ESG-related investment fund disclosure in 2024: “Walk your talk”

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CSA continues to define and refine ESG-related fund disclosure expectations

Two years and two months after the Canadian Securities Administrators (CSA) published CSA Staff Notice 81-334 *ESG-Related Investment Fund Disclosure* (the Original Notice) with respect to environmental, social and governance (ESG)-related investment fund disclosure, updated guidance has been released that replaces the Original Notice (the Revised Notice).

The Revised Notice catalogues the CSA’s findings arising from their ESG-focused reviews of the disclosure and sales communications of investment funds (the ESG-Focused Reviews) and provides guidance relating to a new fund classification - the ESG Limited Consideration Fund. It also clarifies the CSA’s view of what constitutes a “sales communication”.

The addition of a new fund classification to the CSA’s guidance is significant because a fund’s classification determines what can - and what must and must not - be said about an investment fund in its marketing and disclosure documents.

Fund classifications

While the CSA note that their ESG fund classifications are not intended to be used as investor-facing labels, these labels dictate the disclosure and sales communications requirements the CSA expect in connection with each classification. They are:

- **ESG Objective Funds**: funds whose investment objectives reference ESG factors.
- **ESG Strategy Funds**: funds whose investment objectives do not reference ESG factors but that use ESG strategies, where the consideration of ESG factors plays a significant role in their investment process.
- **ESG Limited Consideration Funds**: funds whose investment objectives do not reference ESG factors but that use ESG strategies, where the consideration of ESG factors plays a limited role in their investment process.

- **Non-ESG Funds**: funds that do not consider ESG factors in their investment process.

Collectively, ESG Limited Consideration Funds, ESG Objective Funds and ESG Strategy Funds are referred to as: **ESG-Related Funds**.

Outstanding issues and challenges

BLG believes that the industry will continue to face challenges in calibrating ESG disclosure practices, despite (or perhaps because of) the extensive guidance in the Revised Notice. We expect that IFMs will need to carefully consider how to classify their ESG Related Funds – particularly those that use ESG integration. The CSA themselves have acknowledged the potential challenge of delineating between an ESG Strategy Fund and an ESG Limited Consideration Fund, stating that there is no bright line test to distinguish one from the other, and noting that IFMs are best positioned to assess the significance of the consideration of ESG factors in the investment process and how this may ultimately impact portfolio selection. We can hope that the CSA doesn't second guess IFMs as they make such assessments, especially since the CSA have indicated that the analysis of what "weight" is given to ESG factors used for a fund is about *relative* weight, having regard to the overall investment process and that the CSA are not looking for a quantitative measure.

The Revised Notice defines ESG integration as a strategy where the fund considers, on an ongoing basis, ESG-related factors within an investment analysis and decision-making process with the aim of improving risk-adjusted returns. Materiality of ESG factors is both contextual and dynamic which means that, in the context of an ESG integration strategy, there is a temporal and subjective nature to the analysis of whether ESG will be an important feature of a portfolio manager's particular investment decision. In addition, this analysis might vary between the various portfolio holdings of a single fund and between different fund types. The Revised Notice imports a requirement for IFMs to periodically reevaluate the extent to which ESG factors impact the investment analysis and decision-making process and to reconfirm or update the ESG-Related fund categorization – and resulting disclosure - accordingly. We recommend IFMs keep their notes.

Beyond the challenges related to ESG integration, the CSA's fund classifications impose parameters around the permissible marketing approach in the fund's sales communication and dictate the required disclosure. We expect that some IFMs may consider how they wish to market their funds and reverse-engineer their fund classification (and thus impact their prospectus-disclosure) based on this decision. We anticipate that there will be ongoing questions regarding ESG disclosure, especially relating to which fund classification should apply to a fund at a given time.

The Revised Notice contains guidance on various ESG-related issues that may trigger policy, disclosure and sales communication changes from IFMs, including guidance on proxy voting, continuous disclosure, fund of funds, and index funds, for example.

Key takeaways: What have we learned from the Revised Notice?

- IFMs should identify which of their funds consider ESG factors in their investment process and which do not, then classify their ESG funds within the ESG-Related Fund concepts articulated by the CSA. To classify funds between ESG Strategy Funds and ESG Limited Consideration Funds, IFMs should reference the chart below, which was duplicated from a CSA / Investment Funds Institute of Canada webinar held on May 2, 2024.

<table>
<tr><th></th><th>ESG STRATEGY FUNDS</th><th>ESG LIMITED CONSIDERATION FUNDS</th></tr>
<tr><td>Prospectus Disclosure</td><td>Disclosure about ESG strategies is required.</td><td>Disclosure about ESG strategies is optional unless sales communications reference fund's consideration of ESG factors as part of its investment process, in which case it is required.

If disclosure about ESG strategies is included in the prospectus, the disclosure should clearly explain:

• the limited role that the consideration of ESG factors and/or use of ESG strategies plays in the fund's investment process, and
• whether this approach is specific to the fund in question or whether it is part of the IFM's general process that is applied across all or a segment of its funds</td></tr>
<tr><td>Continuous Disclosure</td><td colspan="2">Disclosure about how composition and changes to the composition of the fund's investment portfolio relate to the fund's ESG strategies is required where such information is material.</td></tr>
<tr><td>Sales Communications</td><td>May include statements in sales communications that accurately reflect the types of ESG strategies used by the fund and the extent to which the fund uses ESG strategies.</td><td>May include statements in sales communications regarding the fund's use of ESG strategies as part of its investment process, but such statements should:</td></tr>
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		• be clear about the limited role that the consideration of ESG factors plays in the fund's investment process, and • only be included if disclosure relating to the limited role that the consideration of ESG factors plays in the funds' investment process is included in the prospectus.

- Ensure that continuous disclosures and sales communications accord with the guidance and best practices articulated by the CSA for the particular type of ESG-Related Fund. The more significant a role that ESG factors play in the investment process, the more ESG-related disclosure a fund is expected to provide, and the more limited a role that ESG factors play in the investment process, the less ESG-related information there should be in both the disclosure documents and sales communications of the fund.
- Non-ESG Funds and ESG-Limited Consideration Funds may need to temper or remove certain ESG-related disclosure, such as in their fund type disclosure and suitability statements.
- Undertake a review of fund disclosure and sales communications with an understanding of the broad definition of "sales communication" set out in the Revised Notice, and ensure that sales communications contain applicable disclaimers and explanatory language within "one click".
- Regularly monitor funds to identify whether a fund's classification has changed, and, if so, make all accompanying changes to disclosure documents and sales communications.
- Ensure that language used to describe ESG factors and strategies is consistent with the plain language meaning, or where applicable, with established industry meaning. Explain the meaning of terms that are used, but not commonly understood, in plain language.
- Ensure appropriate documentation of policies and procedures that cover the consideration of ESG factors and/or the use of ESG strategies.
- IFMs that are not the portfolio adviser of their fund should document oversight of the fund's portfolio adviser regarding the use of ESG.
- Establish processes to update policies and procedures, sales communications and disclosure documents (including prospectuses and MRFPs), as required, for changes in industry or business practice and, of course, to reflect updated securities regulatory expectations (including, it goes without saying, the Revised Notice).

Fund-of-funds, funds tracking indices, climate transition funds and funds with carbon offset features, among other fund types, should carefully review the Revised Notice to align with the CSA's ESG-related expectations.

Sales communications

The Revised Notice offers a discussion of "sales communications" – a term that was the subject of considerable debate during the ESG-Focused Reviews. The CSA take the view that webpages on an IFM's website and other communications that discuss the manager's ESG investing approach are not "image advertisements" which can be exempted from much of the National Instrument 81-102 – *Investment Funds* sales communication regime, but rather, they are sales communications because they involve a discussion of an investment strategy intending to induce the purchase of securities. Where a sales communication includes statements about the manager's ESG investing approach but does not identify a specific fund/fund group to which the statements apply or do not apply, CSA Staff views this as a sales communication pertaining to all of the funds managed by the manager. There is an exception for communications that are explicitly required to be made public as part of a manager's commitment to a voluntary ESG-related initiative that is: i) administered by an organization not affiliated with the fund, its manager, portfolio manager or principal distributor; and ii) widely recognized. The CSA list the Principles for Responsible Investment, Task Force on Climate-Related Financial Disclosures, and the Net Zero Asset Managers Initiative as examples of such ESG-related initiatives.

A simple concept rendered complex

The Revised Notice, at its core, attempts to emphasize the importance of clear and accurate disclosure for investment funds and to map a continuum across which ESG-related information in sales communication and continuous disclosure documents becomes more prominent as the materiality of ESG-related objectives, factors, strategies, and considerations increase. As the CSA said during its May 2, 2024 webinar: "put simply 'walk your talk'".

In practice, the CSA have practically rewritten the Original Notice, requiring nearly 30 pages to explain how existing securities instruments apply to ESG-Related Funds, creating additional prescriptive expectations and best practices. The Revised Notice was designed to address concerns about greenwashing, but may paradoxically result in green-hushing, as some IFMs will seek to avoid ESG nomenclature and claims so as to avoid increased regulatory scrutiny and litigation risk. Interestingly, the CSA remains focused in its concerns about overstating ESG disclosure to investors, as opposed to being equally concerned with any understatements.

We expect that all IFMs and portfolio advisers that interact with ESG-Related Funds will need to carefully review the Revised Notice – it contains many nuances that may necessitate updates to ESG-related policies, procedures, governance, disclosure, and/or training.

Conclusion

Given the additional guidance in the Revised Notice, evolving global ESG-related trends and expectations, and heightened industry concern over greenwashing, we expect both the CSA and industry participants will pay careful attention to all disclosure for any investment funds that employ, or may consider employing, ESG strategies.

If you have any questions about the Revised 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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