

What's in a name: SEBI standing guard against ESG greenwashing

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India's securities regulator SEBI has, in its board meeting on March 29, 2023, approved much-awaited regulations for ESG related disclosures, certifications and labelling to facilitate more transparency and promote sustainability linked investing. Currently there are not more than 15 ESG funds in the Indian market, far lower than the global markets. Despite growing interest in sustainable themed investing, investors do not fully comprehend what ESG funds offer in the absence of adequate disclosures and are wary of greenwashing. The new measures by SEBI aim to improve monitoring of ESG performance and will boost investor confidence and lead to more ESG investing over time.

The amended regulations will gradually increase the obligations of top 1000 listed companies beyond submitting an annual Business Responsibility and Sustainability Report (BRSR), as they will be required to submit mandatory assurance-based disclosures on key performance indicators under specified E, S and G attributes, referred to as the 'BRSR Core' in a phased manner. A regulatory framework has been introduced for ESG rating providers who will be required to apply a minimum set of defined ESG parameters based on the BRSR Core indicators that are assured by third party review. Mutual fund regulations have also been amended to introduce criteria and expand disclosure norms for ESG labelled schemes with focus on mitigating risks of mis-selling and greenwashing.

ESG regulations are sweeping across the world

Indian regulatory action has come in the backdrop of increasing global scrutiny of greenwashing in sustainable investments. The US SEC and Australian Securities and Investment Commission (ASIC) have prioritised greenwashing scrutiny in their agenda setting for 2023 calling out investment funds for inadequate implementation of ESG policies and overstating the scope of their sustainable investments. Last year, European Securities Markets Authority (ESMA) had raised concerns on the use of Sustainable Financial Disclosure Regulation (SFDR) as a marketing tool. In anticipation of SFDR's Level 2 enforcement, many European sustainability related funds reclassified themselves to meet the disclosure requirements.

Proposals have been made in all markets for enhanced disclosure and regulation of sustainability linked schemes. In May 2022, the US SEC proposed that 80% of an ESG fund's AUM should be in the theme and barred investing the remaining 20% in securities that are antithetical to the objective. ESMA too has suggested guidelines on naming ESG and sustainability related funds.

The SEBI regulatory amendments will implement a staggered approach to address similar concerns while recognising global themes in growing Indian markets.

Amended regulations address the disparity of standards in ESG labelling and rating

Mutual fund regulations always required that schemes should state the nature, investment objectives, product characteristics, and risk level. But additional filters are needed in the context of ESG labelled schemes.

Investors want to know how fund managers evaluate their portfolio companies and follow through their stated sustainability objectives. A close look reveals asymmetric practices in the approach to integrating ESG criteria in asset management in India and attaching 'ESG or green' themes to financial products, and there is limited disclosure of the ESG factors in the fund offer documents. Some fund managers could be simply relying on self-reporting by companies or their CSR activities. Some funds rely on a benchmark index or on third party rating agencies who may assign scores based on discretionary and unscientific assessment of risk management. The parameters applied are ambiguous and provide retail investors little clarity on the assessment of ESG performance.

Globally, funds apply a combination of positive criteria relative to the assets in the portfolios and negative sectoral screenings. Positive criteria may include factors such as energy conservation, renewable energy, diversity initiatives, CSR donations etc. Whereas negative screening could involve excluding unconventional weapons, tobacco, fossil fuels, sanctioned countries, or companies with controversial human rights' practices at the fund manager's discretion.

The amended SEBI regulations provide a more exhaustive list of ESG strategies namely exclusionary, integration, impact investing, positive screening and sustainable objectives. Once a fund uses ESG in its name, the fund managers will be required to follow disclosure and monitoring requirements on a continuous basis, such as disclosing voting decisions and how ESG strategy has been applied on the portfolio. Funds must further cite case study examples of engagement with investee companies and annually disclose a fund manager commentary.

SEBI has also mandated a more reliable framework for ESG rating providers for schemes to rely on in their monthly portfolio disclosures. The amended regulations require rating providers to disclose the rating rationale based on qualitative and quantitative factors, key drivers of ESG and the weight assigned. To ensure more credibility, rating providers will also offer a separate category of ESG rating referred to as the 'Core ESG Rating' based on the parameters under BRSR Core which will require a third party assurance and audit. SEBI has further recommended empanelment of rating providers based on prescribed parameters and a standardised ESG scoring process.

Under SEBI Master's Circular for Mutual Funds 2020, thematic mutual funds are required to invest 80% of their total assets in the relevant theme. In a consultation paper preceding the current amendments, SEBI had recommended an additional safeguard that would restrict the fund from investing the remaining 20% in stark contrast to the theme, a move in line with US SEC and ESMA proposals. Though this recommendation was not specifically adopted into the amended regulations, it is expected that compliance with the general asset allocation requirements will be tested more strictly. Separately, the amended regulations mandate ESG schemes to invest at least 65% of the AUM in listed entities where assurance on BRSR Core is undertaken. Additionally, funds will be required to provide third party assurance and an audit certificate on compliance with the scheme's objectives.

Road Ahead for ESG investment regulations in India

Investor knowledge is crucial to tackling greenwashing. Transparent, comparable, and decision-useful disclosures enable investors to make informed investment decisions. The amendments are a step towards the standardisation of disclosure and measurement norms in the Indian ESG

market. The amended regulations not only lay emphasis on reliable assessment and data transparency, but also highlight the stewardship responsibilities of funds for improved corporate governance and protection of investors.

Indian regulators are taking steps to steadily bring the sustainable finance market at comparable standards with global markets. That said, India's emerging market will prefer a phased approach for implementation given the unique domestic context, economic realities, and transition goals for varied industries in the country. As the opportunities for ESG linked investments in India deepen, further regulatory calibration can be expected from time to time.

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