

# Oversight

## ESG Funds in Hong Kong and Singapore

October 2020

### Introduction

The Securities and Futures Commission of Hong Kong (SFC) first broached the topic of environmental, social and governance (ESG) issues in September 2018 when it published its Strategic Framework for Green Finance (Framework). In the Framework, the SFC mentioned that it had been monitoring developments since the 2015 Paris Agreement. The Framework identified two key areas of interest: (i) listed companies' disclosure of environmental information and climate-related risks and (ii) asset managers' integration of ESG factors into their investment process, enabling investors generally to make informed investment decisions. The Framework identified as a challenge the lack of regulatory clarity with regard to the duty of asset managers to consider sustainability factors and risks in the investment decision process. In terms of action, the Framework indicated that the SFC would first conduct a survey of Hong Kong-based asset managers to assess the market for ESG investing in Hong Kong. It can then formulate its regulatory policy with regard to ESG.

The Framework was followed by a circular in March 2019 which heralded the Survey on Integrating Environmental, Social and Governance Factors and Climate Risks in Asset Management (ESG Survey). The results of the ESG Survey were published in December 2019. Prior to this the SFC published, on 11 April 2019, its Circular to management companies of SFC-authorized unit trusts and mutual funds – Green or ESG funds (ESG Fund Circular).

This *Oversight* sets out a brief overview of the ESG Survey and the requirements mandated by the SFC and the Monetary Authority of Singapore (MAS) in relation to the establishment of ESG funds in Hong Kong under the ESG Fund Circular and the situation in Singapore. It first provides a general market overview of the ESG asset management landscape, and then turns to discuss the initial application and ongoing compliance requirements for ESG funds in Hong Kong as well as the consultations by the MAS regarding proposed Guidelines on Environmental Risk Management (Singapore Guidelines) for fund management companies and real estate investment trust managers. For the purposes of this *Oversight*, the focus is on requirements relating to SFC-authorized retail funds.

## Market overview in respect of ESG funds

### Hong Kong

A publicly available register of ESG funds currently authorised by the SFC (and so offered to the public) is maintained by the SFC on its website. There are only approximately 30 unlisted ESG funds registered with the SFC at present. As of 30 September 2020, there is an exchange-traded ESG fund which was launched in January 2020 (the Global X China Clean Energy ETF).

There has been market speculation regarding the relatively low number of SFC authorised ESG funds notwithstanding interest from retail investors and increasing press coverage regarding responsible investing. Some participants suggest that this stems from the difficulty of structuring retail funds to simultaneously maintain a ESG focus and yet attract sufficient retail investors with varying preferences to justify the operating costs. This is unlike the case of unauthorised funds, where managers may customise their fund products and tilt the focus of the fund towards a particular ESG principle (for instance with a greater emphasis towards environmental sustainability rather than other aspects of social responsibility) to suit the preferences of a small pool of targeted professional investors. Since retail funds are by their nature more broadly targeted to appeal to a wider and more mainstream audience, managers may encounter difficulty in selecting an appropriate focus for their proposed fund. Another, more likely, reason for the lack of launches of ESG funds is the stringent requirements set out by the SFC in the ESG Fund Circular to allow managers to obtain the “ESG” label for their funds.

### Singapore

The MAS issued three consultation papers on 25 June 2020 regarding its proposed Singapore Guidelines for financial institutions, including fund management companies.

The proposed Singapore Guidelines will generally be applicable to fund management companies that have discretionary authority over the investments of the funds/mandates that they are managing. The proposed Singapore Guidelines do not directly apply to ESG funds, but set out supervisory expectations for fund management companies in their governance, risk management, and disclosure of environmental risk. The consultation closed in August and the conclusions have yet to be finalised.

The proposed Singapore Guidelines set out the following expectations:

- The board and senior management of fund management companies should oversee the integration of environmental considerations into their strategies, business plans and products.
- Where an environmental risk is deemed material to the funds/mandates managed, fund management companies should designate a senior management member or a committee to oversee environmental risk.
- Fund management companies should develop a risk management framework, and put in place robust policies and processes to manage environmental risk. Material environmental risks should be identified, assessed and mitigated at both an individual investment and portfolio level.
- Fund management companies should also evaluate the potential impact of material environmental risk on an investment’s return potential when carrying out research and portfolio construction, develop sector-specific guidance to aid its investment personnel in understanding their attendant environmental issues and measure and manage environmental risk factors that are present in a portfolio on an aggregate basis, where material.

- On a portfolio level, fund management companies should develop capabilities in scenario analysis to evaluate portfolio resilience and valuation under different environmental risk scenarios. Scenario analysis should incorporate forward-looking information to complement historical data in view of the uncertainties and long-term horizon associated with changes in the environment.
- Fund management companies should make adjustments to the composition of the portfolio or introduce other mitigating measures to account for any environmental risks identified.
- Fund management companies are expected to exercise sound stewardship to help shape positive corporate behaviour and manage environmental risk associated with investee companies through engagement, proxy voting and sector collaboration.
- Fund management companies should make meaningful disclosure of their environmental risk and the potential impact of material environmental risk on the assets it manages.

The proposed Singapore Guidelines follow several other ESG initiatives, including the MAS' Green Bond Grant Scheme in 2017 to encourage the issuance of green bonds, and the MAS' Sustainable Bond Grant Scheme in 2019. In 2019, MAS set up a SGD2 billion green investments programme targeted at public market investment strategies that have a strong green focus, and had said that it will look out for asset managers that actively incorporate environmental considerations into their investment process and direct capital towards underlying investments that have a greener profile.

## ESG Fund Circular

In Hong Kong, the ESG Fund Circular targets SFC-authorized funds which incorporate globally recognised green or ESG criteria as their key investment focus. The SFC has set out a non-exhaustive list of such globally recognised principles at Annex 1 of the ESG Circular, which consists of the United Nations Global Compact Principles, the United Nations Sustainable Development Goals, the Common Principles for Climate Mitigation Finance Tracking, the Green Bond Principles of the International Capital Market Association and the Climate Bonds Taxonomy of the Climate Bonds Initiative, covering a wide range of topics including human rights, anti-corruption and low carbon emission. Managers may also propose other widely accepted principles, benchmarks or indices to the SFC for consideration on a case-by-case basis.

The ESG Fund Circular aims to help enhance the quality of disclosure of ESG funds and address visibility issues when integrating ESG factors in the portfolio selection process. It sets out the SFC's expectations on how the SFC's requirements for all retail funds, the Code on Unit Trusts and Mutual Funds (UT Code), interacts and applies to ESG funds in order to facilitate disclosure and reporting of these products.

The ESG Fund Circular has four areas of focus, namely (i) a general requirement in respect of the investment focus of the relevant fund, (ii) disclosure requirements in respect of fund offering documents, (iii) confirmations of compliance by the manager concerned, and (iv) ongoing monitoring and evaluation.

## Investment focus

Generally speaking, a ESG fund should invest primarily in investments to reflect the particular green or ESG investment focus which the fund has.

The SFC has provided additional guidance regarding how managers may substantiate the claim of investing primarily in ESG investments. For an ESG fund which adopts positive or negative screening or thematic investment strategies, it should demonstrate that at least 70% of its total net asset value is invested in portfolio holdings which reflect the stated green or ESG related investment focus. However, in respect of funds adopting other strategies such as ESG integration or impact investing, the ESG fund's manager is expected to demonstrate its compliance to the SFC on a case-by-case basis.

## Disclosure requirements

The ESG Fund Circular sets out (under paragraph 9) certain disclosure requirements on offering documents – namely, the prospectus, explanatory memorandum and products key facts statement, as applicable – of an ESG fund.

Generally speaking, managers are obliged to disclose information they consider necessary. At a minimum, however, the ESG Fund Circular provides that offering documents must contain the following disclosure to be in compliance with the UT Code:

- the key investment focus of fund, such as “sustainability”, “green” and “climate change”;
- where applicable, how the above-mentioned investment focus is considered to be green or ESG-related;
- the targeted objective of the fund – for instance, to maximise financial return or to mitigate environmental damage;
- the investment strategies to be adopted by the fund, including but not limited to the following:
  - the green or ESG criteria or principles considered;
  - the expected exposure to the investments which reflect the stated green or ESG investment focus (for instance, in terms of the expected percentage of the net asset value of the fund); and
  - the investment selection process and criteria adopted. For instance, managers should disclose, in the relevant offering documents, the following information:
    - the assessment criteria of the underlying investments, such as (i) the usage (if any) of ESG ratings or third party certificates or labels and (ii) eligibility requirements regarding the constituents of any green or ESG-related indices, the carbon footprint and environmental impact associated with companies which form the portfolio of the fund, and the proportion of revenue or profits generated from the relevant green or ESG activities of the issuer companies;
    - the ESG analysis and evaluation methodology employed by the manager in selecting the appropriate investments of the fund, such as any proprietary tool with internal ESG ratings, research provided by third party agencies on ESG rating, certificates or labels, and any engagement with issuer companies to assess their suitability; and
    - any reference ESG benchmark being tracked and the characteristics and general composition of the benchmark;
- any investment restrictions adopted by the fund, such as any specified activities, sectors, countries in which the fund categorically does not invest; and
- risks associated with the investment theme. Possible risks proposed by the SFC in the ESG Fund Circular include the lack of standardised taxonomy; subjectivity of the selection process; managers’ reliance on third party providers for environmental scoring, certification and/or labelling; style drift; and the concentration risk borne by the fund in focusing on ESG-related investments.

In making any application for authorisation of ESG funds, managers should expect the SFC to review each aspect of the disclosure requirements listed above. Managers should also be aware, that the SFC has in certain applications provided substantial comments on the disclosure and ESG evaluation and selection process of ESG funds.

## Confirmation of compliance

Managers of existing SFC-authorized funds and new funds seeking SFC authorisation which seek to be recognised as an ESG fund in compliance, with the ESG Fund Circular must submit either (i) a self-confirmation of compliance; or (ii) a confirmation of compliance supported with independent third-party certification or fund label to the SFC. The confirmation must also be accompanied by the offering documents with proper annotations of the required disclosures as set out in paragraph 9 of the ESG Fund Circular. The standard form of the manager's confirmation (which applies to both self-confirmation and third-party confirmation) is set out in Annex 2 to the ESG Circular (Annex 2 Confirmation).

For managers opting to provide a self-certification, the Annex 2 Confirmation requires the manager to confirm that the relevant fund has incorporated globally recognised green or ESG criteria or principles as its key investment focus. The confirmation should be supported with brief details of the relevant ESG principles and criteria used by the fund. It also requires the manager to confirm that the fund invests primarily in investments which reflect the relevant ESG focus, and that the manager would regularly monitor and evaluate the underlying investments to ensure the fund continues to meet the stated investment objectives.

For managers who are not in a position to submit a self-certification or prefer to appoint an independent third party or fund labelling agency for certification, the SFC expects such party to review (at a minimum) the fund's primary investment to ensure that the fund reflects the relevant ESG investment focus which it represents, the investment selection and ongoing monitoring process, and the fund's adherence to globally recognised green or ESG criteria or principles.

Separately, in respect of existing SFC-authorized funds seeking to be approved as ESG funds by the SFC, managers will also need to consider whether updates to the disclosure in the offering documents for compliance with the ESG Fund Circular would constitute a "scheme change" requiring the SFC's prior approval under the UT Code and, where applicable, prior notice to the investors.

## Ongoing monitoring

Of note is that, subsequent to a fund having been authorised by the SFC as complying with the ESG Fund Circular, managers of ESG funds are also under an ongoing duty to monitor and evaluate the underlying investments of the ESG funds to ensure that such funds continue to fulfil the stated investment objective and requirements provided in the ESG Fund Circular. This is in line with the Annex 2 Confirmation which the manager is required to submit to the SFC in the initial authorisation process.

## Practical implications in light of the ESG Fund Circular

For those managers who are considering establishing a new ESG fund, or wish to have their existing authorised fund approved by the SFC as an ESG fund, it is advisable to approach the SFC for a discussion regarding the acceptability of the fund's proposed ESG evaluation and selection procedures and/or any ESG benchmarks employed. The SFC has to date taken a rigorous approach towards ESG acceptability and requires full compliance with the requirements set out in the ESG Fund Circular. However, it is unclear whether this has been because of the relatively recent launch of the ESG regime and the wish on the part of the SFC to establish a clear benchmark and level playing field.



## ESG Survey

The ESG Survey focussed mainly on climate change risks and its key findings are set out as follows:

- **Consideration of ESG factors, including climate change:** 83% (or 660) of the SFC licensed managers surveyed considered at least one ESG factor when assessing a company's investment potential. Amongst these 660 respondents, 68% clearly acknowledged ESG factors as a source of financial risk.
- **Governance and oversight:** Only 35% of the 660 respondents referred to above have implemented a consistent approach to integrate ESG factors in a systematic manner. Such measures include, for instance, having in place a board-approved ESG policy covering matters such as ESG disclosures and handling of ESG risks, setting clearly defined roles and responsibilities, with effective escalation and communication channels, as well as designing specific board members overseeing ESG investments, risk assessment and management of climate risks.
- **Investment management:** Amongst firms which consistently integrated ESG factors in their investment and risk management processes, more than half were able to incorporate multiple ESG investment strategies. These include negative and exclusionary screening, corporate engagement and shareholder action, ESG integration into financial analysis, norms-based screening, positive and best-in-class screening, ESG-themed and thematic investing, and impact and community investing. An area of development relates to client engagement; most institutional clients of managers participating in the survey revealed that they were not asked about their ESG investment preferences and there was a lack of discussion on climate risks.
- **Risk management:** In terms of the management of climate change-related risks specifically, only 23% of the above 660 respondents have processes in place to handle the financial impact of risks arising from climate change such as incident monitoring mechanisms and scenario analysis. This does not appear to be in alignment with institutional investors' expectations since most clients surveyed expected managers to identify, assess and manage climate risks.
- **Disclosure:** A majority (68%) of the 660 managers mentioned above indicated that information regarding their own ESG practices are not available, and a higher proportion do not disclose climate risk assessments. Disclosures which institutional investors would like to see include evidence of ESG impact, congruity between policies and practice, and information on the analytical tools used.

## Green and Sustainable Finance Cross-Agency Steering Group

The SFC and the Monetary Authority of Hong Kong (HKMA) also released on 5 May 2020 a joint statement on the establishment of the Green and Sustainable Finance Cross-Agency Steering Group (Steering Group). It is co-chaired by the SFC and the HKMA, and other members include the Hong Kong Government's Environment Bureau, the Financial Services and the Treasury Bureau, Hong Kong Exchanges and Clearing Limited, the Insurance Authority and the Mandatory Provident Fund Schemes Authority.

The Steering Group will provide strategic direction in relation to regulatory policy and market development, and facilitate regional cooperation including in the Guangdong-Hong Kong-Macao Greater Bay Area. It is reported that two work streams have been set up within the Steering Group, which target cross-sectoral regulatory issues and the coordination of cross-agency market development efforts respectively. The Steering Group is expected to help in coordinating Hong Kong's green finance strategy as well as potentially strengthening Hong Kong's position as a leading green and sustainable finance centre in Asia.

## Looking Ahead

The ESG Survey and the establishment of the Steering Group have both shown that the SFC and various other regulatory bodies in Hong Kong intend to embrace the trend of ESG investing. However, while the ESG Survey was useful in providing a more comprehensive picture of managers and their ESG policies (or lack of them), it flags what the SFC believes to be areas of improvement for fund managers. The ESG Survey lacks any substantial and practical guidance to fund managers as to how it may better adhere to the SFC's ESG requirements. It also fails to address longstanding issues with the current guidance set out in the ESG Fund Circular such as, for example, the lack of clear and singular definition of the concept of "ESG".

Nonetheless, the ESG Survey has also shown that, going forward, around two-thirds of licensed firms active in asset management in Hong Kong plan to strengthen their ESG practices in the next two years. The SFC has also indicated in the ESG Survey that it aims to achieve the following three outcomes in the near term:

- to set expectations of managers in areas such as governance and oversight, investment management, risk management and disclosure, focusing on environmental risks with an emphasis on climate change;
- to provide practical guidance, best practices and training in collaboration with the industry and relevant stakeholders to enhance the capacity of managers to meet the SFC's expectations; and
- to establish an industry group to exchange views amongst the SFC and experts in environmental and climate risk, as well as sustainable finance.

The SFC's continued commitment to enhancing its ESG regime will therefore result in further regulatory developments. However, in the meanwhile, managers who wish to tap into the ESG asset management market will have to rely on the limited guidance under the ESG Fund Circular. It is hoped that the SFC will produce further guidance which will allow Hong Kong to develop more ESG funds.

Simmons & Simmons advised Mirae Asset Global Investments (Hong Kong) Ltd on the incorporation, SFC authorisation and SEHK listing of Global X China Clean Energy ETF (Stock Code: 02809 / 09809), which is the first and the only listed green and ESG fund in Hong Kong. That fund is also one of the first exchange traded funds (ETFs) offered in the form of an open-ended fund company (OFC) in Hong Kong. In October 2020 Simmons & Simmons advised on the SFC authorisation and SEHK listing of the Haitong MSCI China ESG ETF. Simmons & Simmons JWS in Singapore has advised on the recognition of the Black Rock Strategic Funds - Blackrock Systematic ESG World Equity Fund and the Blackrock Global Funds - ESG Fixed Income Global Opportunities Fund with the MAS for retail offer in Singapore.

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