Understanding the CSA's guidance on ESG disclosures by investment funds

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Earlier this year, the Canadian Securities Administrators (CSA) released CSA Staff Notice 81-334 *ESG- Related Investment Fund Disclosure* (the Staff Notice), describing the results of the CSA's review of public disclosure by investment funds on environmental, social and governance (ESG) considerations. Through the Staff Notice, the CSA provide guidance on compliance with existing requirements and recommend best practices concerning ESG disclosure for regulatory documents and sales communications. Notably, the CSA state that they are not creating any new legal requirements nor modifying any existing ones - rather, the CSA are simply explaining how existing securities regulatory requirements should be considered when providing ESG-related disclosure.

Interest in ESG investing has grown considerably over the past few years, among both retail and institutional investors. The Staff Notice highlights a 2020 report from the Global Sustainable Investment Alliance, which states that, compared to other regions such as the U.S., Japan and Australasia, Canada experienced the largest increase in "sustainable investment" assets over the preceding two years (48 per cent growth). Consequently, the Canadian industry has responded to this demand by creating new products and incorporating ESG into existing products. The CSA suggest that the quick growth of ESG-related products has increased the potential for "greenwashing", where a fund's disclosure documents or sales communications intentionally or inadvertently mislead investors about the ESG-related aspects of the fund.

Key takeaways

- The CSA's review of existing disclosure indicated that investors in ESG-related funds would benefit from greater detail regarding the ESG-related aspects of those funds, particularly regarding investment strategies disclosure, proxy voting disclosure and continuous disclosure documents.
- Guidance on **11** different aspects of regulatory disclosure and sales communications have been provided - while some parts of this guidance are considered "best practices" (denoted by the term "encourage"), and therefore not technically binding (though practically, funds and IFMs may consider it as effectively binding), other parts are intended to clarify existing requirements, which are binding.

- Industry participants now have a rubric for assessing their ESG-related disclosure to ensure that inadvertent "greenwashing" does not occur. A fund does not need to reference an ESG concept in its name in order to trigger many of the expectations in the Staff Notice; simply having ESG concepts in a fund's strategies or marketing may be sufficient.
- CSA staff have been using the Staff Notice to assess prospectus filings. For example, OSC staff is asking fund managers to provide copies of all sales communications, including all advertisements and links to any websites, relating to ESG-related funds that were publicly disseminated within 60 days of a prospectus filing, in order to assess whether prospectus disclosure is consistent with fund marketing. OSC staff also stated that they will request/review marketing materials in order to assess compliance with the Staff Notice in connection with ongoing continuous disclosure reviews.

Guidance

The CSA provide their views on eleven areas of ESG-related disclosure:

- *Investment Objectives and Fund Names*: If a fund's name references ESG, its investment objectives must reference the ESG aspect included in the fund's name, given the suggestion that the fund is fundamentally an ESG fund. If a fund's investment objectives do not reference ESG, the fund's name should not reference ESG. However, ESG funds do not have to refer to ESG in their names; they can reference ESG considerations in their investment objectives.
- *Fund Types*: A fund, which includes ESG in its investment objectives, may characterize itself in its prospectus disclosure as a fund focused on ESG in addition to its primary fund type (*i.e.* "ESG Canadian Equity Fund"). However, a fund that does not include ESG in its fundamental investment objectives should not characterize itself as a fund that is focused on ESG.
- *Investment Strategies Disclosure*: A fund that uses one or more ESG strategies (either as principal strategies or as part of its investment selection process) is required to include disclosure about the ESG-related aspects of these strategies. This disclosure should include any ESG factors used, an explanation of the meaning of each ESG factor and how these factors are evaluated and monitored. An ESG fund should disclose whether it may, at any point in time, hold investments that appear to be inconsistent with ESG values, what those holdings would include (including examples), and how such holdings meet the fund's investment objectives. If an ESG fund is not permitted to hold such investments at any point in time, this should be disclosed, along with information about the monitoring process used by the fund to screen out these investments. If a fund has discretion over whether a type of investment is excluded, this should be clearly disclosed. While the guidance relating to investment strategies disclosure applies to all funds (including index-tracking funds), the Staff Notice provides additional guidance for funds that use proxy voting or shareholder engagement as an ESG strategy, multiple ESG strategies, and ESG ratings, scores, indices or benchmarks.
- *Proxy Voting/Shareholder Engagement Policies and Procedures*: If a fund uses proxy voting as an ESG investment strategy, the prospectus and/or AIF, as applicable, should include a summary of the ESG aspects of the fund's proxy voting policies and procedures. The CSA encourage funds to make the most recent copy of their proxy voting policies and procedures available on their

designated websites. The CSA encourage funds that use shareholder engagement as an ESG strategy to make their shareholder engagement policies and procedures publicly available. Further, the CSA encourage all funds, particularly those that use proxy voting or shareholder engagement as an ESG strategy, to post their annual proxy voting records or disclosure about their past engagement activities on their designated website (including historical records).

- *Risk Disclosure*: ESG-related funds should disclose any material risk factors that are applicable to the fund as a result of its ESG-related investment objectives and/or its use of ESG strategies (*e.g.,* concentration risk, risk of underperformance due to the fund's ESG-related focus, or risk arising from potential overreliance on third-party ESG ratings). All investment funds (regardless of whether they are ESG-related funds or not) should disclose any material ESG-related risk factors applicable to the fund (*e.g.,* climate change risk).
- *Suitability*: In an ESG-related fund's Fund Facts or ETF Facts document, the required statement of the suitability of the fund for particular investors should accurately reflect the extent of the fund's focus on ESG, as well as the particular aspects of ESG that the fund is focused on (if applicable). A fund should only state that it is particularly suitable for investors with ESG-related investment objectives if the fund references ESG in its fundamental investment objectives.
- *Continuous Disclosure*: ESG-related funds should disclose how portfolio composition (and changes to portfolio composition) relate to the fund's ESG-related investment objectives and strategies, and funds should disclose ESG-related results of fund operations in continuous disclosure documents (MRFPs). Where a fund's investment strategies include measurable ESG-related outcomes, progress toward these outcomes should also be disclosed. The CSA encourage ESG-related funds to include in their MRFP, as part of the summary of results of the fund's operations, disclosure about how proxy voting or shareholder engagement during the relevant period align with the fund's ESG-related investment objectives or strategies.
- *Sales Communications*:
  - **Sales communications that indicate that the fund is focused on ESG**: A fund should not include statements that indicate that it is focused on ESG unless its investment objectives reference ESG as well.
  - **Sales communications that reference a fund's ESG performance**: Funds must not make misleading claims about the existence of a direct causal link between the fund's investment strategies and ESG performance or results, or cherry-pick data to present the fund's ESG performance in a positive light.
  - **Sales communications that include fund-level ESG ratings, scores or rankings**: The CSA do not consider ESG ratings and rankings that are primarily weighted averages of company-level ESG ratings for portfolio constituents to be "performance ratings or rankings", however, other types of fund-level ESG Ratings that are not portfolio-based may be considered to be "performance ratings or rankings". The CSA include various guidance on ESG ratings, score or rankings, including how to select a provider to prepare the ESG rating, ranking or score and certain disclosure that should be included clearly (and "not buried within fine print") in a sales communication that includes fund-level ESG ratings, scores or rankings.
- *ESG-Related Changes to Existing Funds*: If a fund intends to change its name to add or remove a reference to ESG, it must also consider whether its investment objectives must be changed as well (which requires securityholder approval).

However, a fund that does not have ESG-related investment objectives may still use ESG strategies, and may add or remove this disclosure in its strategies without referencing ESG in the fund name and without security holder approval. Funds will need to consider whether changing an investment strategy triggers a material change for the fund, with the attendant disclosure obligations.

- *ESG-Related Terminology*: Descriptions of ESG strategies must be written in plain language to ensure that investors can understand, and complex topics must be explained clearly, as ESG-related terms and definitions are not yet standardized across the industry. The CSA encourage industry participants to develop common ESG-related terms and definitions, particularly with regard to ESG strategies, albeit without any specific guidance on how to this could be done.
- *Fund Manager-Level Commitments to ESG-Related Initiatives*: Where a fund manager is a signatory to an ESG-related initiative (such as the UN Principles for Responsible Investment) and discloses this in a regulatory document, it must be clear that this commitment is at the entity level, rather than the fund level, and that all funds managed by the fund manager may not be focused on ESG.

Given the growth of ESG funds and investor interest, we can expect more guidance from the CSA and other Canadian and international organizations on various considerations related to ESG strategies for funds and other investment products.

If you have any questions about the Staff Notice, or would like assistance with incorporating this guidance into your fund's marketing materials or regulatory disclosure documents, please contact one of the authors or your usual BLG Investment Management lawyer.

For more information about ESG, please visit BLG's dedicated webpage on our ESG practice and expertise.

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