SEBI REFORMS - ESG RELATED REQUIREMENTS FOR MUTUAL FUNDS

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Abstract

The world of investment is seeing a proliferation of ESG fund schemes. In India too while there have not been too many schemes, the interest in the same is increasing. With avenues to invest in ESG products increasing, by way of schemes, there is a necessity that standardization be infused into the same as well as transparency. SEBI, the regulator that has always been at the forefront of reform, has adopted a holistic approach in framing ESG related regulation. The last piece in the ESG regulation puzzle was disclosures and standardization in relation to ESG schemes, which has been recently brought in by SEBI. This article elucidates the reform.

Introduction

Over the past few years, the significance of ESG risks as well as economic and financial impact of climate change by investors, particularly institutional investorshasgrown manifold. ESG schemes are increasingly getting launched around the world. A mirror effect is also happening in India, with many ESG funds have been launched. ESG investing is catching up and getting mainstream.

ESG AUM in India

The following table shows the ESG AUM in India over the past five years[1]:

Year	ESG Funds Assets Under Management (Rs. Cr.)
2019	2703
2020	9411
2021	12369
2022	10741
2023	10635

ESG funds in India are still at a nascent stage though 10 out of the 13 ESG funds launched in India have happened over the past three years[2], indicating an increase in interest in investors and consequent rise in offerings by mutual funds.

SEBI and ESG disclosures – adoption of a holistic approach

SEBI, after taking into account the recommendations of the ESG Advisory Committee and pursuant to public consultations, amended the provisions of the SEBI (Mutual Funds) Regulations, 1996 on June27, 2023 to, inter-alia, specify that the funds under environmental, social and governance (ESG) schemes shall be invested in the manner as specified by SEBI from time to time. Accordingly, in July 2023, SEBI brought ESG related requirements for mutual funds.

Accordingly, to gear up the issuer and other stakeholders, SEBI has brought in multiple reforms on the ESG front over the past year, like the

- *Business Responsibility and Sustainability reporting,*
- *BRSR Core reporting,*
- *Green bond framework,*
- *Blue, Yellow and Transition bonds, and*
- *Dos and Don'ts on Greenwashing.*

Thus, a holistic approach has been adopted by SEBI in this matter, so as to benefit all stakeholders.

SEBI has mandated the top 1,000 listed companies (by market capitalization) to make ESG disclosures as per the Business Responsibility and Sustainability Reporting (BRSR) on a mandatory basis from FY 2022-23. SEBI thought fit to introduce measures to address the risks of greenwashing, to be undertaken by both companies and Mutual Funds. ESG disclosures need to be robustmade by Mutual Fund (MF) schemes and so as to mitigating the potential risk of greenwashing and mis-selling. This is an aspect that regulators around the world are combating now. In the face of random disclosures and jargon filled documents, there is a need to make disclosures more standardized and also align with global best practices. India and the US have been at the forefront of transparency – the December 2020 study by morning star rates India as the no.1 market in the world as far as the disclosure and transparency scorecard is concerned[3]. A large part of credit is due to SEBI for this achievement. Continuing the same verve, SEBI adopted a participative and consultative approach to formulate disclosures for ESG funds also.

[1] *Source: Morningstar, August 2023 https://www.morningstar.in/posts/74907/esg-funds-lose-their-sheen.aspx*

[2] *https://www.bqprime.com/business/esg-mutual-funds-in-india-are-having-a-reality-check*

[3] *https://www.morningstar.com/funds/global-disclosure-practices-how-markets-around-world-stack-up*

Constitution of ESG Advisory Committee by SEBI

SEBI, in May 2022, constituted the ESG Advisory Committee (EAC Committee) to recommend streamlining the regulatory framework for ESG Disclosures, ESG Ratings and ESG Investing. The Committee had representatives from companies, investors, rating providers, Mutual Funds, industry associations and other stakeholders. The EAC submitted its report in February 2023, giving recommendations in the areas of ESG Disclosures, ESG Ratings and ESG Investing. SEBI, after taking into account the report of the committee, placed a consultation paper on its website on ESG Disclosures, ESG Ratings and ESG Investing. On ESG Disclosures and matters relating to Mutual Funds, the following were the topics on which views were sought:

- *Enhanced Stewardship Reporting for ESG schemes*
- *Mitigation of risks of mis-selling and greenwashing*
- *Classification of ESG schemes*
- *Annual Fund Manager Commentary*

SEBI stipulations – ESG schemes

Based on the recommendations of the EAC, public consultation and internal deliberations, SEBI made the amendments to the Mutual Fund Regulations specifying that the funds under ESG schemes shall be invested in the manner as specified by SEBI from time to time. Drawing powers from that amendment, SEBI has, vide circular dated July 20, 2023 stated that any scheme under the ESG category shall belaunched withone of the following strategies:

- *exclusions,*
  Excluding securities based on certain ESG related activities, business practices, or business segments
- *integration,*
  Explicitly consider ESG related factors that are material to the risk and return of the investment
- *best-in-class and positive screening,*
  Aim to invest in companies and issuers that perform better than peers on one or more performance metrics related to ESG matters
- *impact investing*
  Seek to generate a positive, measurable social or environmental impact alongside a financial return and how the Fund Manager intends to achieve the impact objective
- *sustainable objectives*
  Aim to invest in sectors, industries, or companies that are expected to benefit from long-term macro or structural ESG-related trends
- *transition or transition related investments*
  Aim to invest in companies and issuers that support/ facilitate environmental transition and just transition

SEBI believes that these measures will:

- *facilitate green financing*
- *have a thrust on enhanced disclosures and*
- *mitigate greenwashing*

Measures taken by SEBI to address green washing and misselling in ESG funds

SEBI has also introduced the following measures, for mutual funds, in order to address the risk of mis-selling and greenwashing, to enhance stewardship reporting requirements and to promote ESG investing:

a. *Mandating ESG schemes to invest at least 65% of the Assets Under management (AUM) in listed entities, where assurance on BRSR Core is undertaken.*
b. *Mandating third party assurance and certification by Board of AMCs on compliance with objective of the ESG scheme.*
c. *Mandating enhanced disclosures on voting decisions with specific focus on environmental, social and governance factors.*
d. *Mandating disclosure of fund manager commentary and case studies which inter-alia highlight how the ESG strategy is applied on the fund / investments.*
e. *Introducing a new scheme category, enabling the launch of multiple schemes on ESG related factors.*
f. *Stipulating that schemes clearly disclose the name of the ESG strategy in the name of the concerned ESG fund.*

Minimum investment limit

ESG schemes have to invest at least 65% of Assets Under Management (AUM) in listed entities, where assurance on the BRSR is undertaken, as specified by SEBI. However, the balance AUM of the scheme can be invested in companies having BRSR disclosures. This requirement will be applicable from October 1, 2024.

Voting and ESG

In order to enhance transparency on votes cast by ESG schemes, SEBI has stated that AMCs will have to categorically disclose whether the resolution has or has not been supported due to any environmental, social or governance reasons. These enhanced voting disclosures will be applicable from April 1, 2024.

In a nutshell, the applicability of the various SEBI stipulations is given in the following table:

Reform	*Applicability*
Disclosure of scheme strategy, scores on securities	*Immediate*
Certification by the Board of AMCs	*for FY 2022-23, by December 31, 2023, thereafter yearly in Annual Reports*
Independent reasonable assurance regarding compliance of ESG scheme's portfolio with the strategy and objective of the scheme	*'comply or explain' by December 31, 2023, thereafter yearly in Annual Reports*
Enhanced Voting disclosures	*From April 1, 2024*
Annual Fund Manager commentary on ESG strategy	*from FY 2023-24*

Conclusion

SEBI has been a pioneer when it comes to approaching the ESG maze holistically and addressing all the issues relating to ESG investing. The measures taken by SEBI will go a long way in ensuring ESG funds in India do not suffer from problems that commonly afflict them like mis-selling, greenwashing, lack of transparency etc. This credibility will also give a fillip to ESG investing in India. MA