Hong Kong capital markets update: Five new ESG reporting requirements that issuers should know when preparing annual or interim reports

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The Hong Kong Stock Exchange (the "**Exchange**") published its consultation conclusions on the Review of the Environmental, Social and Governance Reporting Guide (the "**Guide**") (i.e. Appendix 27 to the Main Board Listing Rules/Appendix 20 to the GEM Listing Rules) and related Listing Rules in December 2019[1], under which it concluded that all the proposals on the amendments to the Guide and the related Listing Rules as outlined in the Consultation Paper issued in May 2019[2] should be adopted with certain modifications or clarifications (the "**Amendments**").

The Amendments will apply to reports prepared for financial years commencing on or after 1 July 2020. We will highlight in this article new ESG reporting requirements that issuers should be aware of, in addition to the key takeaways from the *Leadership Role and Accountability in ESG: Guide for Board and Directors*[3] (the "**Guide for Board and Directors**") and *How to Prepare an ESG Report: a Step-by-Step Guide to ESG Reporting*[4] (the "**Step-by-Step Guide**") published by the Exchange in March 2020.

Background

Back in 2013, the Guide was first introduced as a voluntary guide. Subsequent to a market consultation in 2015, the Listing Rules were amended to require issuers to report on ESG matters annually and in relation to the same period covered in their annual reports. In the Consultation Paper issued in May 2019, the Exchange observed that there had been a notable acceleration in the number of countries that promulgated laws and introduced regulations on ESG reporting.

For instance, in Mainland China, the *Listed Companies' Corporate Governance Code* published by the China Securities Regulatory Commission in September 2018 had imposed a general obligation on listed companies to disclose environmental and social information. Further, the Australian Securities Exchange requires listed companies to disclose whether they have any material exposure to economic, environmental and social sustainability risks on an "if not, why not" basis and, if they do, how they manage such risks.

It was against this backdrop of the changing global regulatory landscape in ESG matters that the Exchange published the Consultation Paper, leading to the amendments to the Guide and relevant Listing Rules as summarised below.

1. Introducing New Mandatory Disclosure Requirements

To make issuers consider ESG issues seriously, the following mandatory disclosure requirements will be imposed:

- **Governance structure:** The board of an issuer will be required to disclose a statement covering (1) the board's oversight of ESG issues, (2) the board's ESG management approach and strategy, including the process used to evaluate, prioritise and manage material ESG-related issues (including risks to the issuer's businesses), in addition to (3) how the board reviews progress made against its ESG-related goals and targets with an explanation of how they relate to the issuer's businesses.

- **Reporting principles:** Issuers will be required to disclose in the ESG reports an explanation of how they have applied the reporting principles of materiality, quantitative and consistency.
  - "Materiality": An issuer should disclose the process for the selection of material ESG factors, including (1) a description of significant stakeholders identified, (2) the process and results of the issuer's stakeholder engagement (if any), and (3) the criteria for the selection of material ESG factors. The Exchange has made clear that stakeholder engagement is not mandatory.
  - "Quantitative": Information on the standards, methodologies, assumptions and/or calculation tools used, and source of the conversion factors used for the reporting of emissions/energy consumption (where applicable) should be disclosed. Further, while the key performance indicators (the "**KPI**s") for historical data must be measurable, targets may be expressed by way of directional statements or quantitative descriptions.
  - "Consistency": The issuer should disclose any changes to the methods or KPIs used, or any other relevant factors affecting a meaningful comparison.

- **Reporting boundaries:** Issuers are required to explain the ESG report's reporting boundary and the process used to identify the specific entities or operations included in the ESG Report.

2. "Climate Change" Aspect – Comply or Explain

Pursuant to the Amendments, a new "climate change" aspect consisting of (1) a general disclosure in relation to policies on measures to identify and mitigate the significant climate-related issues which have impacted, and those which may impact, the issuer and (2) a KPI requiring a description of the significant climate-related issues which have impacted, and those which may impact, the issuer, and the actions taken to manage them will be introduced to the "Environmental" subject area under the Guide. The disclosure obligations under this new aspect are on a "comply or explain" basis, like all other aspects in the Guide.

In addition, the environmental KPIs will be revised to require disclosure of a description of targets set regarding emissions, energy use and water efficiency, waste reduction, etc. and steps taken to achieve them. Also, a relevant environmental KPI will be amended to require disclosure of Scope 1 (i.e. direct) and Scope 2 (i.e. energy indirect) greenhouse gas emissions.

3. Upgrading of Disclosure Obligation and Revisions of Social KPIs

With a view to raising issuers' awareness of the possible impact resulting from social issues, the disclosure obligation of all social KPIs will be upgraded from recommended disclosures (i.e. voluntary disclosures) to "comply or explain".

Also, the social KPIs will be revised such that (1) disclosure of the total workforce by "employment types" shall include "full- or part-time staff", (2) disclosure of the number and rate of work-related fatalities occurring for each of the past three years including the reporting year shall be made (rather than merely for the reporting year), (3) new KPIs in respect of supply chain management will be introduced and (4) a new KPI requiring disclosure of anti-corruption training provided to directors and staff will be added.

4. Encouraging Independent Assurance to Strengthen Credibility

In view of concerns about costs and the potential compliance burden, under the revised Guide, issuers will be encouraged, but not required, to seek independent assurance to strengthen the credibility of ESG information disclosed.

Where issuers do opt to obtain independent assurance, they should then clearly describe the level, scope and processes adopted for assurance in the ESG Report.

5. Shortening Timeframe for Publication of ESG Reports

Initially, issuers shall publish their ESG reports no later than three months after publication of their annual reports. With a view to striking the right balance between improving timeliness and relevance of ESG reporting and the resource constraints on the preparation of a quality ESG report, issuers will be required to publish their ESG reports within five months after the financial year-end, but preferably at the same time as the publication of annual reports.

Under the Amendments, where the ESG report does not form a part of issuers' annual reports, issuers are not required to provide shareholders with the ESG report in printed form, unless specifically requested by the shareholders.

Practical Implications of the New ESG Reporting Regime on Directors of Issuers

To facilitate issuers' understanding of and compliance with the requirements under the new ESG reporting regime, the Exchange has published the Guide for Board and Directors and the Step-by-Step Guide in March 2020. We set out below certain key takeaways from the two publications.

The Guide for Board and Directors

The board of directors of issuers should take leadership for and accountability in overseeing the assessment of the issuers' environmental and social impacts and understanding the potential impact and related risks of ESG issues under the issuers' operating model. Here are some of the actions that the board of directors should take:

- **Integrate ESG issues into key governance processes and enhanced board-level oversight:** The board may consider whether to establish a new ESG committee, or to expand the roles of an existing committee. Also, where the issuers have various business units/multiple operating locations/jurisdictions, group-level policies as high-level guiding principles may need to be formulated.

- **Bring together sustainability, operations, finance, compliance, investor relations colleagues to agree on respective roles:** The board may evaluate whether it is advantageous to have an executive-level ESG working group with authority and expertise, to assess and manage ESG issues. They may also want to ascertain roles of different functions.

- **"Materiality": has the board discussed and determined the most important ESG (including climate-related) issues?** The board should regularly review the latest list of material ESG issues to see if any refinement or adjustment is needed. Materiality assessment should also be conducted systematically.
- **Risk management: do our existing risk management processes take account of ESG risks?** The board should ascertain whether the issuer's business units have sufficient awareness of ESG risks they face and whether they are able to identify the risks and escalate them to the board. Escalation procedures and business continuity plans should also be in place.

The Step-by-Step Guide

The Step-by-Step Guide has identified six steps for the preparation of an ESG report, which are (1) board and ESG working group, (2) understanding the requirements of the ESG Reporting Guide, (3) reporting boundary, (4) materiality assessment, including stakeholder engagement, (5) target setting and (6) writing the ESG report, respectively. It places particular emphasis on the step of conducting materiality assessment (Step 4).

Under the Guide, "**materiality**", as one of the keystone reporting principles, is defined as the threshold at which ESG issues are determined by the board to be sufficiently important to investors and other stakeholders that they should be disclosed. It is vital for an issuer to ascertain which aspects are material to its business and thus prioritise relevant contents in its ESG report accordingly. In this connection, both internal and external materiality assessments should be conducted by senior managers and/or key employees and engaging stakeholders (e.g. investors, customers and suppliers) respectively, even though it is not strictly necessary for an issuer to conduct stakeholder engagement specifically for the purpose of preparing its ESG report.

As for target setting (Step 5), according to the "**quantitative**" principle, issuers are encouraged to set targets which may be numerical figures or directional statements, so as to evaluate/validate the effectiveness of their ESG policies and management systems. Such targets should also be specific, measurable, attainable, relevant and time bound.

Remarks

As the ESG reporting requirements have become more stringent, issuers should familiarise themselves with the Amendments as soon as possible in order to be in a position to fulfil the new ESG reporting requirements. It is also of paramount importance to identify the ESG issues that are the most material to the issuers' business in the first place, which will enable the issuers to report and mitigate such risks and therefore maintain and boost investors' confidence.

For further details, please get in touch with the authors, Enoch Wong (Partner, Hong Kong) and Gigi Lo (Trainee Solicitor, Hong Kong).

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1. Review of the Environmental, Social and Governance Reporting Guide and Related Listing Rules↩
2. Consultation Paper↩
3. Leadership Role and Accountability in ESG↩
4. How to Prepare an ESG Report↩

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