Hong Kong SFC's Revised Requirements on Retail ESG Funds and Relevant EU Regulations on UCITS

Background and introduction

Around the world, there is increasing attention amongst investors, asset managers and regulators regarding ESG investment products. As a major asset management hub in Asia, Hong Kong has also spearheaded market development in green or sustainable finance through a range of policies, regulations and guidance relevant to the financial industry. While this earlier article published on Dentons' ESG Global Solutions Hub, Sustainable Finance and ESG in Hong Kong, set out the broader picture on the relevant regulatory developments and policies relating to sustainable finance and ESG in Hong Kong, this article focuses on the revised requirements of the Hong Kong Securities and Futures Commission ("**SFC**") applicable to retail funds which are marketed to the public in Hong Kong as "green funds" or "ESG funds".

SFC 2019 ESG Circular and ESG funds state of play

In April 2019, the SFC issued a Circular to management companies of SFC-authorized unit trusts and mutual funds – Green or ESG funds ("**the SFC 2019 ESG Circular**") with the key purpose to enhance disclosure and comparability of SFC-authorized green or ESG funds, in order to facilitate investors to make informed investment decisions in this evolving investment area.
The SFC 2019 ESG Circular set out the SFC's expectation on how the existing Code on Unit Trusts and Mutual Funds and disclosure guidelines for the SFC-authorized funds apply to green or ESG funds and provided guidance to narrow the disclosure gap among these funds.

The SFC 2019 ESG Circular is applicable to SFC-authorized funds which incorporate one or more globally recognised green or ESG criteria or principles as their key investment focus, and reflect such in their names and investment objectives or strategies ("**SFC Green or ESG Funds**").

The requirements under the SFC 2019 ESG Circular are mainly two-fold:

- Disclosure requirements:
    i. description of the key investment focus and target objective, and how the key investment focus is considered as green or ESG-related;
    ii. description of the investment strategies adopted, such as the relevant ESG criteria or principles considered, expected exposure to securities or investments that reflect the stated ESG focus; the investment selection process and criteria adopted;
    iii. description of whether an exclusion policy is adopted and the types of exclusion;
    iv. description of risks associated with the fund's investment theme; and
    v. other relevant matters.
- Ongoing monitoring requirements: managers of SFC Green or ESG Funds are required to regularly monitor and evaluate the underlying investments to ensure the SFC Green or ESG Fund continues to meet the stated investment objective and requirements.

By the end of 2019, the SFC set up a dedicated Green or ESG funds webpage, setting out a list of Green or ESG funds that have met the requirements under the SFC 2019 ESG Circular. As of February 2020, there were around 29 Green or ESG funds listed on the SFC's Green or ESG funds website. Two of such funds are domiciled in Hong Kong, while the remaining are UCITS domiciled in Luxembourg. This is consistent with the general market trend where the majority of SFC-authorized funds offered to the public in Hong Kong are EU- domiciled funds marketed in the EU markets as UCITS[1], in particular Luxembourg being one of the most popular jurisdictions.

As of September 2021, there are now around 63 green and ESG funds listed on the SFC's dedicated website. Out of these 63 green and ESG funds, we noted 59 of them are UCITS.

The requirements under the SFC 2019 ESG Circular are currently still applicable to SFC Green or ESG Funds, but the SFC has issued its 2021 ESG Circular (discussed below) with updated requirements which will apply starting from 1 January 2022.

Europe – The Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulation

With the market share of UCITS funds in Hong Kong in mind, before going into the updated SFC requirements, it is relevant to consider the EU sustainable finance rules impacting UCITS.

1 In the SFC 2021 ESG Circular, UCITS is referring to (i) Undertakings for Collective Investment in Transferable Securities (UCITS) domiciled in France, Luxembourg, Ireland and the Netherlands, and (ii) collective investment schemes domiciled in the United Kingdom authorized as UK UCITS.

The Sustainable Finance Disclosure Regulation (SFDR)

The main EU sustainable finance regulation impacting UCITS is the Sustainable Finance Disclosure Regulation[2], issued in December 2019, together with the Taxonomy Regulation[3] and the Low Carbon Benchmarks Regulation[4]. The SFDR introduced various ESG-related disclosure requirements for financial market participants ("**FMPs**") and financial advisers, at entity, service and product levels. Disclosures are to be made on websites, in pre-contractual documentation and periodic reports, as well as marketing communications.

The SFDR aims to provide more transparency on sustainability within the financial markets in a standardised way, thus preventing greenwashing and ensuring comparability for the benefit of end investors. SFDR disclosures are categorised into two levels:

i. Level 1 disclosures, which were provided for directly in the SFDR and whose main operative provisions already took effect on 10 March 2021. These included high-level disclosures on how sustainability risks[5] are integrated into the investment decision-making process, including (i) website disclosures on how FMPs' remuneration policies are consistent with such sustainability risk management policies and (ii) the results of the assessment of the likely impact of sustainability risks on returns of a financial product. Moreover, FMPs had to reveal how they consider principal adverse impacts ("**PAI**")of their investment decisions on sustainability factors[6]. FMPs can nonetheless state they do not integrate sustainability risks and/or do not consider their PAIs if they explain why (comply or explain mechanism)[7].

ii. Level 2 disclosures, which are additional and more detailed disclosures focusing on the 'principal adverse sustainability impacts statement' and on the so-called light-green and dark-green financial products (see further below). These disclosures will be derived from a legislative mandate contained in the SFDR and enacted in the form of regulatory technical standards ("**RTS**") drafted by the European Supervisory Authorities[8] ("**ESAs**") and subsequently reviewed and endorsed by the European Commission ("**EC**") before entering into force. The initial intention was that the RTS would take effect together with the level 1 disclosures, i.e. on 10 March 2021. Due to their complexity and the negative feedback provided by the industry on the first draft published in April 2020, the entry into force was first delayed until 1 January 2022 and has recently been pushed back another six months until 1 July 2022[9].

At a product level, the SFDR has "created" two specific types of funds, which are becoming commonly referred to as "light green funds" and "dark green funds". Light green funds (Article 8 Funds) are the funds that promote environmental or social characteristics ("**light green funds**"); whereas dark green funds (Article 9 Funds) are funds that have sustainable investment[10] as part of their investment objectives ("**dark green funds**").

2 Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

3 Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088.

4 Regulation (EU) 2019/2089 of the European Parliament and of the Council of 27 November 2019 amending Regulation (EU) 2016/1011 as regards EU Climate Transition Benchmarks, EU Paris-aligned Benchmarks and sustainability-related disclosures for benchmarks.

5 Defined as an environmental, social or governance event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investment.

6 Defined as environmental, social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.

7 Nonetheless, through the EC's adoption of the so-called sustainable finance package, the optionality of integrating sustainability considerations into risk management policies will essentially be converted into an obligation for FMPs.

8 The European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA).

9 This is a consequence of major challenges in relation to their practical implementation, including the lack of available and reliable ESG data, which needs to be fed into the various disclosures.

10 Defined as an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective. In particular, an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

When products fall into these two categories, there are further disclosure requirements to be met on the website, in prospectuses and periodic reports. In particular, fund sponsors need to disclose information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the fund product, including data sources, screening criteria for the underlying assets and the relevant sustainability indicators used.

The intention is that being categorised as a light green fund or a dark green fund will set the fund apart from other potentially greenwashed funds, as such funds are more attractive to ESG minded investors. In this connection, the SFDR is also part of the EU's broader policy intention to drive finance and investments towards sustainable or green objectives to meet the EU key green policies agenda. This strategy has already shown positive results, with fund sponsors widely embracing the new categorisation. Market intelligence estimates that more than half of overall European fund flows have gone into light green and dark green funds this year.

Having said that, the market has been struggling with clearly delineating not only ESG funds from non-ESG (mainstream) funds, but also light green funds from dark green funds. In particular, the industry lacks clarity on what "promoting" environmental and social characteristics means as per the categorisation of light green funds. This concern was echoed by the ESAs in a letter addressed to the EC[11], seeking clarity in this area. The EC provided some guidance on certain aspects in its response in July[12]. However, some answers actually raised additional questions and it will take time for many issues to be resolved.

Taxonomy Regulation

The Taxonomy Regulation is the EU's principal mechanism to address greenwashing as it sets out criteria for determining whether an activity is environmentally sustainable, including whether the activity contributes to, or does not significantly harm, one or more specified environmental objectives, i.e.:

(a) climate change mitigation;

(b) climate change adaptation;

(c) the sustainable use and protection of water and marine resources;

(d) the transition to a circular economy;

(e) pollution prevention and control;

(f) the protection and restoration of biodiversity and ecosystems.

While the Taxonomy Regulation targets the E in ESG, the EU also intends to elaborate taxonomies for activities contributing to social (S)[13] and governance (G) objectives in the near future.

The Taxonomy Regulation among others amended the SFDR by empowering the ESAs to design further RTS on taxonomy-related product disclosures ("**Taxonomy RTS**"). These foresee additional disclosure requirements, in addition to those set out in the SFDR, for light green and dark green funds. The EC has decided to bundle the Taxonomy RTS together with the SFDR RTS into a single delegated act, which are now scheduled to take effect on 1 July 2022.

11 JC/2021/02.
12 C(2021) 4858 final.
13 See Platform on Sustainable Finance's draft report on a social taxonomy.

Hong Kong SFC 2021 ESG Circular

In view of international regulatory developments, on 29 June 2021 the SFC published an updated 'Circular to management companies of SFC- authorized unit trusts and mutual funds – ESG funds' ("**the SFC 2021 ESG Circular**"), which will supersede the SFC 2019 ESG Circular. In this revised Circular, the SFC provides further guidance on required enhanced disclosure including periodic assessment and reporting for ESG funds, and with additional guidance for funds with climate-related focus.

Scope

The SFC 2021 ESG Circular is applicable to SFC-authorized funds which incorporate ESG factors as their key investment focus and reflect such in the investment objective and/or strategy ("**ESG Funds**"). An ESG Fund may adopt ESG factors that include those aligned with one or more of the ESG criteria or principles recognised globally or nationally[14] or any other ESG or sustainability criteria or principles or taxonomies. The definition of ESG Funds is substantially similar as that set out in the SFC 2019 ESG Circular and the SFC 2021 ESG Circular. However, in contrast to the SFC 2019 ESG Circular, there is now further guidance and clarity on examples of funds which have certain ESG features but do not incorporate ESG factors as their key investment focus, which are hence not "ESG Funds" for the purposes of the SFC 2021 ESG Circular. Correspondingly, the SFC would generally not expect such fund to name or market itself as an ESG fund although it may permit exceptions on a case-by-case basis.

The Annex in the SFC 2021 ESG Circular sets out illustrative examples of funds which have ESG features but do not incorporate ESG factors as their key investment focus and reflect such in the investment objective and/or strategy.

Climate Funds

For funds with climate-related focus ("**Climate Funds**") the SFC 2021 ESG Circular sets out additional guidance including examples of climate-related focus, climate-related indicators and disclosure relating to designated climate benchmarks.

It is not exactly the same but it should be noted the similarities between the definition of Climate Funds under the SFC 2021 ESG Circular and the reference to the Taxonomy Regulation. The scope of Climate Funds in the SFC 2021 ESG Circular appears to focus on the first two environmental objectives under the Taxonomy Regulation, climate change mitigation and climate change adaptation, thus on climate in a narrower sense.

The concept of Climate Funds was not in the SFC 2019 ESG Circular. We believe this has been introduced to be more comparable with the EU regulations on climate change, and it serves to support the Hong Kong Chief Executive's November 2020 policy address that pledged to achieve carbon neutrality by 2050.

Such new specific guidance and requirements on Climate Funds are particularly meaningful in the context of new funds that may be established by Hong Kong managers and be offered to Hong Kong investors. The climate-related focus on a Climate Fund may include investing primarily in companies which engage in economic activities that contribute to climate change mitigation or adoption, seek a lower carbon footprint as compared to a reference benchmark, contribute to reduction of greenhouse gas emission, achieve positive impact to mitigate or adapt to climate change and facilitate transition to a low-carbon economy.

Name of fund

As noted above, an ESG Fund's primary investments and/or strategy should reflect the particular ESG focus which the Fund name represents. As one of the main purposes of the ESG Circular is to 'reduce opportunities for greenwashing', it is emphasised that the reference to ESG or similar terms in the Fund's name and marketing materials should accurately and proportionately reflect the ESG features vis-a-vis other features of the Fund and should not be overstated or over-emphasised.

14 According to the SFC 2021 ESG Circular, examples are: the United Nations Global Compact Principles, United Nations Sustainable Development Goals, Common Principles for Climate Mitigation Finance Tracking, Green Bond Principles of the International Capital Markets Association and Climate Bonds Taxonomy of the Climate Bonds Initiative.

Disclosure in offering documents

Under the SFC requirements, offering documents of ESG Funds should disclose the following:

i. the ESG focus – description of the ESG Fund's ESG focus and a list of ESG criteria used to measure the attainment of the ESG focus;

ii. the ESG investment strategy – description of the ESG strategy(ies) of the ESG Fund, the binding elements and significance of the strategy(ies) in the investment process and how such strategy(ies) are implemented in the investment process on a continuous basis, a summary of the process of considering ESG criteria, and whether an exclusion policy is adopted by the ESG Fund and types of exclusion;

iii. asset allocation – the expected or minimum proportion of securities or other investments of the ESG Fund (in terms of net asset value) that are commensurate with the ESG focus;

iv. reference benchmark (if applicable, and also the relevance of a designated benchmark to the fund);

v. indication of additional information references where investors can find out about the ESG Fund (e.g. website); and

vi. applicable risks associated with the ESG Fund's ESG focus and associated investments strategies (e.g. limitation of methodology and data, lack of standardised taxonomy, subjective judgement in investment selection, reliance on third party sources, concentration in investments with the particular ESG focus).

Disclosure of additional information

The SFC 2021 ESG Circular also requires ESG Funds to disclose additional information which includes how ESG focus is measured and monitored through the lifecycle of the ESG Fund, methodologies adopted, engagement policies (if any), description of the sources and processing of ESG data, or applicable assumptions.

Such additional information should be reviewed and updated from time to time.

Disclosure of such additional information may be made on the fund manager's website or by other means (such as in the offering documents), which is similar to the different levels or means of disclosures required under the SFDR.

Periodic assessment and reporting

There is now a new requirement under the 2021 ESG Circular for ESG Funds to conduct at least annual assessments to demonstrate how they incorporate ESG factors.

These disclosures should be made periodically, e.g. through the annual report, including:

i. description of how the Fund has attained its ESG focus during the assessment, including:
   - the proportion of underlying investments that are commensurate with the Fund's ESG focus;
   - the proportion of the investment universe that was eliminated or selected as a result of the Fund's ESG related screening;
   - a comparison of the performance of the Fund's ESG factors against the designated reference benchmark (if any);
   - actions taken by the Fund in attaining the Fund's ESG focus (e.g. shareholder engagement activities, proxy voting records of the ESG Fund with respect to its investee companies);

ii. description of the basis of the assessment performed, including any estimations and limitations; and

iii. where the Fund has provided previous periodic assessment, a comparison between the current and at least the immediately preceding assessment period.

Application on UCITS funds

It is apparent that the SFC has taken into account the SFDR and the Taxonomy Regulations in the SFC 2021 ESG Circular. In relation to UCITS funds, the SFC 2021 ESG Circular stated that both the UCITS light green and dark green funds will be considered as ESG funds in Hong Kong ("**UCITS ESG funds"**). Where UCITS funds meet SFDR disclosure and reporting requirements applicable to UCITS ESG Funds classified under Article 8 or Article 9 of the SFDR, such funds will be deemed to have generally complied with the disclosure and reporting requirements under the SFC 2021 ESG Circular.

As set out above, light green funds are those funds that promote environmental or social characteristics. However, these funds do not necessarily need to have one or more of such characteristics as the overarching objective; dark green funds are those funds that specifically have sustainable goals as their objective. Given the uncertainty around the term 'promote', the variation between the definitions of ESG Funds and dark green funds ("incorporate ESG factors as their key investment focus" vs. "having sustainable investment as its objective") and the wide spectrum of ESG factors under Article 8 and Article 9, potentially there might be instances where the investment strategy or objectives of an Article 8 or Article 9 Fund may not squarely fit within the scope of ESG Funds as set out under the SFC 2021 ESG Circular.

In light of the aforesaid problems related to the product categorisation under the SFDR, the SFC's approach should facilitate the distribution of UCITS ESG funds in Hong Kong.

Nevertheless, the SFC retains the power to request enhanced disclosure in respect of the fund's specific strategies and risks, and to impose or vary the requirements in respect of UCITS ESG funds as it may deem fit at any time. The applicability of the SFC requirements to UCITS funds is subject to review and update by the SFC from time to time in view of legal, regulatory and other developments in each relevant jurisdiction, as well as the level of regulatory oversight, supervision, cooperation and assistance of the relevant home regulator and reciprocity accorded to the SFC with respect to the funds it regulates.

On the whole, it would still be a welcomed position for managers of UCITS funds.

Ongoing monitoring

Similar to the requirements in the SFC 2019 ESG Circular, fund managers of ESG Funds should regularly monitor and evaluate the underlying investments to ensure the ESG Funds continue to meet the stated ESG focus and requirements set out in the SFC 2021 ESG Circular.

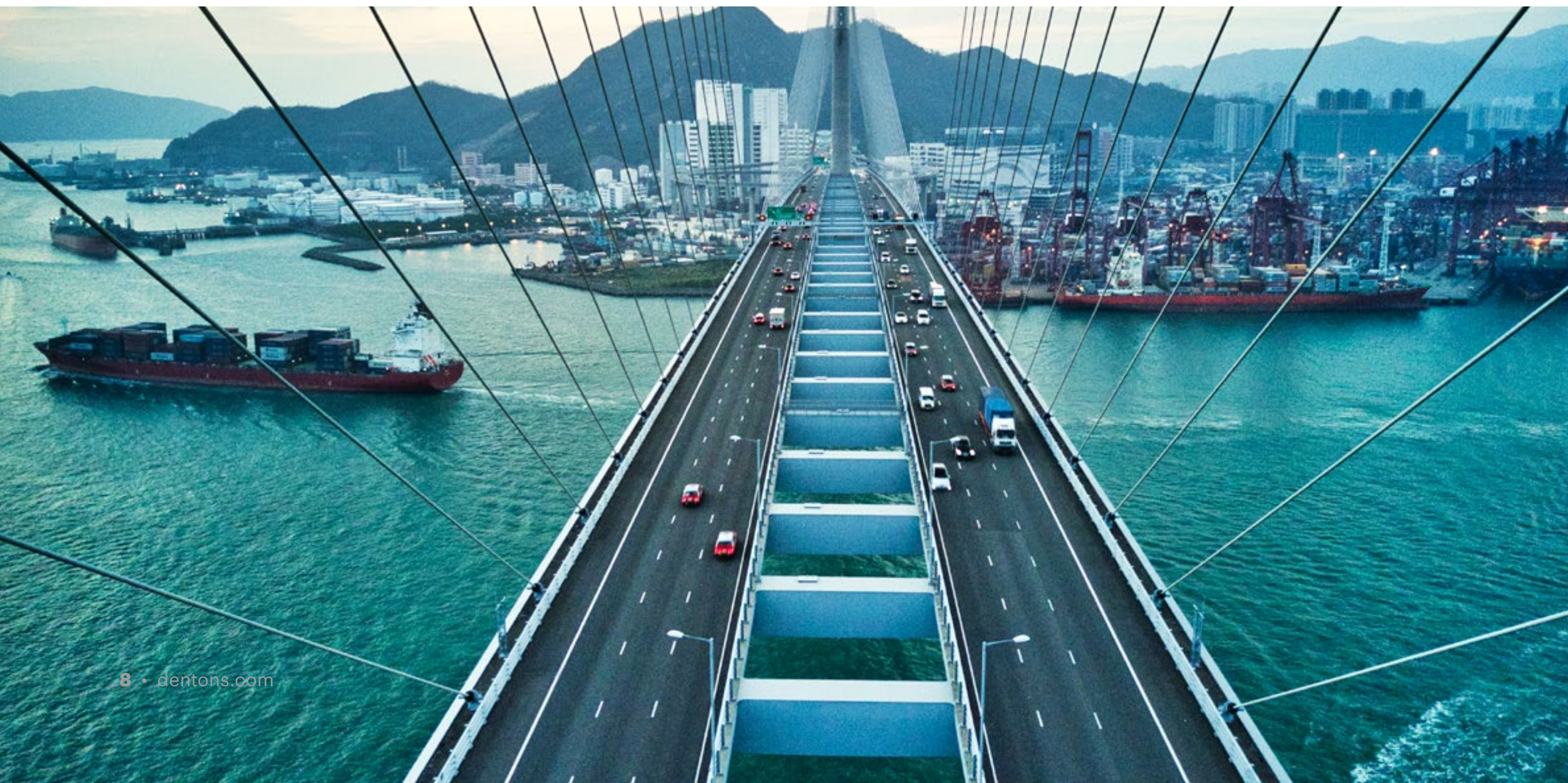
Where an ESG Fund no longer wishes to pursue its stated ESG focus, the fund manager is expected to inform investors and the SFC as soon as reasonably practicable.

It is also set out explicitly that fund managers of ESG Funds should comply with requirements set out in other applicable codes and guidelines in force from time to time. In particular, where the fund manager is licensed by or registered with the SFC, such fund manager is required to also comply with the relevant requirements under the SFC Fund Manager Code of Conduct ("**FMCC**").

In October 2020 the SFC issued a 'Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers' which proposed to introduce requirements for Hong Kong SFC-licensed fund managers to consider climate-related risks in their investment and risk management processes, and to make appropriate disclosures to meet investors' growing demand for climate risk information and to combat greenwashing. The Consultation Paper focuses on fund manager conduct and proposed amendments to the FMCC. The SFC published its Consultation Conclusion together with a 'Circular to licensed corporations – Management and disclosure of climate-related risks by fund managers' on 20 August 2021, further to which the FMCC will be amended to introduce four key areas of requirements, on governance, investment management, risk management and disclosure that are applicable to all fund managers with investment discretion in managing collective investment schemes (and not mandatory for discretionary account managers).

There are baseline requirements that all SFC-licensed fund managers need to adopt, together with enhanced standards which large fund managers (fund managers with collective investment scheme under management which equal or exceed HK$8 billion in fund assets for any three months in the previous reporting year) will need to comply with. Enhanced standards for large fund managers mainly include adoption of certain tools and metrics in the risk management process, and the requirement for more detailed disclosures on the portfolio carbon footprint at product level.

There will be a 12-15 months' transition period before the amendments set out in the FMCC take effect. For large fund managers, they will have to comply with the baseline requirements by 20 August 2022 and the enhanced standards by 20 November 2022, although portfolio carbon footprint disclosures can be made after the financial year end, i.e. the usual due date of the Funds' audited accounts or annual reports. Whereas for other fund managers, they will have until 20 November 2022 to comply with the baseline requirements.



Implementation timeline and next steps

The effective date of the SFC 2021 ESG Circular is 1 January 2022, which was initially aligned with the effective date of application of the SFDR Level 2 disclosure requirements and Taxonomy Regulation disclosure requirements. However, in a twist of event, just nine days after the adoption of the SFC 2021 ESG Circular the EC informed the EU Parliament and Council that it will defer the dates of application of 1 January 2022 by six months to 1 July 2022[15]. So far, the implications of this change are unclear and remain to be seen. As UCITS ESG funds are already supposed to be compliant with Article 8 and Article 9 in substance (from the perspective of EU Level 1 disclosures), whether in the interim the SFC may impose any additional requirement may depend on whether there is any perceived gap between the SFC's requirements under the SFC 2021 ESG Circular and such UCITS ESG funds' current disclosures.

In view of the increasing market expectation and demand for investments and investment funds that incorporate ESG considerations or offer sustainability investment themes, as well as heightened ESG regulations and regulatory scrutiny of ESG Funds, many investment managers are drawn to meeting such investment needs or to develop investment products to achieve sustainability objectives. In doing so and considering next steps in offering ESG or sustainable investment products in key jurisdictions such as the European markets or in Asia, with Hong Kong as a key funds hub, asset managers may wish to conduct a gap analysis of the new requirements under the SFC's 2021 ESG Circular, in comparison to the requirements under EU regulations.

It is expected that there will be more ESG regulations issued globally. In particular, the requirements on periodic assessment, details of which are not yet finalised under the relevant EU regulation (the draft Regulatory Technical Standards). Other regulations that are likely to be interrelated or may cross-reference to other areas should also be noted, such as the conclusion to IOSCO's consultation on ESG ratings and data providers, and evolving areas in green investing, biodiversity, corporate sustainability reporting, EU laws on supply-chain due diligence[16] or the proposed EU Social Taxonomy Regulation[17].

While launching more green or ESG funds to meet investors' demands, asset managers should anticipate the breadth of legal and regulatory changes and ensure there are sufficient and appropriate resources for meeting various regulatory requirements that shall apply to the offering and management of green or ESG funds.

15 FISMA.C.4/LB/mp(2021)4983278.
16 See European Parliament resolution of 10 March 2021 with recommendations to the Commission on corporate due diligence and corporate accountability (2020/2129(INL)).
17 See Platform on Sustainable Finance's draft report on a social taxonomy.

KEY CONTACTS

Vivien Teu
Partner and Head of Asset Management & ESG
Hong Kong
D +852 2533 3682
vivien.teu@dentons.com

Bruno Hrovat
Counsel
Luxembourg
D +352 46 83 83 229
bruno.hrovat@dentons.com

Christina Suen
Of Counsel
Hong Kong
D +852 2533 3683
christina.suen@dentons.com

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