REGULATORY EVOLUTION AND TRENDS IN MUTUAL FUNDS SECTOR WITH FOCUS ON ESG INVESTMENT

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ABSTRACT

Owing to the increasing trend and focus on ESG Investments globally, this paper focuses on the emergence of mutual funds in intersection with ESG and their regulatory framework analysing the current status in India, the United States and Japan. The paper uses doctrinal form of research to establish the need for stricter regulation, and amendments to the current guidelines being followed, to ensure transparency, accountability, and alignment to the UN SDG Goals. The paper also discusses the impact of ESG initiatives on Insolvency proceedings and taxation, hereby drawing inferences for the mutual fund sectors and how investors shall forecast the future of ESG funds.

INTRODUCTION

The rejoining of President Joe Biden to the Paris Agreement and the Securities and Exchange Commission (SEC) appointing a designated ESG policy advisor to further ESG issues point towards the rapid growth of ESG investing and thus emphasising on a new era of revolution lying at the intersection of financial investments and environmental governance.[1] A study conducted by Bloomberg Intelligence infers that ESG assets are on track to hit 53 trillion dollars in assets under management (AUM) by 2025.[2] According to Morningstar, ESG Mutual Funds attracted a net $120 billion in the first half of 2022.[3] Sustainable assets in the US, alone grew by almost 17% from 2014 to 2020, while as of 2020, nearly 35.9% investments can be

[1] Suzame Smetana, *ESG and the Biden Presidency*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Apr. 18, 2024, 3:00 PM), https://corpgov.law.harvard.edu/2021/02/19/esg-and-the-biden-presidency/.

[2] *Global ESG Assets predicted to hit 40 trillion by 2030 despite challenging environment forecast Bloomberg Intelligence*, BLOOMBERG (Apr. 17, 2024, 4:00 PM), https://www.bloomberg.com/company/press/global-esg-assets-predicted-to-hit-40-trillion-by-2030-despite-challenging-environment-forecasts-bloomberg-intelligence/.

[3] Frances Schwartzkopff, *ESG Funds See First Ever Net Outflows Globally After US Exodus*, BLOOMBERG NEWS (Apr. 19, 2024, 6:00 PM), https://www.bnnbloomberg.ca/esg-funds-see-first-ever-net-outflows-globally-after-us-exodus-1.2026342.

classified as sustainable, which is almost 35.5 billion USD.[4] Examining these investment changes, this article aims to analyse ESG Mutual funds and their regulatory position by focusing on India's current regulatory standing on the same, while also discussing the regulatory dimensions in the United States and Japan.

THE GLOBAL REGIME: US AND JAPAN

An increasing amount of portfolios have adopted ESG investment strategies withing their funds, the two most popular ones being negative screening which includes investments in industries like oil and gas and second is ESG incorporation.[5] The United States' Security and Exchange Commission (SEC) is planning to launch rules around climate disclosure, thereby leading to disclosure of information around green-house emission and related risks.[6] A rule proposed in 2022, around the enhanced disclosures by certain group of investment advisors and companies corroborating to ESG investing practices, introduces three different types of ESG investment funds namely integration funds, ESG focused funds and impact funds. California, in 2023, passed two bills known as the Climate Corporate Data Accountability Act and Climate Related Financial Risk Act, both intended at compelling corporate organisations towards disclosure of climate-related financial risks.[7] The Japan Financial Services Agency (FSA) has recently proposed new guidelines to tackle the advent of ESG Public Funds, regulating disclosures by investment trust managers (ITM), registered under the Financial Instruments and Exchange Act of Japan (FIEA), creating funds as ESG public funds.[8] The guidelines compel the disclosure of specific ESG factors taken into account, including environmental-specific issues, the number of ESG factors considered thereby emphasising on explaining the methodology of evaluation, limitations and risks involved with respect to the ESG factors, while if specific portfolios have been designed targeting a certain set of investments, or a specific proportion of investments, for example on the basis of the market price, such reasons and intentions require exclusive disclosure.[9] Performance results

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[4] Massimo Guidolin & Monia Magnani, Do US Active Mutual Funds Make Good of Their ESG Promises? Evidence from Portfolio Holdings, 12(2) MDPI, 41 (2024).
[5] *Id.*
[6] Douglas Gillison & Michelle Price, *US SEC cracks down on funds "greenwashing" with new investment requirement*, REUTERS (Apr. 17, 2024, 8:00 PM), https://www.reuters.com/sustainability/us-sec-poised-ban-deceptive-esg-growth-fund-labels-2023-09-20/.
[7] *2024 Global ESG regulations: Insights for Investors and Asset Managers*, LINKEDIN (Apr. 20, 2024, 4:00 PM), https://www.linkedin.com/pulse/2024-global-esg-regulations-insights-investors-asset-managers-qfxye/.
[8] *Japan Proposes New Guidelines on ESG Public Funds in response to "Greenwashing" concerns*, MORGAN LEWIS (Apr. 21, 2024, 5:00 PM), https://www.morganlewis.com/pubs/2023/01/japan-proposes-new-guidelines-on-esg-public-funds-in-response-to-greenwashing-concerns.
[9] *Id.*

concerning the target must also further be disclosed, and in case of delegated responsibility, the onus of due diligence still lies on the ITM, who still must supervise the disclosures of matters as per Portfolios, Referencing and Ongoing Disclosures.[10] Furthermore, ITMs should also possess required resources like data, infrastructure, and human resources to monitor the investment management in accordance with the strategies on a regular basis, and in case of delay, ITMs shall possess appropriate measures and systems for due diligence during the delayed time period.[11]

EMERGENCE OF MUTUAL FUNDS AND ALIGNMENT TO ESG IN INDIA

The mutual fund industry in India emerged in the year 1964, with the government establishing the unit trust of India.[12] This was the start of the evolution of the Indian mutual fund industry and establishing itself as a key industry in the Indian financial market.[13] The Unit Trust of India maintained a monopoly position in the financial market until 1987 when the government allowed other public sector mutual funds to be set up. But it was only in 1993, that the major change of the government allowing the private sector to set up establish mutual funds was made.[14] The Indian Mutual funds industry is mostly focused on debt funds which also includes the money market funds which account for about 60 percent.[15] ESG funds in India, on average have been successful in generating an absolute return of 21.1% in the last 1 year and 8.3% CAGR over 2 years.[16] Reports forecast that Assets under Management (AUM) for ESG funds could grow about 30% within the coming years, hereby leading to a 34% stake in the overall AUM market in India by 2051.[17] However, the rushed approach in 2020, led to ESG funds witnessing steady outflows, wherein ESG funds lost almost a thousand crores in 2023 alone.[18] India, currently has almost thirty ESG funds as opposed to five hundred in the US and the

[10] *Id.*
[11] *Id.*
[12] Jayant R. Kale & Venkatesh P., Indian Mutual Fund Industry: Opportunities and Challenges, 24(4) IIMB MAN. REV., 245-258 (2012)
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] Chirag Mehta, *ESG Funds can reward investors, create wealth,* ECONOMICS TIMES (Apr. 19, 2024, 9:00 AM), https://economictimes.indiatimes.com/mf/analysis/esg-funds-can-reward-investors-create-wealth-chirag-mehta-of-quantum-mutual-fund/articleshow/101974826.cms?from=mdr.
[17] Rajesh Mascarenhas, *ESG funds' assets may grow 30% every year for a decade: Avendus*, ECONOMICS TIMES (Apr. 18, 2024, 5:00 PM), https://economictimes.indiatimes.com/markets/stocks/news/esg-funds-assets-may-grow-30-every-year-for-a-decade-avendus/articleshow/103916575.cms?from=mdr.
[18] Nasrin Sultana, *ESG funds losing sheen in India*, FORBES INDIA (Apr. 18, 2024, 6:00PM), https://www.forbesindia.com/article/take-one-big-story-of-the-day/esg-funds-losing-sheen-in-india/87645/1.

Britain, 182 in Japan and 119 in China.[19] While there are multiple types of ESG funds, the most common ones are green funds which invest in companies and organisations focussing on sustainability, social impact funds which invest in organisations who aim at creating a social change or make an impact, ethical funds invested in corporates adhering to high ethical and social standards, while SDG funds which invest in companies aligning themselves or working towards the United Nations Sustainable Development Goals.[20] Some of the most popular ESG funds in India include Aditya Birla Sun Life ESG Fund, Axis ESG Equity Fund, Invesco India ESG Equity Fund, ICICI Prudential ESG Fund, Kotak ESG Opportunities Fund, Quant ESG Equity Fund, Quantum India ESG Equity Fund and SBI Magnum Equity ESG Fund, while most of them were launched recently in 2019, 2020 and 2021, SBI Magnum has a long history owing to its inception in 1991, and has been able to attract investors steadily.[21] While the highest return is provided by Quant ESG Equity with 35%, the average still is nearly 14%.[22]

SEBI GUIDELINES AND RULES FOR ESG FUNDS IN INDIA

As of July 2022, the Securities Exchange Board of India (SEBI) has released detailed guidelines and regulations, thus creating new categories at the juncture of ESG investments and Mutual Funds.[23] There are two ways for institutions in India to become ESG compliant. [24] The first is to bring in ESG changes within the institutional policy itself focusing on high usage of environment-friendly sources, employee health and safety, encouraging diversity and improving corporate governance.[25] The second is to invest and provide financial support to sectors more aligned with these ESG goals.[26] SEBI's guidelines and policies are endeavours to encourage higher investments, specifically mutual fund investments towards ESG-focused development.[27] This has encouraged SEBI to allow mutual funds to launch multiple ESG schemes, which can be entered around themes of exclusion, integration, best-in-class and positive screening, impact investing, sustainable objectives and transition or transition-related

[19] *What are ESG Mutual Funds: Types, Benefits and How it Works*, IND MONEY (Apr.15, 2024, 5:00PM), https://www.indmoney.com/articles/mutual-funds/what-are-esg-funds.
[20] *Id.*
[21] *The Rise of ESG Funds in India*, LINKEDIN (Apr. 15, 2024, 4:00 PM), https://www.linkedin.com/pulse/rise-esg-funds-india-icra-analytics-ltd/.
[22] *Id.*
[23] Securities and Exchange Board of India, New category of Mutual Fund schemes for Environmental, Social and Governance ("ESG") Investing and related disclosures by Mutual Funds, SEBI/HO/MRD/DP/CIR/P/125 (Issued on July 20, 2023).
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*

investments.[28] It is important to note this remarkable benchmark since before the advent of these policies, SEBI allowed mutual funds to launch just one scheme with ESG as the central investment theme.[29] Tightening the regulatory environment, SEBI has also launched strict rules regarding investment criteria for such ESG schemes.[30]

Presently, it is mandatory for the ESG schemes of Mutual Funds to invest in companies with broad and detailed Business Responsibility and Sustainability Reporting (BRSR) disclosures.[31] An ESG scheme shall invest at least 65% of AUM in companies reporting honest BRSR, however since this comes into force from 1 October 2024, it still gives leeway in the current governance scenario.[32] ESG schemes failing to comply with this requirement can still bring in changes till 30 September 2025, however, during this one year of incomplete regulation they are not allowed to undertake any fresh investments in companies without the BRSR.[33]

SEBI has emphasised firmly on the disclosure requirements for ESG Schemes.[34] It is mandatory for mutual funds to disclose the name of the ESG strategy and sub-strategy in the name of the ESG fund/scheme.[35] Furthermore, Mutual Funds should disclose two important numbers, firstly security wise detailed BRSR scores through a valid SEBI registered ESG Rating Provider (ERPs) and secondly the details of the ERPs itself.[36] Even if there has been a change, it shall be disclosed in the next monthly portfolio statement.[37] This ensures accountability aligning with the larger goal of enhancing corporate governance through environment friendly practices.[38] One of the most important aspects is the Annual Fund Manager Commentary. This commentary shall include how ESG strategy was applied on the fund, how engagements were carried out, what strategies were applied and how the ESG ratings were tracked. It shall also include engagement details and outcomes achieved, also the mode of communication used along with the percentage of AUM invested in such companies where there is no BRSR and the impact on the Fund score.[39] It is compulsory for all Asset

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[28] *Id.*
[29] *Id*.
[30] *Id.*
[31] Securities and Exchange Board of India, New category of Mutual Fund schemes for Environmental, Social and Governance ("ESG") Investing and related disclosures by Mutual Funds, SEBI/HO/MRD/DP/CIR/P/125 (Issued on July 20, 2023).
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*

Management companies to obtain independent reasonable and valid assurance on the ESG scheme's portfolio being compliant with the strategy and goals the scheme wanted to achieve, keeping in mind that the assurance provider possesses the required skill set.[40] This requirement, although crucial, might give way to toxic governance. Since SEBI does not certify or validate any sort of assurance providers, it might be difficult to scrutinise whether a particular provider genuinely possesses the skills or is being manipulated for profits. Thus, SEBI should focus on bringing out mechanisms and requirements to certify assurance providers to ensure transparency and accountability.

CONCLUSION

Viewing these latest developments, it is important to note how SEBI is actively taking measures and steps to regulate ESG mutual funds. Although this industry is growing, it is noteworthy how SEBI is aligning India's regulatory policies with global expectations and advancements. However, it is important for SEBI to be stricter with regulations since the original objective of ensuring a transparent and accountable corporate governance environment might be hindered due to small lee ways. The exclusion strategy launched by SEBI will prove to become a popular option for investors wanting to avoid investments in areas of ESG-related activities, business practices or business segments. The new developments involving the disclosures to be made, the BRSR score, and the ESG audits will not only boost transparency and accountability, but will also ensure thorough decision making, thereby providing investors with a better understanding of the funds invested. The advent of ESG focussed funds is now also impacting two other important regulations in India: namely the IBC, and the taxation policies. The IBC, that is the Insolvency and the Bankruptcy Code of India, governed by the IBBI, that is the Insolvency and Bankruptcy Board of India, is now focussing on including ESG liabilities as one of the prima facie liabilities during the approval of restructuring plans. Since, courts time and again have proved that restructuring environmental liabilities like those of "absolute liabilities" is difficult, senior professionals from IBBI themselves have submitted a proposal paper stressing on the need for an inclusive IBC, thereby suggesting amendments to tackle the issues around restructuring environmental liabilities.[41] Similarly, global regulators are now focussing on inclusion of ESG in taxation policies, owing to the amount of greater

[40] *Id.*

[41] Banikinkar Pattanayak, *In a first, senior IBBI functionaries endorse focus on ESG in insolvency resolution*, ECONOMICS TIMES (Apr. 14, 2024, 6:00 PM), https://economictimes.indiatimes.com/news/economy/policy/in-a-first-two-ibbi-members-endorse-focus-on-esg-in-insolvency-resolution/articleshow/104168133.cms?from=mdr.

transparency, and accountability it brings forth, thereby compelling institutional investors to integrate ESG factors and foster such discussions with stakeholders and decision makers, while NGOs, investment managers and portfolio companies are developing sophisticated measures and policies which, leading to inclusion of ESG sensitive taxation measures and governance.[42]

[42] *ESG and Tax: Increasing importance to Institutional Investors*, KPMG INTERNATIONAL (Apr.13, 2024, 9:00 PM), https://kpmg.com/xx/en/home/insights/2021/09/esg-and-tax.html.