DEMYSTIFYING SEBI'S CONSULTATION PAPER ON 'ESG DISCLOSURES, RATINGS AND INVESTING'

1. INTRODUCTION

Environmental, social and governance (or "**ESG**") attributes are no longer a mere catchphrase. As more data emerges, suggesting a positive co-relation between investment decisions premised on ESG parameters and financial returns[1], regulators, investors and businesses are progressively aligning on the need to devise a robust regulatory framework detailing ESG-related norms and processes.

On May 6, 2022, the Securities and Exchange Board of India ("**SEBI**") constituted an ESG advisory committee ("**EAC**"), tasked with advising on a range of ESG-related matters. Basis the recommendations of the EAC, the SEBI has released the consultation paper on 'ESG Disclosures, Ratings and Investing' on February 20, 2023 ("**Consultation Paper**")[2], and has sought public comments on the regulatory framework for ESG disclosures, ESG ratings and ESG investing, on or prior to March 6, 2023.

The key proposals in the aforementioned Consultation Paper have been summarized below:

2. THE 'BRSR CORE' FRAMEWORK

Through the SEBI circular issued on May 10, 2021, the 'Business Responsibility Report' ("**BRR**") was replaced by the 'Business Responsibility and Sustainability Report' ("**BRSR**")[3]. Under the BRSR framework, listed companies were required to disclose their performance against each of the nine principles laid out in the National Guidelines on Responsible Business Conduct ("**NGRBC**") issued by the Ministry of Corporate Affairs in 2019.[4] The principles laid out in the NGRBC included conducting business in an ethical, sustainable, transparent, and accountable manner, promoting inclusive growth and being responsive to stakeholder interests. Under the BRSR framework, reporting under each principle was further sub-divided into 'essential' and 'leadership' indicators. Reporting of essential indicators, such as: (i) research and development investment in technologies to improve environmental and social impact; (ii) measures to improve the well-being of employees; and (iii) identification of key stakeholders, were mandatory. However, reporting of leadership indicators, such as: (i) awareness programmes conducted for value chain partners; (ii) conduct of life-cycle assessments; and (iii) process for consultation with key stakeholders, were voluntary.

With the top one thousand listed companies (by market capitalization) being mandatorily required to make ESG disclosures in accordance with the BRSR framework from the financial year 2022-23, the Consultation

[1] https://www.oecd-ilibrary.org/sites/b854a453-en/index.html?itemId=/content/component/b854a453-en
[2] https://www.sebi.gov.in/reports-and-statistics/reports/feb-2023/consultation-paper-on-esg-disclosures-ratings-and-investing_68193.html
[3] https://www.sebi.gov.in/legal/circulars/may-2021/business-responsibility-and-sustainability-reporting-by-listed-entities_50096.html
[4] https://pib.gov.in/Pressreleaseshare.aspx?PRID=1568750

Paper has rightfully recognized that 'assurance' of any disclosures made by a company is imperative to enhance the credibility of any sustainability related reporting.

Drawing a distinction between 'limited assurance' and 'reasonable assurance', the Consultation Paper notes that while limited assurance may be easy to implement, reasonable assurance, although expensive, can inspire greater confidence amongst investors. However, the Consultation Paper does not offer a precise definition of the term 'assurance' and 'reasonable assurance'. Instead, it proposes the introduction of the 'BRSR Core', with select key performance indicators ("**KPIs**") for each environmental, social and governance attribute. Acknowledging that the BRSR framework is in itself at a nascent stage, the current BRSR framework is proposed to be revised to include the KPIs specified in the BRSR Core. Reasonable assurance on BRSR Core is proposed to be made mandatory for the top two hundred and fifty companies from the financial year 2023-24. Thereafter, the requirements will be extended to the top five hundred companies, from the financial year 2024-25, and the top one thousand companies from the financial year 2025-26.

Importantly, the proposed BRSR Core framework is premised on three key principles: (i) ensuring quantifiable and outcome-oriented metrics; (ii) inclusion of relevant attributes within the BRSR Core; and (iii) facilitating comparability across jurisdictions. In this regard, the BRSR Core has suggested the usage of metrics such as 'gross wages by gender', to ascertain the gender diversity practices implemented by companies and 'intensity ratios' (which may be adjusted based on purchasing power parity) to assess greenhouse gas emissions and water footprints, to aid comparability at a global level. Incorporating the aforementioned metrics can lend veracity to the disclosures made, thereby, minimizing the risk of 'green-washing'[5] by companies.

3. ESG DISCLOSURES AT THE SUPPLY-CHAIN LEVEL

The Consultation Paper has highlighted the need to implement ESG disclosures across the supply chain, given that significant ESG risks may exist at various levels of the company's supply chain. It has been suggested that doing so would provide a comprehensive outlook of the ESG risks associated with the company's operations. In view of the same, limited ESG disclosures (as per the BRSR Core) for the supply chain for the top two hundred and fifty companies (by market capitalization) are proposed to be implemented on a 'comply or explain' basis from the financial year 2024-25. However, assurance of the disclosures will not be mandatory for the financial year 2024-25. From the financial year 2025-26 onwards, it is suggested that assurance of disclosures will also need to be made on a 'comply or explain' basis for the supply chain for the top two hundred and fifty companies (by market capitalization).

The introduction of ESG disclosures at the supply-chain level is likely to present a wide range of challenges. Often, the company's supply chain partners are dispersed and unorganized, resulting in companies having to incur significant costs to ascertain, quantify and collate the relevant data. As a consequence, the credibility of the ESG disclosures run the risk of being diluted.

4 ESG RATINGS

[5] Greenwashing refers to the practice of making misleading and exaggerated claims to deceive people about the environmental worthiness of a product or action.

Building upon the consultation paper titled 'Environmental, Social and Governance (ESG) Rating Providers for Securities Markets' issued by the SEBI on January 24, 2022[6], SEBI has attempted to address the following concerns. First, a discussion on specific factors in the Indian context which ESG rating providers ("**ERPs**") should consider when assigning ESG ratings. And second, the reliability of ESG ratings for investors to make considered investment decisions.

With respect to the first point, SEBI has made a distinction between emerging and developed jurisdictions based on the significance of different metrics forming part of the ESG ratings, such as inclusive development and gender diversity at the employee level being more pertinent for emerging markets like India. Accordingly, SEBI on the basis of the recommendations of the EAC has introduced fifteen ESG parameters which are relevant in India. Such parameters are formulated as the minimum requirements to standardize ESG ratings on environment, social and governance indicators, with ERPs being permitted to identify additional customized ratings.

In relation to the environmental parameters, certain existing standards framed by other regulatory bodies have been adopted for operational convenience of companies. However, the Consultation Paper also provides that ratings would be adjusted after such standards are mapped against global standards. The Consultation Paper does not deliberate the specifics of how such adjustment will be given effect to. Additionally, an interesting aspect that the parameters include is the amount spent on corporate social responsibility ("**CSR**") as a proportion of the amount mandated under applicable law, including whether funds have actually been utilized if CSR activities are undertaken by trusts or foundations. Governance parameters also have significant focus on aspects of related party transactions.

In relation to the reliability of ESG ratings, SEBI has noted that there are concerns with the information which is self-reported by companies. It has been proposed that such information should be assured, audited or verified to make ESG ratings more reliable for investors.

5 ENHANCED STEWARDSHIP FOR ESG SCHEMES

SEBI has undertaken an active role in developing a regulatory framework for ESG mutual funds, which is currently at an emerging stage in India. While the suggested measures in relation to ESG mutual funds as laid out in the Consultation Paper are a step in the right direction, discussions by SEBI on ESG mutual funds have been implemented on a piecemeal basis. For instance, SEBI issued a consultation paper on October 26, 2021 related to disclosure norms for ESG mutual fund schemes[7]. SEBI has now, in the Consultation Paper, sought to address the ill consequences of green washing and mis-selling, both at the level of the ESG scheme and the investee company. In this regard, SEBI has proposed to place additional responsibilities on asset management companies ("**AMCs**") and mutual funds when engaging with investee companies and greater transparency in relation to casting of votes by ESG funds on resolutions of their investee companies. Such transparency is sought to be introduced through disclosures, if resolutions have been supported or voted against because of any environmental, social or governance reasons. If an AMC has holdings in an investee company under an ESG scheme and a non-ESG scheme, and where the voting approach under the schemes are contrary, then rationale for such contradiction shall be provided by the AMC. The above voting disclosures shall become mandatory from financial year 2023-24 onwards.

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[6] https://www.sebi.gov.in/reports-and-statistics/reports/jan-2022/consultation-paper-on-environmental-social-and-governance-esg-rating-providers-for-securities-markets_55516.html
[7] https://www.sebi.gov.in/reports-and-statistics/reports/oct-2021/consultation-paper-on-introducing-disclosure-norms-for-esg-mutual-fund-schemes_53500.html

Additional disclosure obligations are proposed to be placed on engagements between AMCs and their portfolio companies. The effectiveness of the engagement shall be measured basis the outcome achieved against the objectives of the engagement, and disclosures in this regard are proposed to be made effective from the financial year 2025-26 onwards. In addition to the measures discussed above pertaining to the mitigation of green washing by investee companies, SEBI has also proposed the following mitigation measures at the ESG scheme level:

1. An ESG scheme shall invest at least sixty-five percent of the assets under management in companies which are reporting on comprehensive BRSR and are providing assurance on BRSR Core disclosures. This requirement is proposed to be effective from October 1, 2024, and in case a scheme is not compliant with the above condition, then additional time until September 30, 2025 shall be provided.

2. Monthly portfolio disclosure shall include security wise BRSR Core rating or scores, along with the details of the ERP determining the scores.

3. Third party reasonable assurance shall be provided in relation to scheme portfolio being in compliance with the objectives of the scheme on a 'comply or explain basis', from April 1, 2023 and shall be mandatory from April 1, 2024.

4. From April 1, 2023 onwards, mutual funds shall obtain a certificate, pursuant to an internal ESG audit conducted to factually review various aspects including the correctness of the scheme information documents, stewardship reporting and responsible investment policy. The trustees may also be made responsible for obtaining such certificate as part of their 'core responsibilities'.[8]

SEBI has also proposed a section on fund managers' commentary to be added under fund disclosures containing details on explanation on various matters including ESG strategy, engagements undertaken, and annual tracking of ESG ratings movements in investee companies. The fund managers' commentary is proposed to be made effective from financial year 2023-24 onwards.

6 CLASSIFICATION OF ESG SCHEMES

With the intent of permitting mutual funds to launch multiple schemes under the ESG thematic category as against only one ESG scheme under the current framework, SEBI has proposed to create five sub-categories of ESG schemes which are: (i) exclusions, (ii) integration, (iii) best-in-class and positive screening, (iv) impact investing, and (v) sustainable objectives. The exclusions sub-category excludes certain securities basis ESG considerations. The integration sub-category considers ESG parameters along with financial factors. Best-in-class is reserved for investing in companies which are comparatively faring better on ESG indicators as against their peers. Impact investing focuses on investing in companies making real world social and positive impact. Sustainable objective sub-category targets companies that benefit from long-term macro or structural ESG-related trends.

7 INDUSLAW VIEW

The Consultation Paper is indubitably a step in the right direction, seeking to introduce greater transparency, consistency, comparability and quantifiability in relation to ESG disclosures and ratings. It

[8] https://www.sebi.gov.in/reports-and-statistics/reports/feb-2023/consultation-paper-on-review-of-role-and-obligations-of-mutual-fund-trustees_67946.html

has the potential to shape corporate conduct through the internalization of these values and offer greater confidence to investors.

In this regard, acknowledging that participation from relevant stakeholders can facilitate the creation of a robust regulatory framework, SEBI has sought public comments on various aspects of the Consultation Paper on or prior to March 6, 2023. These include recommendations on: (i) whether the suggested KPIs under the BRSR Core are suitable, and whether assurance must be sought on the entirety of the BRSR framework; (ii) the nature and feasibility of ESG disclosures at the supply-chain level; (iii) whether the parameters identified for ESG ratings are appropriate for the Indian domestic context; (iv) whether the measures suggested to mitigate green-washing and mis-selling are viable; and (v) whether a new category for ESG schemes must be introduced.

Additionally, to meet the intended objectives and develop a comprehensive and resilient regulatory framework, relevant stakeholders may consider seeking more clarity on the following aspects, such as (i) the procedure for adjusting intensity ratios (which are a key KPI under the BRSR Core) on the basis of purchasing power parity; (ii) the means for collecting verifiable data on ESG risks from an unorganized supply chain; (iii) the mechanism for adjusting ratings for environmental parameters against global standards; and (iv) the procedure for auditing or verifying ESG ratings.

Importantly, reports suggest that while globally, the focus on ESG factors was spearheaded by institutional investors, in India, the same was thrust upon investors by fund managers.[9] In this context, the regulatory framework proposed under the Consultation Paper must also focus on the need to create awareness amongst retail investors and investment professionals. The modern retail investor is a conscious consumer, aware of her investment goals and values. Consequently, it is critical that sufficient guidance is provided to retail investors to choose the correct products which align with her investment goals and values. Additionally, it is also necessary for investment advisors to be sufficiently trained so as to integrate ESG parameters into their investment evaluation.

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[9] https://www.bqprime.com/business/esg-mutual-funds-in-india-are-having-a-reality-check