

Oversight

Hong Kong issues Revised Circular on ESG and Climate Funds

July 2021

Introduction

On 29 June 2021, the Securities and Futures Commission (SFC) issued a [circular](#) entitled *Circular to management companies of SFC-authorized unit trusts and mutual funds – ESG funds* (Revised Circular), which revises and supersedes its previous circular on green or environmental, social and governance (ESG) funds issued in April 2019 (2019 Circular).

The Revised Circular sets out SFC's expectations on disclosure of retail funds' ESG-related product features. The stated objective of such disclosure is to assist investors' understanding and assessment of whether a fund's features align with their investment needs. In particular the Revised Circular provides that: (i) in addition to the disclosure in the ESG funds' offering documents, certain information be disclosed (as reviewed and updated from time to time) on the manager's website or by other means; and (ii) an ESG fund is expected to conduct periodic assessment and reporting as regards ESG at least annually. It also provides clarifications to some unanswered questions in the 2019 Circular and has been updated in line with the global regulatory developments. For example, the SFC has taken into account the Sustainable Finance Disclosure Regulation (SFDR) enacted recently in the European Union, and clarified Hong Kong's treatment of UCITS funds which have complied with the disclosure and reporting requirements under SFDR. Each of these are further explained below.

A publicly available register of ESG funds (ESG Register) currently authorised by the SFC (and so offered to the public) is maintained by the SFC on its website. As of 15 July 2021, there are 57 unlisted ESG funds and three exchange-traded ESG funds included in the ESG Register.

This **Oversight** gives an overview of the key features of the Revised Circular and examines their implications. In the Revised Circular, the SFC has provided additional guidance for funds with climate-related focus (Climate Funds) - the relevant specific disclosure requirements are also discussed below, where appropriate. At the back of the Revised Circular, there are two Annexes – the first contains illustrative examples of ESG funds whilst the second is a prescribed confirmation required to be provided by managers of ESG funds to the SFC.

Scope of the Revised Circular

Like the 2019 Circular, the Revised Circular does not apply to private funds. The Revised Circular only applies to funds authorised by the SFC pursuant to section 104 of the Securities and Futures Ordinance (i.e. retail funds which may be publicly offered in Hong Kong) which incorporate ESG factors as their key investment focus and reflect such in the investment objective and/or strategy (ESG funds). ESG factors include those which are aligned with one or more of the ESG criteria or principles recognised globally or nationally (such as by the United Nations).

As mentioned, the SFC lists out a non-exhaustive list of illustrative examples of what constitute ESG funds in Annex 1 to the Revised Circular. As observed from the examples, in general, ESG funds are those which invest primarily in investments reflecting the particular ESG investment focus represented to be adopted by the fund. "Fund B" and "Fund C" in Annex 1, for instance, are said to invest at least 70% of their respective net asset values in companies with ESG themes or generating positive ESG impact, as the case may be. On the other hand, if ESG factors are merely considered alongside with other financial factors and the fund does not invest primarily in investments which reflect any ESG investment focus (e.g. "Fund E" in Annex 1), such fund will not fall within the scope of an ESG fund.

For the avoidance of doubt, where an SFC authorised fund falls outside such a scope, the fund has to observe the convention on naming, i.e. it cannot label itself as an ESG fund.

Naming of the Fund

The Revised Circular provides more elaborate guidance on the naming of funds in the context of ESG. In general, the SFC says its goal is to ensure that investors will not be misled by the name of a fund as to the importance and role of ESG in the fund's overall investment objective and/or strategy. Therefore, if a fund does not fall within the scope of an ESG fund as described above, the fund should not name or describe itself as an ESG fund, unless it is permitted by the SFC on a case-by-case basis to do so, upon the SFC having received written submissions from the manager as to why. Managers should be prepared to give a clear and detailed explanation to the SFC as to how the proposed fund name is consistent with and proportionate to the ESG features of the fund as a whole and will not mislead investors as to the importance or role of ESG in the fund's overall objective and/or strategy. In any event, it should be noted that the SFC has the discretion not to grant exceptions, and to withhold authorisation or approval for funds with names which the SFC considers to be misleading.

For an ESG fund, the Revised Circular states that the particular ESG focus represented by the fund name should correspond with the fund's primary investments and/or strategy. The reference to ESG or similar terms in the fund's name and marketing materials should accurately and proportionately reflect the ESG features against other features of the fund. Thus, if the ESG features are relatively insignificant as compared to the other features of the fund, the ESG features should not be over-emphasised.

Disclosure in Offering Documents

The Revised Circular provides that the offering documents – namely, the prospectus, explanatory memorandum and products key facts statement, as applicable (Offering Documents) – must contain certain disclosure to be in compliance with the SFC's Code on Unit Trusts and Mutual Funds (UT Code), as set out below.

ESG Focus

The Offering Documents should provide a description of the fund's ESG focus (for example climate change, green or low carbon footprint) and a list of ESG criteria (for example filters, indicators, ratings, third party certificates or labels) used to measure the attainment of its ESG focus.

For Climate Funds, the SFC says examples of climate-related focus may include: primarily investing in companies which contribute to climate change mitigation or adoption, seeking a lower carbon footprint as compared to a reference benchmark, contributing to reduction of greenhouse gas emissions, achieving positive impact to mitigate or adapt to climate change, and facilitating transition to a low carbon economy. Examples of climate-related indicators are carbon footprint, weighted average carbon intensity, greenhouse gas emission, revenue or profit generated from or capital or operating expenditure commitment in activities that favourably contribute to climate change mitigation or adaptation.

ESG Investment Strategy

The Offering Documents are required to set out details of an ESG fund's investment strategy(ies), the binding elements and significance of that strategy(ies) in the investment process, and how the strategy(ies) is/are implemented in the investment process on a continuous basis. The process of consideration of the ESG criteria, including the methodologies in measuring these criteria, their sequencing relative to the investment strategies, and examples of the most important ESG criteria considered (if any), must also be summarised in the Offering Documents.

If an ESG fund adopts an exclusion policy, such policy and the types of exclusion should also be set out in the Offering Documents

By way of an illustration, Annex 1 to the Revised Circular describes “Fund A” which uses the best-in-class / positive screening strategy to achieve its ESG focus (i.e. investing in companies that have better ESG performance than their peers). In measuring the ESG performance, ESG ratings are assigned based on the robustness of the investee companies’ ESG profile and the trend in improving such profile, which will in turn be assessed using quantitative (for example relevant data in third party certificates or labels) and qualitative measures (such as case studies). In terms of its exclusion policy, a fund like Fund A should disclose that it “*will not invest in companies involved in carbon intensive businesses, in particular, the supply and use of fossil fuels and deforestation*”.

Asset Allocation

The Offering Documents should set out the expected or minimum proportion of securities or other investments (e.g. in terms of net asset value of the ESG fund) that are commensurate with the fund’s ESG focus. For example, funds like “Fund B” and “Fund C” in Annex 1 should make a disclosure that they invest at least a specified percentage of their respective net asset values in companies which reflect their ESG focus. In the examples provided by the SFC, the percentage is 70%.

Reference Benchmark

Where a fund seeks to measure its ESG focus against a designated reference benchmark, the Offering Documents should contain an explanation of how the designated reference benchmark aligns with the ESG focus of the fund. If the fund is tracking an ESG benchmark (for example it is an index fund), similar to other index funds governed by the UT Code, the SFC expects that details of the benchmark including its characteristics and general composition be included in the Offering Documents.

For a Climate Fund, the SFC expects that any disclosure in relation to the designated climate benchmark includes an explanation as to (i) how any climate benchmark is continuously aligned with or relates to the fund’s climate-related focus; and (ii) why and how the designated index differs from a broad market index, where appropriate.

Risks

The Offering Documents should include a description of risks or limitations associated with the fund’s ESG focus and the associated investment strategies. Examples provided by the Revised Circular include concentration in investments with the particular ESG focus, subjective judgment in investment selection, and reliance on third party sources.

Disclosure of Additional Information

In addition to the above, in order to enable investors to understand how an ESG focus is measured, verified and maintained, the Revised Circular provides that the following information should be disclosed on the relevant manager’s website or by other means (and the Offering Documents should indicate where investors can access such information). The SFC also says this information should be reviewed and updated from time to time to ensure accuracy. The additional required information is as follows:

- how the ESG focus is measured and monitored throughout the lifecycle of the relevant fund and the related internal or external control mechanisms;
- the methodologies adopted by the manager to measure the ESG focus of the fund and the ESG fund’s attainment of its ESG focus;
- the due diligence carried out by the manager in respect of the ESG-related attributes of the ESG fund’s underlying assets;
- engagement (including the proxy voting) policies (if any); and
- the sources and processing of ESG data or a description of any assumptions made by the manager where relevant data is not available.

For second and fifth points above, a Climate Fund is expected to disclose clearly the methodologies for measuring climate indicators, including (where appropriate) the metrics used and their calculation basis or formulas, the relevant data sources, any assumptions or estimations made and their limitations.

Periodic Assessment and Reporting

The Revised Circular contains a new section on periodic assessment and reporting. It provides that an ESG fund should conduct periodic assessment, at least annually, to assess how the fund has attained its ESG focus. The following information about its periodic assessment should be disclosed via appropriate means (such as being included in the ESG fund's annual reports):

- the actual proportion of underlying investments that satisfy the fund's ESG focus;
- the actual proportion of the investment universe that was eliminated or selected due to ESG-related screening;
- a comparison of the fund's ESG factors against the designated reference benchmark (if any);
- actions taken by the fund in attaining its ESG focus (e.g. shareholder engagement activities and proxy voting records of the ESG fund with respect to its investee companies); and
- any other information considered necessary by the manager.

The basis of the assessments must be disclosed, including any estimations and limitations. Where an ESG fund has provided any previous periodic assessment(s), a comparison has to be drawn with at least the previous assessment period. In the case of a Climate Fund, it may demonstrate the attainment of its climate-related focus by comparing the fund's climate indicator(s) against those of the previous assessment period or the reference benchmark or the investment universe.

Ongoing Monitoring

The SFC states that 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 ESG focus and requirements provided for in the Revised Circular. This is consistent with the prescribed Annex 2 confirmation which the manager is required to submit to the SFC in the initial authorisation process, as described below.

Where there is a change in the investment objective and/or strategy such that an ESG fund no longer pursues its stated ESG focus, the manager is expected to inform investors and the SFC as soon as reasonably practicable.

Failure to comply with the Revised Circular in respect of an approved ESG fund may lead to removal of the fund by the SFC from the ESG Register. Furthermore, inability to meet the stated investment objective and/or strategy in the Offering Documents may lead to regulatory action by the SFC. Ultimately a manager could be prevented from managing SFC authorised funds in future and the fund itself could be de-authorised.

Application to UCITS Funds

UCITS funds which incorporate ESG factors as their key investment focus and reflect such in the investment objective and/or strategy will be regarded as ESG funds in Hong Kong and, if being authorised by the SFC, will be expected to comply with the Revised Circular. In this regard, UCITS funds are treated the same as Hong Kong domiciled funds.

In line with its streamlined approach to the authorisation of UCITS funds from specified jurisdictions under the UT Code, the Revised Circular clarifies that the SFC will deem the qualified UCITS funds as having generally complied in substance with the disclosure requirements as summarised in sections "Disclosure in Offering Documents", "Disclosure of additional information" and "Periodic Assessment and Reporting" above, provided that they have met the disclosure and reporting requirements as prescribed in Article 8 or Article 9 of the SFDR.

The SFC nonetheless says that it reserves the right to request enhanced disclosure on a UCITS fund's specific strategies and risks, and to impose or vary the requirements applicable to UCITS ESG funds where the SFC feels appropriate.

Implementation

The Revised Circular will take effect on 1 January 2022 (Effective Date).

For an existing SFC authorised ESG fund which is included in the ESG Register, managers should review the fund's current disclosures, and make appropriate updates and revisions to comply with the Revised Circular by the Effective Date.

For new funds or existing funds which are not listed on the ESG Register, managers may continue to adopt the requirements in the 2019 Circular and make appropriate updates and revisions by the Effective Date.

In this regard, managers will need to consider whether updates to the disclosure in the Offering Documents for compliance with the Revised Circular would constitute a "scheme change" requiring the SFC's prior approval under the UT Code and, where applicable, prior notice to the investors. Managers should therefore consult their legal counsel in good time.

Confirmation of Compliance

As part of the application for SFC authorisation, new ESG funds applications submitted on or after the Effective Date must include either a self-confirmation of compliance, or a confirmation supported with independent third party certification or fund label to demonstrate compliance. 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 Revised Circular (Annex 2 Confirmation).

For managers opting to provide a self-certification, the pro forma Annex 2 Confirmation requires the manager to confirm that (i) the relevant fund has incorporated ESG factors as its key investment focus; and (ii) the manager regularly monitors and evaluates the underlying investments with proper procedures in place to ensure the fund continues to meet the stated ESG focus and requirements under the Revised Circular.

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 portfolio to ensure that the fund reflects the relevant ESG investment focus which it represents, the investment selection and ongoing monitoring process. The submission of such third party Annex 2 Confirmation should be accompanied by documentary evidence of the relevant certification or fund label.

Implications

Whilst the Revised Circular imposes additional disclosure requirements, most of the disclosure requirements concern methodologies, such as the ESG criteria to measure the fund's attainment of the ESG focus, how the designated reference benchmark aligns with the ESG focus as well as how the ESG focus will be measured and monitored. These are presently considered in any event in the initial stages of establishing and authorising an ESG fund, and therefore should not add an excessive additional burden on the managers to ensure compliance. Going forward, for the purposes of conducting periodic assessments and reporting, managers may wish to consider engaging ESG specialists to carry out regular audits to monitor and evaluate the underlying investments to ensure that the ESG focus is not "tainted".

In approving ESG funds, the SFC says that it will adopt a holistic approach judging funds' eligibility on a case-by-case basis. As each application has its own particularities, managers (whether considering establishing a new ESG fund or wishing to have their existing authorised funds approved by the SFC as ESG funds) are advised to approach the SFC to discuss whether the relevant fund falls within the scope of the Revised Circular, the acceptability of the fund's proposed ESG evaluation and selection procedures and/or any ESG benchmarks employed. This should avoid misunderstanding and wasted time and effort before any application to the SFC is lodged.

Conclusion

The Revised Circular represents further “meat on the bones” of the ESG regime. It should increase disclosure comparability among SFC authorised ESG funds, as well as their transparency and visibility. Investors should therefore be in a position to better understand and assess whether retail ESG funds suit their preferences or investment needs, facilitating more informed investment decisions.

Simmons & Simmons acted as the legal adviser to all three exchange-traded ESG funds in Hong Kong included in the ESG Register. In January 2020, 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 listed green and ESG fund in Hong Kong. That fund is also one of the first exchange traded funds offered in the form of an open-ended fund company (OFC) in Hong Kong. In October 2020 and March 2021, Simmons & Simmons advised on the SFC authorisation and SEHK listing of the Haitong MSCI China ESG ETF (Stock Code: 03031 / 09031 / 83031) and the Harvest CSI 300 ESG Leaders Index ETF (Stock Code: 03108 / 83108) respectively.

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