Canadian securities regulators conduct a “green” sweep of ESG products and practices

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The Ontario Securities Commission and the British Columbia Securities Commission are currently performing desk reviews of registrants identified as participants in ESG investing. Fund managers, portfolio managers and exempt market dealers should be prepared to respond on their ESG-related portfolio and fund management, compliance and marketing and disclosure practices. Misleading practices may result in regulatory enforcement action and investor claims for misrepresentation.

As retail and institutional investors continue to incorporate environmental, social and governance (ESG) factors into their investing philosophies, many new products and services purporting to meet investors’ ESG needs have entered the market. The Canadian Securities Administrators (CSA) has kicked off an initiative whereby regulators such as the Ontario Securities Commission and the B.C. Securities Commission are conducting ongoing desk reviews or “sweeps” of the ESG practices of select investment fund managers, portfolio managers and exempt market dealers. These registrants have been identified as participants in ESG investing because they manage and/or offer ESG investment products, or offer advisory services with an ESG element.

These reviews have generally focused on two areas:

- Whether ESG factors have been integrated into the registrant’s service offerings; and
- Marketing practices and materials relating to a registrant’s corporate brand, including marketing of key people and product lines.

What regulators are looking for

Securities regulators wish to confirm that the representations registrants are making about the incorporation of ESG principles in their investment decision-making processes are consistent with their actual policies and procedures. Both continuous disclosure documents and marketing materials are being examined.

To do this, securities regulators have contacted registrants with a questionnaire seeking information on the following topics:

Portfolio/fund management

ESG investing

Information about ESG products that the registrant offers to clients and/or ESG concepts that it integrates into its investment process.

Information on the features of ESG products that the registrant offers to clients, such as investment objectives, methods used to consider ESG issues, active ESG screens and percentage of portfolio holdings expected to adhere to ESG objectives and restrictions.

ESG principles and metrics

Information about specific ESG principles, such as the United Nations Principles of Responsible Investment, to which the registrant adheres, and whether the registrant employs any quantitative or qualitative ESG metrics.

ESG firm framework

Information about the registrant's approach to applying ESG principles and metrics; whether a third-party vendor is used for ESG data, research or analysis; the nature of the registrant's ESG policies and procedures (including whether policies exist on active ownership and proxy voting); and the manner in which the registrant engages with issuers and industry groups on ESG-related matters.

Compliance

ESG oversight framework

Information about how the registrant conducts ESG compliance, including the personnel involved in ESG oversight, whether the registrant's board of directors receives reports of ESG compliance, and whether staff are trained and/or required to be accredited on ESG matters.

Marketing and disclosure

ESG marketing

Information about the types of marketing that the registrant uses to promote ESG investing, the degree of oversight applied to this marketing, and how alignment is ensured between marketing statements and the registrant's ESG processes, policies and procedures.

ESG disclosure

Information about the type, frequency and dissemination of the registrant's ESG disclosure, including whether educational materials about ESG investing are provided to interested investors.

In addition to this questionnaire, securities regulators are reviewing registrants' websites and other publicly available materials and may follow up with questions, regardless of whether the registrant is part of the broader desk review.

Regulatory standards for disclosure

In the absence of a standardized framework for ESG disclosure or even a standardized glossary of ESG terms, securities regulators are concerned about "greenwashing," which is when investors are misled or deceived about the environmentally responsible nature of a registrant's products, aims and policies. Securities regulators want to ensure that a registrant's marketing claims regarding ESG practices align with the registrant's actual portfolio management practices or fund investment objectives.

Although there is no specific standard regulating ESG disclosure, the CSA has existing tools to address this issue. In addition to the requirement in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* that all registrants must deal fairly, honestly and in good faith with their clients, there are specific rules that apply to marketing prospectus-qualified mutual funds:

- Paragraph 15.2(1)(a) of National Instrument 81-102 *Investment Funds* (NI 81-102) states that sales communications must not be untrue or misleading.
- Section 13.1 of the Companion Policy to NI 81-102 lists some of the circumstances in which, in the view of the CSA, a sales communication would be misleading. An example of a misleading statement is one that lacks the explanations, qualifications, limitations or other statements that are necessary or appropriate to make the statement not misleading.
- OSC Staff Notice 81-720 *Report on Staff's Continuous Disclosure Review of Sales Communications by Investment Funds* states that sales communications should not contain statements that are vague, exaggerated or that cannot be verified.

In addition to the risk of regulatory enforcement action from misleading marketing materials, ESG claims in fund disclosure documents (such as prospectuses and offering memoranda) that do not correspond with actual portfolio management activities may expose a fund manager to investor claims for misrepresentation. Disclosure documents should be closely reviewed to confirm the manager has accurately described the ESG philosophy and process used by the fund. Further, managers may wish to consider ESG risk disclosure, explaining that the manager's view of ESG may not align with the view of all investors and that the manager's ESG screens may eliminate investments that could outperform investments that satisfy the screening requirements.

A reference point: SEC's review of ESG disclosure

South of the border, the U.S. Securities and Exchange Commission (SEC) has conducted a similar "green" sweep. The SEC has examined whether U.S.-based

investment firms are accurately disclosing their ESG investing approaches and whether they have implemented policies, procedures and practices that align with their ESG-related disclosure. SEC staff observed instances in which investment advisers, registered investment companies and private funds, among other entities, provided potentially misleading statements regarding ESG investing processes, lacked ESG policies and procedures despite claiming to have such policies, and failed to have compliance programs that were reasonably designed to guard against inaccurate ESG disclosures and marketing.

The SEC also noted a number of practices it considered to be particularly effective and reasonably designed. These included having simple and clear disclosure regarding the registrant's approach to ESG investing; explanations regarding how investments were evaluated using global ESG frameworks; policies and procedures that addressed ESG investing and covered key aspects of the registrant's relevant practices; and compliance personnel that were knowledgeable about the registrant's specific ESG-related practices. These findings of the SEC are a helpful indicator of what Canadian securities regulators may find favourable or unfavourable in their ESG reviews.

ESG disclosure rules come into effect in Europe

The European Union took a step closer to harmonizing its framework for ESG disclosure when Level 1 of the Sustainable Finance Disclosure Regulation (SFDR) came into effect on March 10, 2021. Level 1 SFDR requires certain financial market participants, such as asset managers and financial advisers whose business is in the European Union, to provide mandatory ESG disclosure on their websites and pre-contractual information communications. These financial market participants must post their policies on integrating sustainability risks in their investment decision-marking processes or advice, or explain their non-compliance.

As part of the European Union's 2030 Agenda for Sustainable Development, SFDR is intended to help investors make informed investment decisions and to prevent "greenwashing." Level 2 of the SFDR will be phased-in starting on January 1, 2022. Level 2 SFDR will require in-scope financial market participants to provide ESG disclosure in periodic reports and to ensure their ESG disclosure complies with regulatory technical standards. ESG disclosure mandated by SFDR may help Canadian registrants understand regulatory expectations and provide a useful reference point for developing an ESG compliance regime in Canada.

Key takeaways

- Canadian securities regulators are reviewing registrants' ESG disclosure and marketing materials to ensure that they are consistent with registrants' actual ESG policies and practices.
- Disclosure that could potentially mislead investors into believing that a registrant's ESG policies and procedures are more stringent or effective than they actually are could expose that registrant to regulatory enforcement and potential liability for investor claims of misrepresentation.
- All registrants that participate in ESG investing need to ensure that they have clearly defined ESG policies and principles and that their disclosure documents and marketing materials align with these policies and principles.

If you have been contacted by a securities regulator regarding ESG disclosure and would like assistance with your response or you have any questions about your firm's ESG disclosure or policies and procedures, contact your BLG Investment Management lawyer or any of the key contacts listed below.

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