CFA Institute

CFA Society India

INDIA INSIGHTS

CFA SOCIETY INDIA AND CFA INSTITUTE ROUNDTABLE ON ENVIRONMENTAL, SOCIAL, AND GOVERNANCE DISCLOSURE STANDARDS

January 2022

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The mission of CFA Institute is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.

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Introduction

CFA Society India and CFA Institute convened a roundtable on environmental, social, and governance (ESG) disclosure practices on 10 December 2021. The roundtable had the following agenda:

1. Chris Fidler, CFA, senior director, standards, CFA Institute, discussed the recently released CFA Institute Global ESG Disclosure Standards for Investment Products and answered questions on the standards and the state of ESG disclosures around the world.

2. The participants, including fund managers, asset owners, and other stakeholders representing product, marketing, and communication functions, presented their views on ESG disclosures, the Security and Exchange Board of India (SEBI) consultation paper on ESG disclosure of mutual fund schemes, and the way forward.

3. Mohan Kumar Prabhu, CFA, CFA Society India volunteer, presented a comparison between the CFA Institute disclosure standards and the SEBI consultation paper, briefly presented the CFA Society India response to the consultation paper, and answered questions.

The following are the minutes of the discussion.

CFA Institute Global ESG Disclosure Standards for Investment Products

Chris Fidler provided a brief overview of the Global ESG Disclosure Standards for Investment Products ("the standard"), which are ethical standards based on the principles of fair representation and full disclosure. They are designed to communicate information about an investment product's consideration of environmental, social, and governance (ESG) issues in its objectives, investment process, or stewardship activities.

The core of the standard is to disclose how asset managers have brought ESG considerations into product design. The standard includes 10 fundamental requirements, relating to how managers need to prepare disclosures and make them available to investors. Sample ESG disclosure statements are useful for managers to see how these requirements come together for various types of products.

Feedback from global stakeholders on the standard

Fidler touched on the feedback CFA Institute received on this standard from asset managers and other stakeholders globally and explained how this feedback influenced changes in the final version. The first topic is categorisation and labelling. When CFA Institute started this project, it was open about the standards it wanted to build and felt that labelling and categorisation would help investors understand the different kinds of products in the market as well as the strategies that might meet their needs. In the first draft, CFA Institute proposed six different features that could be mixed and matched to create different products. Based on feedback, however, no agreement was reached on the terminologies or how people think about these strategies. The regulators were framing rules for different labels and terminologies. CFA Institute realised it needed to make the standard flexible enough to work in all markets. Part of the solution is to not require managers to use certain terminologies as well as not prohibit them from doing so. The final draft includes a section on terminologies, which provides recommendations but not requirements. These recommendations can be summarized in three points. First, you should use plain language wherever possible. Second, if you have to use specialised terminology, you need to define those terms, which is just good communication practice. Third, we referenced the terms from our ESG certificate, Principles of Responsible Investment (PRI), and Global Sustainable Investment Alliance (GSIA). In many cases, the terms are similar, and managers can choose among them and define them for their readers.

CFA Institute has received good feedback on the final standard. Managers have appreciated the open architecture and the flexibility to frame the disclosures, along with some guidance.

The standard and existing regulations

An important question we asked is how the standard fit with regulations. This issue is pertinent for this group, in keeping with the SEBI consultation paper on ESG disclosures for mutual fund schemes. The standard was carefully designed to fit with the regulations. The standard is complementary to the European Sustainable Finance Disclosure Regulation (SFDR) and the International Organization of Securities Commissions (IOSCO) recommendations for asset managers on investment product disclosures. SFDR and the Taskforce on Climate Related Financial Disclosures (TCFD) focus on high-level questions. SFDR asks questions about whether the product has a sustainable investment objective, what strategy the product pursues, and whether the product considers adverse impacts. These high-level questions are addressed by specific sections in the standard. The standard provides a good blueprint for managers to disclose the information sought by the regulations.

Another point of feedback CFA Institute received from asset owners, consultants, and advisers was that the standard would help them streamline the product search as well as the manager search process. The standard improves how managers can communicate about their products with their buyers.

Trade-off between standardisation and flexibility

One participant asked how the standard, which offers flexibility in terms of use and other disclosures, could simultaneously provide a degree of comparability across providers. Fidler said the main way it offers comparability is by understanding how a product has incorporated ESG. An impact product is different from an integration product. For example, the latter does not focus on solar panels. It looks at how the ESG factors, which vary for different securities, affect their risk and return. In contrast, the impact product will have a specific objective, will possibly screen out certain investments, or may have allocation targets for industries. One could make comparisons at that level. At a more granular level, exclusionary screening criteria, for example, has disclosure requirements like segments, thresholds, and definitions that also can be compared across products.

A lot of existing products are like black boxes, and regulators want to standardise them like, for example, certain inches long or weights. The standard provides a level of information on products with which categorisation and comparisons can be made. If readers look through the four sample disclosure presentations, they will recognise information organised across dimensions and should be able to compare products.

SFDR

Another participant said that if a categorisation scheme could accompany SEBI proposals, along the lines of SFDR article 8 (light green) and article 9 (dark green) funds, it would help the ecosystem. Another participant remarked that SFDR does not make it clear what should be categorised as article 8 or article 9, and most managers are struggling to categorise their funds accordingly. Some managers are taking a more conservative approach whereas others are taking a more aggressive approach to classifying their funds. SFDR has not defined what it means for a product to have a sustainable investment as an objective. An impact fund clearly could be an article 9 fund. It is ambiguous, however, if an investment product makes an allocation to investments that are sustainable according to the EU taxonomy, then it might qualify as an article 9 product. Alternatively, it can be viewed as an environmental or social characteristic, which might qualify it as an article 8 fund. European regulators did not intend the articles to be used as a label, but they should have anticipated this application. When the standard was built, the fact that different disclosure requirements would be triggered by different kinds of products was a good thing, because ultimately this led to categorisation.

Another participant asked about the future of SFDR. SFDR is an important initiative, but other regulators are likely evolving their own regulations. Climate disclosure is an area where some consensus seems to be evolving. Regardless of how the regulations evolve, the standard could be a guiding north star, because it covers different type of products, across asset classes, and it is market neutral—that is, it is designed to accommodate different investor preferences. The standard does not try to achieve any policy objectives, only product transparency.

Materiality

Another participant asked about materiality, specifically whether the standard requires asset managers to disclose quantitative criteria on their products, such as carbon or water intensity.

First, the standard does not require the asset managers to build the products in a certain way. Asset managers, however, do need to consider material ESG factors in their active strategies. Materiality should be interpreted as factors material to the investment objectives of the client. The investment objectives could be risk and return, values, or anything else. It is difficult to devise a set of standardised measures for all of the investments in a portfolio, particularly given changing portfolio compositions and the fact that some of the measures are not widely available or standardised.

Another question was raised about who should define materiality: regulators or standard setters?

Materiality is contextual, and it depends on the investment, strategy, time horizons, and client preferences, among other things. Applying an absolute standard of materiality for which judgement is needed is the wrong approach.

More broadly, policy makers view finance as a tool to create a sustainable future. Finance plays an important role, but occasionally it has gotten ahead of consumer demand. A lot of investors do not understand terms such as net zero. It is important to see some consumer demand in terms of product choices and for policy makers to pull other levers, such as a price on carbon, to achieve the desired outcomes.

Climate-related disclosures

Does the standard cover climate-related disclosures like the TCFD? Or are these disclosures tackled separately outside of the standard?

These disclosures overlap. TCFD recommends that managers disclose how they consider ESG risks and transition risks. Our standard requires managers to disclose material factors relevant to the investment process, including climate change. TCFD also goes into risk management and targets. If those targets are part of the product design, they must be disclosed as part of the standard. In this way, the standard is complementary to the TCFD asset manager recommendations.

Regarding next steps for the standard, CFA Institute plans to release a handbook that explains and interprets the provisions of the standard. CFA Institute also will release assurance procedures for independent assurance providers to examine the manager's disclosures and to test whether they meet the standard. Last, an optional disclosure template will be released to address demand from some asset managers and other stakeholders to aid standardisation and comparability.

Participant Views on ESG Disclosures and SEBI's Consultation Paper

Following the presentation, the participants shared their initial views on ESG disclosures and SEBI's consultation paper. One participant felt that SEBI's proposal for fund managers to report on stewardship and engagement on every ESG product is expansive and adds to compliance burden. Currently, stewardship reporting is done at the fund house level, and if a fund house has multiple funds, the engagement with the issuer is not different across funds.

At this point, we remarked that stewardship reporting in India is nascent, primarily viewed as a compliance exercise, and mostly lacking a narrative explanation of how fund managers are engaging with companies. We asked participants if stewardship reporting for ESG funds could nudge funds to take a different tack and report their engagement with companies in a meaningful way. To this, a participant responded that most of their engagement happens with companies that do not consider sustainability in their business. The holdings in the ESG fund, however, are selected carefully among those that are performing well on the ESG dimensions, which might be a fraction of the companies the analyst engages with. The analyst in this case might report not only which companies she engaged with but also the level of engagement, the topics of engagement, and voting decisions with reasons. Therefore, if you require engagement at the ESG fund level, and not just at the fund house level, you will end up with multiple reports on the same holdings at the fund house, the mutual fund, and the portfolio management services levels.

A second aspect in the SEBI's paper is difficult at this stage—that is, funds should demonstrate real-world outcomes. Most funds consider ESG aspects within the investment process, without looking at the real-world outcomes or impact that their funds are creating. It is better to focus on ESG risks and opportunities that are being considered as part of the product.

SEBI's Business Responsibility and Sustainability Reporting (BRSR) is mandatory for top 1000 companies. One participant said that SEBI's proposal to make BRSR disclosure mandatory for inclusion in ESG funds might disincentivise small-cap funds, which may invest outside top 1000 companies, to become ESG oriented. Therefore, as long as there are some ESG disclosures, it is better to not make BRSR mandatory. CFA Society India also discussed this issue and arrived at the same recommendation. Some participants questioned that view, saying ESG funds are given the flexibility of adopting ESG considerations only up to 80% of the investments. Investments beyond the top 1000 companies, which are microcaps, are likely small. Therefore, it was not necessary to make BRSR optional. The economics made perfect sense, but the recommendation for not making it mandatory was based on a principle that asset managers should be allowed to make their judgements about ESG factors of a company and should not be restricted by BRSR disclosure requirements.

One participant remarked that it is difficult for public funds to demonstrate impact outcomes, one of the categories in the paper. He felt that it is easier for investors in private markets to create impact outcomes than for public funds, which have small stakes in public companies, to do the same. Another participant agreed and said perhaps impact in the public context means investing in certain segments, such as education or health care, which are oriented towards certain social outcomes.

Another participant suggested that the dates for implementing the BRSR requirement for funds should be rolled forward by one year, because BRSR is made mandatory for top 1000 companies only from March 2023. He also suggested that imposing standardisation at such an early stage of ESG investing is not conducive for innovation. Presently, ESG is viewed primarily through a risk lens. In time, ESG may be considered in terms of opportunities, and that would be the time to mandate disclosures on impact and other dimensions.

One participant remarked that the consultation process got it backwards, viewed from a regulator and fund manager perspective. When the participant asked investors why they invest in ESG funds, almost everyone said they wanted better returns than the benchmark. Sovereign wealth funds might take an enlightened ESG perspective, but investors care about returns. The SEBI consultation paper does not recognise this perspective. We asked participants if the disclosures could bring about a change in mindset and play an educational role surrounding sustainability considerations, rather than wait for investor attitudes to change. One participant said that the disclosure requirements has come about because of the change in perception, however small. Another participant said the awareness about what these funds stand for is important. Disclosures are a first step, and we need to see how attitudes evolve.

Comparison between SEBI's Consultation Paper and the Standard

Mohan Kumar Prabhu walked the participants through a comparison between SEBI's consultation paper on ESG disclosures and the standard.

SEBI's proposals are a combination of firm-level, product-level, and periodic disclosures, although they are not structured as such. The proposals cover policies and procedures, in addition to disclosures. CFA Institute ESG disclosure standards, however, cover only disclosures, and therefore our comparisons are limited.

On firm-level disclosures, SEBI's proposals cover a responsible investment policy and disclosures around ESG investing on the firm's website. The responsible investment policy includes the universe of companies the fund invests in, the processes to review investments, and the expectation that the investments generate a beneficial sustainable impact alongside financial returns. The website disclosures cover aspects related to ESG investing like information sources, investment processes and philosophy, key ESG factors, and engagement policies. CFA Society India recommended that the disclosures on the website be aligned with other disclosures in the Scheme Information Documents (SID) and Key Information Memorandum (KIM), and website disclosures, such as ESG data sources, and key ESG factors should be made part of the product disclosures.

One participant asked what a beneficial sustainable impact means. We remarked that, in practice, it could mean a better ESG score, even if the scores are subjective.

On product-level disclosures, the distinction between SEBI's disclosures and the standard is subtle. SEBI ties the investment objectives with the nomenclature of the fund; the standard does not cover naming but rather requires managers to disclose any third-party labels and certifications that the investment product complies with, and those certifications or labels might cover naming conventions. Also, the detail in SEBI's consultation proposal varies across investment approaches—for example, an investment strategy that incorporates screening or exclusions has detailed disclosure requirements, such as the characteristic or type of exclusion, thresholds, and reference to third-party guidelines, whereas a best-in-class or positive screening approach merely requires funds to disclose "details and specifics of the metrics." The standard provides detailed guidance across approaches. The standard also has fewer investment approaches compared with SEBI's consultation paper because it combines similar ones—for example, for the purpose of disclosures, best-in-class/positive screening or exclusions/negative screening are treated as one approach. Likewise, for the purpose of disclosures, impact investing and sustainable objectives also are combined in one approach.

For some investment objectives, the standard requires disclosures that are complementary to SEBI's proposals. For example, for an impact investment objective, the standard requires managers to disclose how the impact objectives are expected to be attained, the effect of investments on environment and governance issues, and how adverse impacts are managed. In addition, the standard also requires managers to disclose the stakeholders who are expected to benefit, discuss any trade-offs between impact and financial objectives, and explain how the impact objectives contribute to Sustainable Development Goals (SDGs), if stated.

We asked participants how they differentiated an impact investment strategy and a sustainability objective. One participant responded that impact investing needs a beneficiary, whereas sustainability objectives are related to SDGs, but some could overlap. Others said sustainability objectives would require investing in companies that have great potential from an ESG perspective, like clean tech or sustainable agriculture. These objectives might have an impact as well, but they are defined primarily in terms of opportunities.

Conclusion

In summary, CFA Society India recommended that SEBI's proposals be structured in terms of firm-level, product-level, and periodic disclosures, for readability. Required disclosures and recommendations related to practices, policies, and procedures of the fund should be differentiated. SEBI also may consider additional disclosure requirements from the CFA Institute disclosure standards to refine its own disclosure requirements and to facilitate fair representation and full disclosure of an investment product's ESG considerations.

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