**Better and more integrated ESG investing standards are progressing**

*An enhanced Canadian ESG identification framework is advancing on a foundation of international and domestic norms*

There is perhaps no more topical, engaging – and hotly debated – subject among investment sector professionals in recent years than ESG (environmental, social, governance) investing.

The intense, ongoing discussion is not surprising. The spectacular rise of investor interest in and product offerings catering to the enthusiasm for ESG investments is unparalleled. As National Bank Financial Management stated in its Canadian ETF Flows report for 2021: “ESG is moving money and shaking the foundation of the asset management industry.”

ESG has special significance for ETFs because of the dramatic rise in product offerings in a remarkably short period of time. Responding to investor appetite, the number of ESG ETFs doubled to 100 in 2021 from 50 in 2020, NBC Financial states, while inflows accelerated in both years, benefitting ESG-themed equity, fixed-income and asset allocation ETFs. In its ETF and index funds report for 2021, Investor Economics reported that $7.7 billion was invested in Canadian ESG ETF assets by the end of last year, up from $2.75 billion the year before. The worldwide growth picture is equally impressive: the ESG ETF industry had 954 products, 2,730 listings, $US 379 billion in AUM, and 188 providers in 32 countries, ETFGI announced in February.

Accompanying this extraordinary upward trend, and the corresponding need to validate ESG differentiation claims, has come an entire ESG intelligence ecosystem. It includes an array of ESG principles and standards, assessment and scoring criteria, financial management methodologies, analytical tools and information resources to support investment measurement, selection/rejection and comparison. Your firm is likely a subscriber to *at least* one ESG reporting platform from a host of reputable international firms. You can also use online screeners from NEO ETF Market, TMX Money – and CETFA – that offer free, fast and easy access to search for ESG-oriented ETFs (and which also support meeting client-focused reforms’ KYP requirements).

Not only is there no lack of information for investment professionals to make ESG selection decisions, there is probably too much and it may not always be helpful. More than a few frank observers have called out inconsistencies in ESG ratings and assessment criteria. These criticisms have not diminished the appeal of ESG products for investors. But they do undermine confidence among investment professionals about the legitimacy of ESG labels and in making recommendations.

**The sector recognizes it needs to improve when it comes to ESG classifications**

Challenges from the absence of a robust, *uniform* set of ESG decision criteria are recognized and have aroused skepticism and caused confusion within the sector – we know this. Investor demand for ESG investment opportunities has also stimulated an increase in dubious competitive-advantage-seeking claims that have led to charges of “greenwashing” against some companies and investment funds. Morningstar, one of the organizations that provide ESG rating/ranking systems, announced it was stripping 1,200 funds (about one in five) with $US 1 trillion in assets of their ESG status. Funds that used “light or ambiguous ESG language” were removed, [BNN Bloomberg](https://www.bnnbloomberg.ca/esg-funds-managing-1-trillion-are-stripped-of-sustainable-tag-by-morningstar-1.1721423) reported in February. Morningstar apparently expects to catch more offside funds over time.

Ultimately, investors who cannot trust an ESG claim will vote with their dollars and will either decline investing in or will pull investments out of funds that don’t deliver on their promises. Broad international agreement underscores the need for a consistently comparable global ESG standard. But that consensus has not yet produced a durable, *universally accepted* formula.

For example, a recent article published by [ETF Stream](https://www.etfstream.com/news/sfdr-key-tool-for-evaluating-esg-etfs-brown-brothers-harriman-survey-finds/) said that the Sustainable Finance Disclosure Regulation (SFDR) of Europe holds sway with European investors “more than any other tool” (28% rely on it). However, U.S. investors primarily select ESG ETFs on the basis of “brand recognition of the ETF issuer.”

Last November, as Investment Executive reported ([IOSCO seeks standards for ESG ratings, data](https://www.investmentexecutive.com/news/research-and-markets/iosco-seeks-standards-for-esg-ratings-data/)), the International Organization of Securities Commissions (IOSCO) called for “greater oversight of ESG ratings and data providers.” IOSCO also issued “recommendations for regulators to follow in establishing requirements for ESG ratings and data, and the firms that provide these products.” In the same month, the CFA Institute issued its final [Global ESG Disclosure Standards for Investment Products](https://www.cfainstitute.org/en/ethics-standards/codes/esg-standards), “the first global voluntary standards for disclosing how an investment product considers ESG issues in its objectives, investment strategy, and stewardship activities.” The CFA declared it will follow up with additional resources to provide explanation, interpretive guidance and procedures to enable independent assurance by the beginning of May.

Adding further momentum to the search for a convincing solution, in January the Canadian Securities Administrators (CSA) [published guidance on ESG-related investment fund disclosure](https://www.securities-administrators.ca/news/canadian-securities-regulators-publish-guidance-on-esg-related-investment-fund-disclosure/). The CSA guidance is based on existing regulatory requirements and broadly affects disclosure, marketing and sales practices to help “investors make informed decisions about ESG products, as well as preventing potential greenwashing,” The CSA also declared it will continue to monitor ESG-related disclosure of funds. Its guidance brings Canadian ESG regulations into alignment with other international investment regulatory and governance bodies, namely the U.S. SEC as well as the European Union, which is widely regarded as the leader in sustainable investing.

**Some critical observers have proposed unbundling the formula to fix it**

Ironically, efforts to consolidate and refine a shared and trusted ESG standard are occurring as the public conversation about ESG “deficiencies” considers the merits of unpacking its three distinct components. Some commentators have asked: Should they be lumped together in a single rating when each element captures its own unique concern? (At the time of writing, the [Financial Times Moral Money](https://www.ft.com/moral-money) microsite features a thoughtful examination of this and other ESG-related issues).

To play devil’s advocate, it can be argued that governance (“G”) is really just table stakes: *All* investment-worthy companies require good governance. The social (“S”) dimension is extremely complex, especially in an international context, and is influenced by the other two metrics. Meanwhile, the environmental (“E”) aspect has been the true draw for investors (an understanding of investor motivation that Mark Noble, executive VP, ETF strategy with Horizons ETFs presented in response to the CETFA’s request for member insights). However, judgments and rankings vary widely about good versus bad environmental behaviour, which companies should be included/excluded, and how to fairly determine their “green” status.

**Separating out ESG rating components will *not* be readily embraced as an effective alternative**

Focusing on only one aspect of ESG “profoundly misunderstands the concepts of ESG and responsible investing,” Dustyn Lanz, a senior advisor with ESG Global Advisors, told the CETFA. ESG integration, he emphasizes, “is about taking a broader lens to company valuation to get a more complete picture.” There is always more than one material ESG issue to consider: “It’s equally hard to perceive a sound case for creating separate sets of standards for each issue because that would lead to more fragmentation at a time when the market actually needs convergence around a common framework.” But from an advisor’s perspective, “all-in-one” fund ratings do not consider a fund’s stewardship activities or its intentions and obfuscates nuances that are meaningful, Lanz cautions. (An August 2021 column Lanz wrote for IE, [An advisor’s short guide to greenwashing](https://www.investmentexecutive.com/inside-track_/dustyn-lanz/an-advisors-short-guide-to-greenwashing/), explores these issues in depth.)

It’s clear to the CETFA that any move to unbundle ESG is unlikely to gain traction given what investors want and expect, where the industry is and where it’s headed, and what investment professionals need to confidently advise their clients. The motivation to clarify and solidify what ESG truly stands for – as a unified concept – isn’t going away. So where do we go from here?

Although some elements are still to be introduced, the standards published by the CFA have had an impact in Canada. “The CFA’s disclosure standard for investment products is the only credible disclosure framework for ESG funds globally,” says Lanz. “That said…there is still a gap in the market that needs to be addressed. This is easier said than done, since there are so many approaches to ESG…but I think it’s important for industry groups to explore this for the benefit of retail investors and advisors.”

The Canadian Investment Funds Standards Committee (CIFSC) has also expressed its confidence in the CFA’s standards. Last December, CIFSC stated that they “will be crucial for transparency” and will be used to inform its work in reforming the ESG identification framework (see the IE article: [Data providers to build on new ESG disclosure](https://www.investmentexecutive.com/newspaper_/focus-on-products/data-providers-to-build-on-new-esg-disclosure/)). That framework will largely align with the CFA Institute’s Global ESG Disclosure Standards for Investment Product and will complement recent [CSA guidance around ESG fund disclosures](https://www.securities-administrators.ca/news/canadian-securities-regulators-publish-guidance-on-esg-related-investment-fund-disclosure/), using common language and terms.

Outgoing CIFSC chair Reid Baker, vice president, analytics & data with Fundata Canada, and incoming chair, Ian Tam, director of investment research, Canada at Morningstar told the CETFA that CIFSC has been working to improve ESG/RI standards since March 2020 and the development process is at an advanced stage. “Now that the CFA guidelines are out and the CSA has published its guidance on ESG-related investment funds, it’s a good time to finalize our work,” said Reid, with Ian adding: “The proliferation of sustainable funds exemplifies the need for a common framework to help investors and advisors identify approaches being used by Canadian fund managers.”

Once the framework is finalized and stakeholder input has been incorporated, the final version will be released for public comment and will then be adjusted as needed. CIFSC members can then “seed” the list with existing funds that fit one or more confirmed ESG approach; the same approach will apply to new funds, and everything will be made public via the CIFSC website. “Having a standardized ESG identification framework will provide advisors with a more efficient basis for undertaking their research,” said Ian.

**Work towards finalizing a workable and advisor-friendly ESG solution is progressing**

From the CETFA’s perspective, moving towards a binding set of ESG criteria in Canada that can satisfy the many expectations of them remains a work in progress, but that work *is progressing*. Perhaps there can be never be a single, absolutely accepted codification of ESG globally, but that need not be a stumbling block for Canadian advisors to deliver advice prudently and confidently.

Eventually, the lack of a solitary worldwide “ESG rulebook” may not present as many complications to ESG investing as it seems today. Advisors may ultimately *prefer* to guide their clients’ ESG investment choices by applying *their* judgment to credible, vetted sources (plural) with an emphasis on using those with a sound, made-in-Canada perspective. Time will tell.

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