CHAPTER 2

ESG investing by mutual funds

This article aims to:

- Provide an overview of the recent developments in the area of ESG investing.

Introduction

Sustainable finance has become a prominent initiative and is gaining traction as the world faces challenges relating to climate change, biodiversity, health, financial inclusion, livelihood, women empowerment and food security. As a result, organisations, investors, financial intermediaries and other stakeholders are taking into account Environmental, Social and Governance (ESG) assessments in their investment decisions.

Considering that investors and asset managers are key pillars in the sustainable finance structure, the Securities and Exchange Board of India (SEBI) has issued regulatory guidelines which administer and give an impetus to ESG investing. It would enable consistent, comparable and decision useful scheme disclosures which would empower investors to make informed investment decision and prevent greenwashing.

Circular on ESG investing

In May 2022, SEBI constituted an ESG Advisory Committee (EAC) which, *inter alia*, provided recommendations for expanding the disclosure norms for ESG funds through public consultations[1]. Subsequently, the SEBI (Mutual Funds) Regulations, 1996 (MF Regulations) were amended on 27 June 2023 to *inter-alia* specify that the funds under ESG schemes should be invested in the manner as specified by SEBI.

Accordingly, on 20 July 2023, SEBI issued a circular for mutual funds, implementing some key measures to facilitate green financing with a thrust on enhanced disclosures and mitigation of green washing risk (circular on ESG investing).

1. SEBI Consultation paper on ESG Disclosures, Ratings and Investing issued in February 2023.

The diagram below illustrates the requirements prescribed in the circular on ESG investing:

Multiple strategies under ESG schemes

A separate sub-category for ESG investments introduced under ‘equity schemes’.

Effective immediately

Investment criteria

At least 65 per cent of the Assets Under Management (AUM) to be invested in companies reporting on comprehensive BRSR and providing assurance on BRSR Core disclosures.

Effective from 1 October 2024*

Disclosure requirements

- Scheme strategy
- ESG scores of securities
- Voting disclosures
- Annual fund manager commentary.

Effective date:

- *Strategy and ESG scores:* Immediately
- *Voting disclosures:* FY 2024-25
- *Annual fund manager commentary:* FY 2023-24 (certain disclosures are required w.e.f. FY24-25 and FY25-26)

Assurance

- Independent reasonable assurance
- Certification by the board of Asset Management Company (AMC).

Effective date:

- ***Independent assurance:*** FY22-23- on a comply or explain basis by 31 December 23. Mandatory thereafter.
- ***Certificate by board:*** Mandatory w.e.f. FY22-23. FY22-23 reporting by 31 December 23.

* In case of non-compliance with the investment criteria by 1 October 2024, an extension period till 30 September 2025 has been prescribed (subject to certain conditions) to ensure compliance.

(Source: KPMG in India’s analysis, 2023, read with circular on ESG investing)

I. Multiple strategies under the ESG scheme

Prior to the issuance of the circular on ESG investing, mutual funds could launch only one ESG scheme under the thematic category of equity schemes.

SEBI has now introduced a separate sub-category for ESG investments under the thematic category of equity schemes, by including six new strategies that the mutual funds can adopt to align their investments with ESG considerations. The strategies include:

- **Exclusion:** This strategy involves excluding securities based on certain ESG-related activities, business practices, or business segments. The exclusions can be based on factors such as adverse impact, controversy, faith, etc.
- **Integration:** Funds adopting this theme will consider ESG-related factors that are material to the risk and return of the investment, alongside traditional financial factors while making investment decisions.
- **Best-in-class and positive screening:** This strategy aims to invest in companies and issuers that outperform their peers on one or more ESG performance metrics.
- **Impact investing:** The fund based on this strategy should seek a non-financial (real world) impact and evaluate if that impact is being measured and monitored. Fund managers should provide a methodology for assessing the impact of investments and have processes in place to identify and manage any adverse effect.
- **Sustainable objectives:** Funds based on this strategy 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:** Funds under this category aim to invest in companies and issuers that support/facilitate environmental transition.

AUM requirement: In accordance with the Master Circular[2], at least **80 per cent** of the total Assets Under Management (AUM) of ESG schemes should be invested in equity and equity related instruments of the chosen strategy. The remaining portion of the investment should not contradict the strategy of the scheme.

There should be a clear distinction in terms of asset allocation, investment strategy of the mutual fund schemes launched, etc.

Effective date: The requirements related to the new category for ESG schemes are applicable with immediate effect.

Key considerations

A separate category for ESG investments under the equity schemes will enable AMCs to launch multiple ESG schemes with diversified strategies. This is likely to help investors direct their funds on ESG themes they resonate the most with, while boosting growth in select companies.

2. As per the Master Circular, a mutual fund with a thematic category under the equity scheme should have a minimum investment of 80 per cent of total Assets Under Management (AUM) in equity and equity related instruments of that theme.

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II. Investment criteria

Currently, ESG schemes of mutual funds are mandated to invest only in such companies which have comprehensive Business Responsibility and Sustainability Reporting (BRSR) disclosures.

SEBI vide the circular on ESG investing has mandated ESG schemes to invest at least **65 per cent** of its AUM in companies which are reporting on comprehensive BRSR **and** are also providing assurance on BRSR Core disclosures. The balance AUM of the scheme can be invested in companies having BRSR disclosures (investment criteria).

Effective date: This requirement will be applicable with effect from 1 October 2024.

Extension period for compliance: In case ESG schemes are unable to comply with the investment criteria by 1 October 2024, an extension period of one year (till 30 September 2025) has been prescribed to ensure compliance. However, during this extended period of one year, ESG schemes cannot undertake any fresh investments in companies that do not have assurance on BRSR Core.

65 per cent AUM

Companies disclosing
Comprehensive BRSR + Assurance on BRSR Core

35 per cent AUM

Companies disclosing
Comprehensive BRSR

(Source: KPMG in India's analysis, 2023 read with circular on ESG investing)

Key considerations

Investment opportunities for fund managers: Currently, the top 1,000 listed entities are required to report on comprehensive BRSR as part of their annual report. SEBI, vide a circular dated 12 July 2023[3] has also prescribed a regulatory framework for reporting and assurance of BRSR Core[4]. As per this framework, the top 1,000 listed entities (by market capitalisation) are required to provide the BRSR Core disclosures as part of the annual report from FY2023-24. Additionally, a glide path has been provided for listed entities to obtain a mandatory reasonable assurance on the BRSR Core disclosures by an independent assurance provider (glide path). The glide path is given in the table below:

Financial Year	Applicability of mandatory assurance on BRSR Core
2023-24	Top 150 listed entities*
2024-25	Top 250 listed entities*
2025-26	Top 500 listed entities*
2026-27	Top 1,000 listed entities*

* by market capitalisation

Mutual funds with ESG schemes are required to comply with the investment criteria of investing 65 per cent of the AUM in companies reporting comprehensive BRSR and obtaining assurance on BRSR Core by 1 October 2024. As per the glide path, only the top 150 companies (by market capitalisation) would have compulsorily obtained an assurance on their BRSR core disclosures. This will reduce the investment universe size, in the initial year and could restrict fund managers in terms of the investment flexibility of the mutual funds.

However, given that BRSR Core has a limited set of KPIs for assurance, companies desirous of attracting investments from mutual funds could voluntarily obtain an assurance on BRSR Core disclosures voluntarily from FY2023-24 onwards.

Assets Under Management: While making investment decisions and managing AUM, fund managers would need to consider the following regulations:

- As per the Master Circular, sectoral/thematic funds under the equity schemes should at the minimum invest 80 per cent of their AUM in equity and equity related instruments of a particular sector/theme. The remaining portion of the investment should not contradict the strategy of the scheme.
- As per the circular on ESG investing, ESG funds should *inter alia* comply with a specific investment criterion- i.e. 65 per cent of the AUM should be invested in companies reporting comprehensive BRSR and obtaining assurance on BRSR Core. Balance 35 per cent of the AUM could be invested in companies reporting BRSR.

Fund managers would need to ensure compliance of both these regulations when they make investment decisions.

3. SEBI circular no. SEBI/HO/CFD/CFD-SEC-2/P/CIR/2023/122 dated 12 July 2023.
4. The BRSR Core is a sub-set of the BRSR, comprising of a set of Key Performance Indicators (KPIs) under nine ESG attributes.

III. Disclosure requirements

The circular on ESG investing has prescribed the following disclosure requirements:

Scheme strategy

The name of the ESG fund/scheme should clearly disclose the ESG strategy it is based on. For example, ABC ESG Best-in-class Strategy Fund[5].

ESG scores of securities

New disclosure requirements

The monthly portfolio statements of ESG schemes should include the following information:

- Security wise **BRSR Core scores** along with BRSR scores
- Name of the ESG Rating Providers (ERPs) providing ESG scores, along with the ESG scores. In case there is a change in the ERP, the reason for such change should also be disclosed in the next monthly portfolio statements of ESG schemes

Effective date: These requirements are applicable with immediate effect.

Voting disclosures

The Master Circular requires mutual funds to compulsorily vote on all resolutions of their investee companies. Additionally, it requires mutual funds to disclose certain matters, which *inter alia* include:

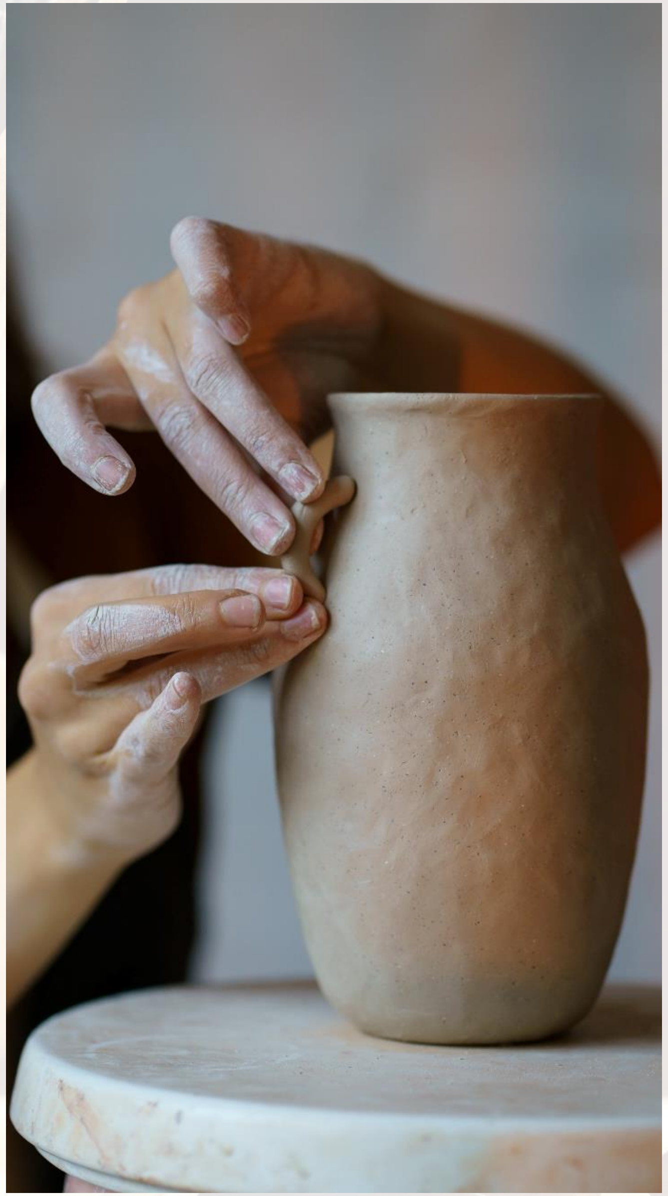
- Votes cast by mutual funds in respect of resolutions passed in general meetings of the investee companies
- Specific rationale supporting their voting decisions (for, against or abstain) with respect to each vote proposal.

New requirements for ESG funds

In order to enhance transparency on votes cast by ESG funds, the following additional disclosure requirements have been prescribed:

- While disclosing the rationale for voting decisions (whether in favor or against), AMCs should categorically disclose whether the resolution has or has not been supported due to any environmental, social or governance reasons
- Mutual funds may have holdings in the same investee company(ies) under both, the ESG and non-ESG schemes. Where voting approach for both ESG and non-ESG schemes is the same, disclosure of the voting rationale may be made at the mutual fund level. However, where the voting approach for ESG and non-ESG schemes of any mutual fund is not the same, the details and rationale for votes cast on behalf of ESG schemes and non-ESG schemes should be disclosed separately.

Effective date: These enhanced voting disclosures are applicable from FY 2024-25 i.e. for Annual General Meetings held from 1 April 2024 onwards.



5. This requirement is in line with SEBI's earlier communication to AMFI on disclosure norms for ESG mutual fund schemes dated 8 February 2022. As per SEBI's earlier communication, the name of the scheme should accurately reflect the nature and extent of the scheme's ESG focus taking into account investment objective and type of strategy followed.

Annual fund manager commentary and case studies

SEBI, vide its letter dated 8 February 2022 had prescribed that mutual funds should provide disclosures about their stewardship and shareholder engagements. SEBI, vide its letter dated 8 February 2022 had prescribed that mutual funds should provide disclosures about their stewardship[6] and shareholder engagements.

New requirements for ESG funds

In addition to disclosures of the engagements undertaken by mutual funds for ESG schemes, ESG funds are required to provide a 'fund manager commentary', which would be included in the annual report of the ESG schemes.

The annual fund manager commentary should include the following:

A. ESG strategy

- Examples on how ESG strategy was applied on the fund
- How engagements were carried out
- Any escalation strategy that the fund manager may have applied on the portfolio companies
- Annual tracking of ESG rating movements in the investee companies etc.

B. Case studies

Case studies where fund managers have engaged with portfolio companies with a clear objective of engagement and engagements carried out for exercise of votes.

C. Engagements

- Details on number of engagements carried out in a year
- The modes of communication employed
- Outcomes achieved by ESG schemes based on objectives of the scheme
- Additional areas to be covered in case studies and
- Minimum disclosures should be specified by AMFI in consultation with SEBI.

D. ESG rating/score

Annual tracking of ESG rating/score movements in the investee companies.

E. AUM

Percentage of AUM invested in such companies where there are no BRSR disclosures (investments prior to 1 October 2022) and its impact, if any, on the fund score.

F. Change in ERP

Where there is a change in the ERP, reason for such a change.

Effective date: The requirement of the annual fund manager commentary should be applicable from FY 2023-24. The disclosure of case studies mentioned in point (B) and (C) above would be applicable from FY 2024-25 and the engagement details should be disclosed from FY 2025-26 onwards.

6. Stewardship responsibilities include monitoring and actively engaging with investee companies on various matters including performance (operational, financial, etc.), strategy, corporate governance (including board structure, remuneration, etc.), material environmental, social, and governance (ESG) opportunities or risks, capital structure, etc. Such engagement may be through, detailed discussions with management, interaction with investee company boards, voting in board or shareholders meetings, etc.

IV. Assurance

A. Independent assurance

New requirements for ESG funds

- AMCs should obtain an independent and reasonable assurance on an annual basis regarding their ESG scheme's portfolio being in compliance with the strategy and objective of the scheme stated in the Scheme Information Documents (SIDs).
- The AMCs should ensure that the assurance provider for an ESG scheme has the necessary expertise for undertaking reasonable assurance and there is no conflict of interest[7] with the assurance provider appointed.

Effective date: Such assurance is applicable as below:

- On a 'comply or explain basis' for all ESG schemes for FY 2022-23 by 31 December 2023.
- On a mandatory basis for FY 2023-24 and onwards. Disclosure of such assurance should be made in the scheme's annual report.

Key considerations

The circular on ESG investing requires the assurance provider to have necessary expertise for undertaking reasonable assurance that the ESG scheme's portfolio is in compliance with the strategy and objective of the scheme. The AMCs should ensure that there is no conflict of interest with the assurance provider appointed. For instance, it should be ensured that the assurance provider or any of its associates do not sell its products or provide any non-audit/non-assurance related service including consulting services, to the AMC or its group entities. There is a need for AMCs and their audit committees to assess the relationships of the potential assurance providers with the AMCs or its group entities in determining any potential conflicts of interest before appointing the service providers.

The SEBI, vide the Frequently Asked Questions (FAQs) dated 8 August 2023 has provided clarifications on certain matters pertaining to assurance providers of BRSR Core (the FAQs)[8]. Both, the BRSR Core Framework and the ESG investing framework have similar qualification requirements for assurance providers. Both the frameworks require the assurance provider to:

- Have the necessary expertise for undertaking reasonable assurance
- Not have any conflict of interest with the company- i.e. the assurance provider or any of its associates should not sell its products or provide any non-audit/non-assurance related service including consulting services, to the AMC or its group entities.

In the absence of similar clarifications for assurance providers of ESG schemes, reference may be made to the FAQs while appointing assurance providers for the scheme.

B. Certification by the board of directors of AMCs

New requirements for ESG funds

Basis a comprehensive internal ESG audit[9], the board of directors of AMCs are required to certify compliance of ESG schemes with the regulatory requirements, including disclosures, in the annual report of the scheme.

Effective date: The board of directors of AMCs should provide the certificate for FY 2022-23 by 31 December 2023. Thereafter, the certification should be disclosed in the annual reports of the schemes.

7. The circular on ESG investing has stated that to ensure there is no conflict of interest, the assurance provider or any of its associates do not sell its products or provide any non-audit or non-assurance related service to the AMC or its group companies.
8. The FAQs have clarified the following matters:
   - The qualification of assurance providers, and who can be appointed as an assurance provider
   - What activities can be undertaken by the assurance provider, and which activities would lead to a conflict of interest
   - What is the meaning of 'group' of an entity and who would be considered as an 'associate' of an assurance provider
   - Which assurance standard should be followed by an assurance provider for the BRSR Core.
9. Internal ESG audit would inter-alia include verifying the Scheme Information Documents, Stewardship Reporting and Responsible Investment Policy of the ESG Funds and any other relevant document, to ensure that the statements made in these documents are factual.

Bottom line and next steps

The circular on ESG investing prescribes a balanced regulatory framework for ESG investing, to mitigate greenwashing and mis-selling risks, while facilitating easier compliances. Given here are some of the key considerations:

Strong internal processes: Reasonable assurance is now applicable to AMCs on a comply or explain basis with effect from FY 2022-23 and on a mandatory basis for FY 2023-24 and onwards. Additionally, there has been an increased focus on internal ESG audit. AMCs will need to ensure that strong risk management processes and robust internal processes are in place so that AMCs meet all compliances and disclosures on a timely basis.

Business opportunities: The adoption of sustainable investing will help companies attract capital from investors based on good governance, environmental and social practice adopted by them (non-financial criteria) and thus could help them enhance their businesses.

Investor education: SEBI should, through webinars and other mechanisms, educate the investors regarding the ESG funds and the manner of interpreting the data surrounding it, such as the investment criteria, disclosure requirements and assurance.