THINKING OF FORMING AN ESG FUND? FIVE POINTERS FOR FUND MANAGERS

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Among other lessons learned during 2020 (and there certainly have been many) is that environmental, social, and governance (ESG) factors and responsible investment (RI) matter. A lot. According to a 2020 Morningstar, Inc. report, global ESG assets reached US $ 1.06 trillion as of June 30, 2020, with this staggering growth continuing into 2021 and beyond.

The intertwined concepts of ESG and RI are rapidly evolving. There have been many calls for the implementation of standardized terminology and the industry is certainly making progress in this regard but, for now, ESG and RI can mean a myriad of things - along with the numerous variations on these terms, such as "sustainable investing", "impact investing", and "values-based investing", to name a few. The meanings of these terms could range from funds entirely dedicated to investing in assets that contribute to a designated social cause, to funds that exclude investments in certain industries, to the internal business of the fund managers themselves and how they address topics such as gender balance and diversity and the environment, and everything in between. The term “ESG” is used in this article to broadly encompass all of these concepts.

In structuring and launching an ESG fund, managers should bear the following key pointers in mind.

1. Survey the Landscape

There are a growing number of ESG related frameworks, standards, regulations, and other initiatives being developed, both within Canada and internationally. They range from voluntary disclosure frameworks to ratings systems for funds to mandatory regulatory requirements, focusing on a wide range of topics such as disclosure, measurement, metrics, reporting, benchmarks, ratings, best practices, guiding principles, and the development of standardized terms and definitions.

Fund managers looking to enter this space should first consider conducting a survey of the landscape to determine which frameworks, standards, regulations, and initiatives may assist in guiding fund structuring and investment decisions in relation to their business, funds, investments, and investors. This review may include:

GRI ***Global Reporting Initiative Standards***	**CDP** ***(formerly, the Carbon Disclosure Project)***	**UNPRI** ***United Nations Principles for Responsible Investment***	**SASB** ***Sustainability Accounting Standards Board***
1997	**2000**	**2006**	**2011**
Modular standards that contain requirements, recommendations, and guidance. Three Universal Standards apply to sustainability reports: (i) Foundation (starting point for using the GRI Standards); (ii) General Disclosures (for contextual information about an organization); and (iii) Management Approach (management approach for each material topic).	CDP's questionnaires (on climate change, forests, and water security) provide a framework for environmental reporting and climate change information in global mainstream corporate reporting. Responses lead to letter grade scores that measure environmental performance. Updated in April 2018 to align with the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD).	United Nations' supported initiative that encourages incorporation of environmental, social, and corporate governance factors (ESG) into investment decision-making. Six principles regarding analysis of ESG issues in investment process, ownership, and disclosures provide a global framework for institutional investors to consider ESG issues.	Sustainability disclosure standards that are industry-specific and based around the concept of materiality from a financial reporting perspective. On average, SASB Standards include 13 accounting metrics per industry. The metrics are accompanied by technical protocols that provide guidance on definitions, accounting, compilation, and presentation.
UN SDGs ***United Nations Sustainable Development Goals***	**TCFD** ***Task Force on Climate-Related Financial Disclosures***	**WEF** ***World Economic Forum International Business Council Stakeholder Capitalism Metrics***	**IIRC** ***The International Integrated Reporting Council – International <IR> Framework***
2015	**2015**	**2020**	**2021**

Aspirational goals, adopted by all United Nations Member States in 2015 as a universal call to action to end poverty, protect the planet, and ensure that all people enjoy peace and prosperity by 2030. Covers a range of topics including poverty, health and education, inequality, economic growth, climate change, and environmental matters.	Establishes recommendations for disclosing clear, comparable, and consistent information about disclosure of risks and opportunities presented by climate change. In its final report released in January 2021, Ontario's Capital Markets Modernization Taskforce recommended mandating certain ESG disclosure that is compliant with the TCFD.	Set of 21 core and 34 expanded Stakeholder Capitalism Metrics and disclosures focused on people, planet, prosperity, and governance. Contributes towards the Sustainable Development Goals (SDGs). Examples of core metrics include GHG emissions, water consumption, and pay equality. Collaborative effort with the Bank of America, and the "big four" accounting firms.	Establishes seven guiding for effective corporate reporting, with particular focus on stakeholder relationships, materiality, and a holistic picture of the business enterprise. Information to be included in an integrated report for use in assessing an organization. Primarily for use in the context of private sector, for-profit companies of any size.

Fund managers should also carefully review the guidance published by the Canadian Securities Administrators (CSA) and the Toronto Stock Exchange, such as the guidance devoted to climate risk disclosure, and current initiatives in progress, such as the consultation paper released by the Chartered Financial Analyst Institute (CFA Institute), which is aiming to release a voluntary, global industry standard later this year. Fund managers active in other jurisdictions, especially Asia and Europe, should pay careful attention to the current and proposed regulations and guidelines being developed in these jurisdictions as many are or will be mandatory and prescriptive (such as the recently implemented Sustainable Finance Disclosure Regulation (SFDR) in Europe).

2. Think About the Future

Although in Canada there is growing convergence toward and support for the TCFD recommendations, it is still unclear what the regulatory and business landscapes will look like in a few years' time. Industry pressure continues to grow for some type of standardization, such as the joint statement released in November 2020 by the CEOs of eight leading Canadian pension plan investment managers calling for more consistent and complete ESG information.

As the landscape develops, fund managers may wish to consider how their ESG funds will be able to adapt to changing regulatory requirements or other commercial considerations. For example, if prescriptive regulations are released, what steps will the funds need to take to comply? There are many organizations that are launching ratings systems for ESG funds, including Morningstar (Sustainalytics) and MSCI, to name a few. Fund managers may wish to consider what types of approvals, consents, and / or notices may be required (if any) should they wish to modify certain aspects of a fund's mandate to permit it to meet the requirements of a particular rating agency.

3. Internal Operations

For fund managers making their first foray into the ESG space, an examination of internal operations and personnel should be conducted to determine that the advising representatives of the manager have the necessary education, training, and proficiency to effectively manage an ESG investment strategy or if any updates, additional training, or enhancements should be undertaken. Fund managers may also wish to consider forming an oversight committee to review ESG related matters or a specific ESG investment committee, hiring qualified personnel focused on ESG matters, or creating new reporting functions and roles specific to ESG matters.

Apart from internal personnel, processes, and governance relating to ESG investments, fund managers may also want to consider their own internal policies and procedures. Investors are becoming increasingly focused on not only the funds themselves, but also whether the business of the manager reflects these same principles. Fund managers should review their internal policies, procedures, and operations and assess how they align with the overall investment principles their ESG funds have adopted. This may include considering factors such as the investment strategies utilized by other funds advised by the manager, gender balance and diversity of staff, wellbeing and mental health, community involvement, and environmental footprint.

4. Reporting and Compliance

Of key importance for any ESG fund are the answers to the following questions:

- How will the fund measure and monitor performance and compliance with its ESG guidelines?
- How will ESG performance and compliance be disclosed / reported?

The first question requires fund managers to consider both the due diligence conducted on portfolio investments to ensure it meets the fund's ESG criteria and compliance testing and monitoring of the fund's portfolio itself. Whether a fund manager chooses to follow a set of published guidelines or not, it should ensure that the fund's disclosure is clear, transparent, measurable, and coherent.

Fund managers can consider:

- How due diligence and monitoring processes will address inconsistent or incomplete data across assets;
- How to ensure accountability for the information presented;

- What controls (external and internal) will be in place to provide reasonable verification and assurance of any facts and assumptions;
- What are the intended results and impacts;
- What quantifiable and comparable metrics will they use to measure their progress;
- How to assess and evidence performance against non-financial goals and outcomes that may be difficult to measure;
- Benchmarking, including against peers, and ensuring that standards are well aligned and not misleading or "cherry-picked"; and
- What circumstances will permit deviations from the stated investment policy or strategy and how would a deviation be documented and disclosed.

Fund managers may also wish to speak with their service providers to determine if they have systems and technologies that can accommodate ESG compliance monitoring. In addition, fund managers can consider if there are other technological advances that may assist them in this regard. For example, advanced data analytics has become a component of ESG analysis, where artificial intelligence (AI) and other tools can be used to assist in analyzing and assessing investments.

5. Avoid Ambiguity

Given the wide variance in approaches and terminology in this field, there is risk that ambiguous offering documents and marketing materials may put fund managers at risk of regulatory scrutiny or being unfairly labeled as "greenwashing" (i.e., providing misleading information or claims about ESG practices, performance, products, or credentials).

Fund managers should review their offering documents and marketing materials to ensure that it is clear how ESG factors will be incorporated into their funds and their investments, and how these matters will be measured and reported. Marketing materials should be fair, clear, and not misleading. The focus on ESG-related disclosure should be consistent with and proportionate to the focus on ESG within the fund's strategy. With increased attention by the regulators in this space, fund managers of ESG funds can likely expect regulatory scrutiny with respect to their funds in some capacity. Notably, the Securities and Exchange Commission (SEC) recently announced the formation of a Climate and ESG Task Force under the purview of the SEC's Division of Enforcement that will develop initiatives to proactively identify ESG-related misconduct and the Ontario Securities Commission (OSC) has been conducting a targeted review of ESG funds.

Given the focus on ESG considerations, even fund managers that are not currently planning on forming ESG focused funds may wish to familiarize themselves with and start having internal discussions on this topic. Investors and shareholder activists are increasingly adding ESG as a part of their standard due diligence process and managers may wish to develop a view point on this subject so that they are prepared to respond to these types of inquiries.

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Learn about new developments in sustainability and how McMillan LLP can help you reach your ESG goals here.

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.