Republican led states that basically prohibit investment managers from considering climate and ESG related risks, like you rightly pointed out. But I do think that the impact largely varies, and I would say that certain regions are seeing more traction than others, which is reflected in AUM. I'm curious, what do you make of this as we go further out in the year, if this landscape shifts and whether there's a contagion effect beyond borders?

Michael Littenberg: It's a good question. I think as we continue to move out, during the course of the year, I think we are going to see more state level legislation around ESG, both legislation that's pro ESG and legislation that anti ESG or seeks to limit integration of ESG factors by asset managers. Certainly, some states have had more traction on anti ESG legislation than others. I think Texas and Florida come to mind there for a lot of people, but also Kentucky, West Virginia, Louisiana, Indiana, among others. Based on our tracking, there's currently 20 states that restrict or propose restricting consideration of ESG factors in investment decisions. There's 11 states that target entities that boycott particular industries, and there's some overlap between those 20 states and those 11 states, so they're not all unique. And there's other bills that of course have been proposed that have not gained traction. For example, New Hampshire recently had a bill that was proposed that would've criminalized consideration of ESG factors, and that bill did not make it very far in the state legislature and that bill is no longer an active bill. Your question though about contagion or spillover effect, I do think that is something that we will continue to see. We've seen it in the past, including last year, the year before. There is a lot of coordination among states around ESG, both states that are pro ESG and anti ESG. And I think that's something that's going to continue. And some of the legislative proposals that have come out around ESG, in particular, some of the anti ESG proposals have come out of think tanks, so you do see similar bills being, and as in many cases, identical bills being proposed in different states. Maybe I can ask you a question 'cause I know you're so active within this area. In terms of investment flows, what are you seeing in terms of some of the ESG flows and also just the sentiment in the US?

Dimple Gosai: Yeah, this is a good question, very different in the US compared to Europe. US ESG funds actually faced a very challenging year where they saw net outflows of around $7.1 billion in 2023, which was the worst flow performance in the funds' history after five consecutive years of inflows, but that being said, it's not all dismal. Total US ESG AUMs still grew by 24% in 2023, and a fun fact is we actually saw the number of US ESG funds grow by 9% last year, so I do think specific themes are still gaining traction. The clean energy transition, for example, or things like food security, certain areas where ESG investors are very much focused by and large. But related to this, I do think that the potential change in administration is a risk or could add another layer of complexity, which also brings me to the second question I want to ask you around SEC and climate risk disclosure rules. Because that's faced many delays, and I think it's a key question of what happens next? Will these actually manifest in light of this year's challenges?

Michael Littenberg: I think everybody who's tried to predict a date for the rules has been wrong and has been wrong multiple times since they keep getting pushed back. With that said, I do think that we're going to see a final rule get adopted, and I think we're going to see that final rule sooner rather than later, just based on where we are in the cycle, if it doesn't occur relatively soon, that just increases the risk that it could get rescinded under the Congressional Review Act if there's a change in administration, depending upon how elections break in November. I think though it's important to remember is that even if we do see a final SEC climate rule, it is a virtual certainty that rule is going to face litigation. If we do have a change in administration, I think there's a good chance that if we do have a final rule this year, putting aside the litigation around it, the application of the rule could be watered down by a Republican led SEC, it's no secret that the Republican commissioners on the SEC feel that the existing regulatory framework is sufficient and that the rule that's been proposed by the SEC is overly prescriptive. It is somewhat of an open question as to what the final rule will look like when we see it. What will the phase ins look like? Whether scope three emissions will be in the rule or out of the rule, and that's been a controversial topic and it's not just been along party lines. There's also been significant democratic constituencies that have urged the SEC to leave scope three out of the rule. There's an open question as to whether the financial statement requirements will be in the rule, and if so, what those will look like. And then also, what the audit requirements will look like among many other open questions relating to the rules.

Dimple Gosai: I tend to agree. But I guess my one question around this is we also saw major business groups sue California over the California disclosure laws, which I think adds a layer of complexity to the implementation of these laws and maybe also influence the direction of SEC proposals. What do you think? Do you agree or do the California laws even get implemented if SEC does?

Michael Littenberg: I think that the litigation in California, the two rules you're referring to are SB 253 and SB 261, and those relate to greenhouse gas emissions and disclosure of climate risk. I think the challenge to those rules, it certainly does complicate their implementation. I don't think it's fatal necessarily to the implementation, unless obviously a court agrees with the plaintiffs and the rules get struck down, and they're being challenged on two primary grounds. First, that they violate the first Amendment to the Constitution, which deals with free speech, so they're violating that by compelling particular speech, and then the second argument is that they're preempted by the Federal Clean Air Act. I think many people feel that those same arguments will be made with respect to whatever rule the SEC ultimately adopts. And there was a view that that was going to be the case even before we saw the lawsuit in California, so I don't think there's a whole lot of surprise to these particular challenges that were being brought. I think specific to the California rules, besides the litigation, putting that aside, there are other implementation challenges. I think there's a good chance that implementation of the rules will get pushed back. When he signed the bills in October, California Governor Gavin Newsom, in his signing statement did express that he had reservations around the timing of implementation, that both the California Air Resources Board needed more time, but also companies needed more time to prepare for the rules. Even though he signed the particular bills, he said he was going to work with the legislature during 2024 to amend those bills to push back the timing. I do think that the time period for the implementation of the California rules is likely to get pushed back. In terms of how they may affect the SEC's decision-making process, I think that they'll mostly factor in to the economic analysis that the SEC has to do in connection with its rulemaking. And the upshot there is having rules and other jurisdictions that require many of the same disclosures that the SEC rules would require, will bring down the unique costs specific to the SEC rules, so that will take some pressure off of the economic analysis. Chair Gensler of the SEC had previously indicated effectively that would be the case. And it's possible that when the SEC comes out with its adopting release for its final rules, that in the framing of some of its decisions around the rules and some of the economic analysis, it may piggyback on some of the arguments that have been made in California in the litigation to try to refute those upfront or at least provide a roadmap for refuting those in a challenge to the SEC rule.

Dimple Gosai: Going back a step though, do these delays even matter when we think about it? Because with the EU's Corporate Sustainability Reporting Directive, which I believe is launching early this year, don't companies that operate within the EU have to comply with some of these mandatory disclosure rules anyway? It becomes a bit of a competitive dynamic at that point, and I feel like US companies then will have to report regardless, or am I wrong?

Michael Littenberg: In some cases, the SEC rules or the California rules won't matter because of the EU Corporate Sustainability Reporting Directive or CSRD. And that's a point that I and many others have made in other places. And since CSRD presumes that climate is material, we are going to see, I think most subject companies reporting on climate. But it's important to remember that reporting may be limited to EU subsidiaries of entities that are subject to CSRD, and also that not all of the institutions that will have to report under CSRD also will have to report under SEC rules or California rules. Although there is a lot of overlap, there certainly isn't perfect overlap with California or SEC, but with that said, CSRD certainly is a game changer. Approximately 3000 non-EU companies are going to need to report under CSRD and also approximately 50,000 EU entities, including the EU subsidiaries of many US parents, will have to report under CSRD as well. It's going to result in a lot of additional climate disclosure out in the marketplace and that disclosure will also be much more structured than current climate disclosure since it's going to have to be data tagged.

Dimple Gosai: That's a good point. On that note, let's talk about ESG disclosure regulations in light of the increased greenwashing that we've been seeing. In the US, the SEC has required all public companies to disclose information that's obviously material to investors, which includes information on ESG related risks. And they've also issued guidance and rules that basically set forth its disclosure expectations, so what I really am curious to know is that are there any examples of enforcement actions that's related to some of these ESG issues that you can point to?

Michael Littenberg: Sure. And so first, just to start with the point you made at the beginning of your remark, the SEC has published guidance regarding ESG related disclosures, and they've done that in particular with respect to climate. They put out guidance on climate as far back as 2010, more specifically on enforcement. The anti-fraud rules that the SEC has, which are not specific to ESG and are not new, those apply to both corporate issuers, as well as investment funds. There have been three public ESG related enforcement actions involving asset managers. And then on the corporate side, the SEC's ESG Enforcement Task Force has announced a settlement against a large corporate Brazilian mining company based on what they were alleged to have known, with respect to a particular mine before collapsed, and there was a loss of life in connection with the collapse of that mine. The SEC has recently indicated that its ESG Enforcement Task Force continues to pursue other alleged corporate wrongdoings. I think we may very well see additional enforcement actions coming out of that task force. Looking forward, I think that the principle ESG related enforcement risk is probably around climate disclosures and those may take the form of securities fraud suits, so alleged, inaccurate or inadequate disclosures of climate risks and climate impacts, and those risks may increase over time, as companies restate prior climate disclosures due to better information or changing methodologies. There's also, I think, a risk of consumer protection claims relating to product disclosures, for example, carbon neutral claims. There's a recent new California law, the Voluntary Carbon Markets Disclosure Act, which requires specified information in connection with net zero and greenhouse gas emission reduction claims. I think over time that may increase enforcement risk relating to product claims, although the VC MDA won't be the only driver of those sorts of claims. Maybe Dimple a question I can ask for you, since we are on this topic of ESG risk. I know that's an area that you're following closely. Maybe you could tell me a little bit about just what you've written in that area or the work that you've done on specific sectors where ESG related risks or materializing?

Dimple Gosai: Yeah, of course. I think there's a few examples I can give you. I'll allude to three different sectors. With PFAS (Per- and Polyfluorinated Substances) specifically, PFAS the chemical, we've actually found that stocks have collectively lost around $145 billion, that's almost 60% in market cap since January 31st of 2018, due to the rise of PFAS litigation. PFAS is that chemical that's found in everyone's frying pans and in rain jackets and in drinking water, and I feel like this is something that's getting bigger and more problematic as time goes. That's the one, the other one is the insurance sector. Evidence from the Federal Insurance Office and Federal Reserve suggests that climate risks are obviously still not being adequately priced in. And this is as historical data sets that are used in modeling are maybe unable to fully capture climate changes non-linear physical risks, so this continues to be a risk factor going forward for the sector itself, and then the third example I'd point to is on the labor side. More recently we saw these strikes and threats of strikes that have resulted in the highest wage increases since 1990 across multiple industries, including autos, logistics, and healthcare, which has obviously also played a role in rising inflation and supply chain disruptions. And some of these risks have also shown up in the last 2023 proxy voting season, when it comes to human capital, for example, or climate risk issues, or chemicals, nanoplastics and so forth, where we've seen over 700 shareholder proposals centered around ESG issues. Aside from what we see on this side, are you seeing any ESG issues that continue to attract shareholder activism and are there any specific topics that you're speaking to your clients about?

Michael Littenberg: I think we're certainly going to see a large number of shareholder proposals again this year relating to ESG, although I think it will probably be down slightly from last year. In terms of the types of proposals that we're seeing, I would say that so far, they largely track the sorts of proposals that we've seen last year and prior years. A lot of proposals around climate, human capital, political spending, human rights, and certainly there's niche proposals within each of those different areas. I think also in terms of a support that proposals receive, I think this year is going to look very much like last year in that mainstream support for ESG proposals is going to be lukewarm. I think there is a place for ESG related activism, but it looks like it's for the time being going to be probably limited to niche investors with very specific agendas rather than being pursued by mainstream investors, at least in most cases. Overall, I expect that large institutional investors, their support for ENS proposals will probably be relatively weak this year. But with that said, I don't think that means that institutional investors aren't expressing concerns and expectations around ESG. Mainstream stewardship concerns mostly I think are being addressed one-on-one rather than through activist campaigns or through proxy voting, and I think that approach generally makes the most sense based on where we are today. Companies are managing ESG issues in a very different way than they were three or four years ago. Most companies are now proactively managing financially material ESG risks and opportunities. Therefore, I think engagement relating to ESG risks and opportunities is more nuanced and it requires a different type of engagement than the blunt approach of the shareholder proposal.

Dimple Gosai: I think it's certainly going to make for an interesting year. With that, this has been an amazing discussion. Thank you for all your insights, Michael.

Michael Littenberg: Thank you, and thanks for having me here today.

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