In recent years, environmental, social, and governance (**ESG**) policies have become a touchstone in terms of how corporates present themselves as responsible, caring citizens to the outside world, many of them seeking to roll out in Asia policies agreed in their global headquarters. In parallel with this, Hong Kong regulators have been increasingly focused on promoting sustainable finance initiatives and developing the ESG regulatory regime, especially with respect to the compliance obligations of listed companies and SFC-authorised "ESG funds".

The regulatory regime in Hong Kong underpinning ESG is mainly administered by an alphabet soup of regulators, including the Hong Kong Monetary Authority ("**HKMA**"), the Securities and Futures Commission ("**SFC**"), the Hong Kong Exchanges and Clearing Limited ("**HKEx**"), the Registrar of Companies, the Financial Services Development Council ("**FSDC**") and the Insurance Authority ("**IA**").

## The Green and Sustainable Finance Cross-Agency Steering Group

In May 2020, the HKMA and the SFC initiated the establishment of the Green and Sustainable Finance Cross-Agency Steering Group ("**Steering Group**"), a multi-regulator steering group seeking to coordinate the management of climate and environmental risks in the financial sector and to accelerate the growth of green and sustainable finance in Hong Kong, while supporting the Hong Kong government's climate strategies.

The Steering Group announced its ambition to have mandatory climate-related disclosure requirements aligned with the Task Force on Climate-related Financial Disclosures ("**TCFD**") framework by 2025 across all relevant sectors, and to develop a green classification framework for adoption in the local market to align with the Common Ground Taxonomy ("**CGT**") report prepared by the International Platform on Sustainable Finance, reflecting the results of an in-depth comparison of taxonomies between China and the European Union.

The Steering Group also launched the Centre for Green and Sustainable Finance ("**GSF Centre**"), a cross-sector platform which coordinates the efforts of financial regulators, government agencies, industry stakeholders and academia in formulating recommendations regarding capacity building and green and sustainable finance data availability for financial operations.

## SFC Initiatives

The independent statutory body regulating the securities and futures markets in Hong Kong, the SFC, is also playing a key role in the promotion of green and ESG-related financial practices.

### SFC-authorized ESG funds

In June 2021, the SFC published a circular addressed to management companies of SFC-authorized unit trusts and mutual funds on ESG funds.

The circular sets out the regulatory expectations as to how requirements under the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products are applicable to SFC-authorized funds which incorporate ESG factors as their key investment focus and reflect the same in their investment objectives and/or strategies ("**ESG funds**").

The circular took effect on 1 January 2022: as a result, enhanced disclosure obligations have been imposed on ESG funds. In summary, an ESG fund must disclose in its offering documents:

- the ESG focus of the fund and the criteria used to measure fulfilment;
- the ESG investment strategy;
- the proportion of securities or other investments that are consistent with the fund's ESG focus;
- details and relevance of any reference benchmark for the purpose of attaining the ESG objective;
- where investors can locate additional information references about the ESG fund; and

- a description of risks or limitations associated with the fund's ESG focus and associated investment strategies.

In addition to the above, an ESG fund must disclose: (i) the benchmark and methodologies for measuring and monitoring its ESG focus and related control mechanisms; (ii) due diligence carried out in respect of the ESG-related attributes of the ESG fund's underlying assets; (iii) engagement policies (if applicable); and (iv) sources and the processing of ESG data.

An ESG fund must conduct periodic assessments, at least annually, to assess and disclose whether the fund has attained its ESG focus, the basis of the assessment performed, along with a comparison between the current or the prior assessment period.

Fund managers must monitor and evaluate the underlying investments regularly to ensure the ESG fund meets the stated ESG focus. Where an ESG fund no longer intends to pursue its stated ESG focus, the fund manager must inform investors and the SFC as soon as practicable, so that the SFC may remove the fund from its list of ESG funds as appropriate.

In the meantime, the SFC considers that provided that they incorporate ESG factors as their key investment focus and reflect such in the investment objective and/or strategy, funds authorised under the Undertakings for Collective Investment in Transferable Securities ("**UCITS**") will be treated as ESG funds in Hong Kong. The SFC may request enhanced disclosure in respect of the fund's specific strategies and risks, and impose or vary the requirements in relation to the UCITS ESG fund as it sees fit.

Please click here to view the circular.

## Fund Manager Code of Conduct

In August 2021, the SFC, through amendments to the Fund Manager Code of Conduct ("**FMCC**"), introduced obligations on fund managers managing collective investment schemes ("**CIS**") to take climate-related risks into consideration in their investment and risk management processes and to make appropriate disclosures.

The amended FMCC sets out the expected standards for compliance which include (i) baseline requirements for all those managing CIS ("**Fund Managers**"), and (ii) enhanced standards for Fund Managers with CIS under management which equal or exceed HK$8 billion in fund assets for any three months in the previous reporting year ("**Large Fund Managers**").

All Fund Managers must comply with the following baseline requirements:

- **Governance**. Fund Managers must assign and define roles and responsibilities of the board and at management level in terms of overseeing the incorporation of climate-related considerations into investment and risk management processes, setting goals and determining the execution process.
- **Investment management.** Fund Managers are expected to identify and examine the relevant and material physical and transition-related climate risks for each investment strategy and fund they manage, and to assess the impact of these risks on the performance of the underlying investments.
- **Risk management.** Fund Managers must take climate-related risks into account and ensure that steps have been taken to identify, assess, manage and monitor the relevant and material risks for each investment strategy and fund. Fund Managers are also required to apply appropriate tools and metrics in quantifying climate-related risks.
- **Disclosures.** Fund managers responsible for the overall operation of a given fund must make appropriate governance-related and investment management and risk management-related disclosures to investors at the [fund manager] entity level. If different governance structures, investment and risk management approaches are adopted across different strategies or funds, fund managers may elaborate on the strategy at the fund level as appropriate. Disclosures should be made to investors via various channels, such as websites, newsletters or reports and ensure investors' attention is drawn to the information.

Large Fund Managers must also comply with enhanced standards of risk management and disclosure.

The new requirements will be implemented in phases based on the following transitional periods:

- A 12-month transition period for Large Fund Managers to comply with the baseline requirements (i.e. until 20 August 2022) and a 15-month transition period for them to comply with the enhanced standards (i.e. until 20 November 2022).
- A 15-month transition period for other Fund Managers to comply with baseline requirements (i.e. until 20 November 2022).

Please click here to view the circular.

## HKMA Initiatives

### Supervisory Policy Manual on Climate Risk Management

In December 2021, the HKMA issued a new module in its Supervisory Policy Manual ("**SPM**"): GS-1 "Climate Risk Management" to provide high-level guidance to authorised institutions ("**AI**") on building climate resilience by incorporating climate considerations into the following:

- **Governance.** AIs must establish a governance structure and identify the relevant roles and responsibilities of the board and management, and set a risk appetite statement, climate goals and relevant actions for the AI.
- **Strategy.** AIs must formulate a strategic assessment covering all aspects of the AI and carry out effective strategy implementation by aligning resources and defining roles within the organisational structures.
- **Risk management.** AIs must identify and measure (where applicable) climate-related risks at portfolio, counterparty and the transactional level, conduct scenario analysis and stress testing, monitor the process, and report exposures to climate-related risks.
- **Disclosure.** AIs must take actions to prepare climate-related disclosures that align with TCFD recommendations, and make their first climate-related disclosures by mid-2023. AIs are then required to make disclosures at least on an annual basis, and are encouraged to adopt the "comply-or-explain" approach.

The HKMA also encourages AIs to take into consideration the guidance in the Principles for the Effective Management and Supervision of Climate-related Financial Risks issued by the Basel Committee on Banking Supervision when strengthening their management of climate-related financial risks and implementing the SPM module GS-1 on climate risk management. The HKMA also noted that it will assess the need to align the existing regulatory framework with the abovementioned principles.

Please click here to view the SPM GS-1 and here to view the circular.

### Green and Sustainable Banking

The HKMA has adopted a three-phase approach towards promoting green and sustainable banking, and has announced its Phase I measures which prioritize the development of a common framework to assess the "Greenness Baseline" of individual banks.

In December 2021, the HKMA issued a circular on sound practices adopted by banks to support the transition to carbon neutrality that are of reference value to AIs in formulating their own climate strategies, including reducing greenhouse gas emissions of own operations, reducing financed emissions through portfolio alignment, assisting clients to transition, and promoting collective efforts to assist the economy with net zero transition.

Separately, the HKMA is currently developing a new module on Green and Sustainable Finance under the Enhanced Competency Framework for Banking Practitioners to take forward the recommendations set by the working groups of the GSF Centre. AIs should keep an eye out for this new module.

Please click here to view the circular.

## FSDC Paper – Developing Hong Kong into the Global ESG Investment Hub of Asia

The FSDC has made "green finance" one of its key agenda items with an aim of fostering the development of an ESG ecosystem in Hong Kong.

In July 2020, the FSDC published the FSDC Paper No.44 setting out recommendations formulated with a view to developing Hong Kong into a global ESG investment hub in Asia. In its paper, the FSDC noted that the IA has promulgated guidelines on Corporate Governance of Authorised Insurers and Enterprise Risk Management, but has yet to set guidance or regulation on ESG-related matters. In this context, the FSDC recommended that the IA encourage authorised insurers to (i) publish and explain their policies on their consideration of ESG risks in their investments and (ii) provide their boards with information on their exposure to financial risks arising from climate change. The FSDC also noted that issuance of some forms of guidance (such as by way of frequently asked questions or non-binding guidelines) would help authorised insurers in formulating their own ESG-related practices and disclosures.

Please click here to view the FSDC Paper No.44.

## ESG disclosure obligations for registered companies

The Companies Ordinance (Cap. 622) (**CO**) requires all registered Hong Kong companies, unless exempted under section 388(3) of the CO, to prepare a directors' report for each financial year.

Schedule 5 of the CO sets out required contents under the business review section of a directors' report. The following information relevant to ESG should be included: (i) a description of the principal risks and uncertainties facing the company; (ii) discussion on the company's environmental policies and performance and on the company's compliance with relevant laws and regulations that have a significant impact on the company; and (iii) an account of the company's key relationships with its employees, customers and suppliers and others that have a significant impact on the company and on which the company's success depends.

## ESG disclosure obligations for listed companies

Companies listed on the Main Board and the Growth Enterprise Market ("**GEM**") are required to comply with their respective listing rules. The Main Board Listing Rules and the GEM Listing Rules each include an ESG Reporting Guide, which was first introduced in 2013 and is regularly updated.

Listed companies have, since July 2020, been required to make disclosures in ESG reports annually at the same time of the listed company's annual report, which can either be part of its annual report or issued separately. The ESG Reporting Guide mandates two levels of disclosure obligations, including mandatory disclosure, and comply or explain provisions.

It is important for a listed company to include in its ESG Report a statement by the board containing: (i) a disclosure of the board's oversight of ESG issues; (ii) 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 company's businesses); and (iii) how the board reviews progress made against ESG-related goals and targets with an explanation of how they relate to the issuer's businesses.

In preparation for the ESG report, the listed company must also comply with the following reporting principles:

- **Materiality:** The ESG report must disclose: (i) the material ESG factors; and (ii) stakeholder engagement (if any).
- **Quantitative:** Information on the standards, methodologies, assumptions and/or calculation tools used, and source of conversion factors, for the reporting of emissions/energy consumption (if applicable) should be disclosed.
- **Balance**: The report must be unbiased and should avoid any selections, omissions, or inappropriate presentation formats.
- **Consistency:** The listed company must disclose in the ESG report any changes to the methods or key performance indicators used.

The ESG Reporting Guide also sets out the "comply or explain" provisions, meaning each listed company must either make a disclosure, or provide an explanation as to why one or more of the provisions were not reported. The provisions mainly cover two ESG subject matter areas: environmental and social.

The HKEx also encourages listed companies to adopt recommendations by the TFCD when disclosing climate change-related information under the ESG Guide.

In April 2021, the HKEx also issued its consultation paper on Review of the Corporate Governance Code and Related Listing Rules. Key proposals cover (i) corporate culture; (ii) board independence, refreshment and succession planning; (iii) diversity; (iv) communication with shareholders; and (v) environmental, social and governance. The HKEx will provide further guidance in this regard.

Under the amended HKEx Guidance Letter HKEx-GL86-16, new listing applicants are also required to disclose in their prospectus their board diversity policy and details of the applicant's risk management and internal control systems, including processes used to identify, evaluate and manage significant ESG risks, including climate-related risks.

Please click here to view the HKEx ESG Reporting Guide and here to view the HKEx consultation paper.

## Conclusion

It would appear that in recent years just about every major regulator in Hong Kong has, in some greater or smaller way, sought to establish its ESG credentials, requiring its regulated subjects to adhere to ESG-related norms and criteria. While Asia has tended to lag behind Europe and the UK in terms of rolling out ESG legislation and benchmarks, the lead Hong Kong currently holds in the fund market over its rival Singapore cannot be taken for granted, especially in light of the challenges with retaining highly mobile senior managers arising out of Hong Kong's strict COVID-19 policy. While the FSDC 2020 paper envisaged the ambitious goal of making Hong Kong a global ESG investment hub, the more pressing driver for change in this area may well have been that being seen as upholding best industry practice was a necessity in order to retain a competitive advantage. For those rolling out global ESG policies in institutions that have hung their reputational hat on ESG compliance and with AIs increasingly focusing on product and investment sustainability as a selling point, ESG is not merely window dressing or an afterthought, but is now an essential part of the compliance landscape in Hong Kong.