SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Industry Workshops on ESG funds

Investment Products

The content of this presentation is for general reference only and is not meant to be exhaustive. It may be updated from time to time for providing further guidance in light of local and international market and regulatory developments.

You are encouraged to consult the Investment Products Division if in doubt.

Section A

1st workshop on 4 March 2022

Introduction

ESG fund applications

- Increasing number of funds that seek SFC authorization as an ESG fund in Hong Kong – ESG funds are required to meet the requirements set out in the SFC circular dated 29 June 2021
  - "**Eligibility**" requirement: the fund incorporates ESG factors as a key investment focus i.e. ESG factors have a significant influence on the fund's selection of underlying assets
  - **Disclosure**: offering documents (incl. KFS) contain the required ESG-related disclosures

- ESG fund confirmation (Annex 2 of the SFC circular) – submitted as part of fund application documents
  - Fund manager should select the most representative ESG theme and strategy of the fund
  - ESG-related disclosures in the KFS should reflect the most representative ESG theme and strategy as indicated in the confirmation

- SFC's review of application – whether the submissions satisfy the above (*see guidance/observations on the following pages*)

UCITS funds

Whether SFDR Article 8 and 9 funds are ESG funds in Hong Kong?

- Depends on whether the UCITS fund incorporates ESG factors as a key investment focus

- Irrespective of the UCITS fund's classification (whether Article 8 or Article 9) under the European regulation on sustainability-related disclosures in the financial services sectors ("SFDR")

- Not all Article 8 funds would qualify as ESG funds in Hong Kong as some may not have ESG as their key investment focus

Whether SFC will provide comments on the offering documents disclosure on ESG fund applications?

- While the KFS should be concise, not misleading and short, SFC will request for clarification on any unclear disclosure so that the main elements of the ESG theme and strategy are clear to investors

Common ESG strategies

Strategy	Description
Thematic	Investment in companies that engage in specific ESG or sustainability themes or economic activities (e.g. sustainable energy, etc.)
Best-in-class / Positive screening	Investment in companies or sectors that have better ESG performance than peers
Impact investing	Investment in companies or financing for business with a purpose of generating measurable positive ESG impact

ESG strategy: Thematic

What is the key investment theme and how the theme is ESG related?

- Themes that are **clearly defined** and **self-explanatory**, e.g. climate change, clean energy, environment
- Themes that **need further elaboration**, e.g.
  - Water: companies that protect and improve sustainability of global water resources
  - Food: companies that engage in business that improve food management practices with the purpose of improving sustainability of the agricultural practices, natural resource efficiency, and affordability and quality of food
  - Forestry: companies that resolve global environmental challenges through sustainable forest management and wood-based materials

ESG strategy: Thematic

What are the criteria for considering whether a company/investment is related to that ESG theme?

- Companies with at least XX% of total turnover / profit / capex (or any alternative parameters) in that ESG theme and related sectors (e.g. clean energy)
- Companies that engage in products and services that directly or indirectly provide solution for the ESG theme (e.g. climate mitigation and/or adaptation) based on various quantitative factors and performance indicators of which the fund manger consider different threshold depending on the related activities (e.g. details are disclosed separately on the fund's website)

What is the expected or minimum proportion of fund assets to be invested in those underlying investments?

- The fund should primarily invest in those ESG-themed investments

ESG strategy: Thematic

Illustrative examples of KFS disclosure

Example 1 – Climate change

- The fund invests primarily (i.e. at least XX% of the fund’s net asset value) in equity securities of global companies that provide solutions for mitigation and/or adaptation of climate change risk

- This relates to companies that derive more than XX% of revenues from products and services that directly or indirectly reduce global emissions, improve resource efficiency, and/or protect against the physical consequences of climate change

- The solutions activities are generally associated with renewable energy, energy efficiency, water & waste management, sustainable transportation, and/or sustainable forestry & agriculture

ESG strategy: Thematic

Illustrative examples of KFS disclosure

Example 2 – Energy transition

- At all times, the fund invests primarily (i.e. at least XX% of its net asset value) in equities and/or equity equivalent securities issued by worldwide companies that conduct a significant part of their business (i.e. at least XX% of the total turnover) in energy transition

- Energy transition activities include, but are not limited to, renewable & transitional energy, energy efficiency, sustainable transport, green building and infrastructure

ESG strategy: Thematic

Illustrative examples of KFS disclosure

Example 3 – ESG / sustainability

- The fund invests primarily (i.e. at least XX% of its net asset value) in equities of companies engaging in activities facilitating the achievement of one or more SDGs i.e. companies which offer products, services or solutions across the themes of affordable healthcare, energy transition (de-carbonizing the energy system by transitioning away from fossil fuels towards clean energy), food security (meeting the growing food demand for affordable and nutritious food whilst improving sustainability of the food system), financial inclusion (improving availability of financial services to underprivileged communities)

- Depending on a company's operational sector/industry, different quantitative factors and performance indicators may be considered in assessing whether a company engages significantly in the above themes; and the relevant quantitative and qualitative factors may also vary in importance

ESG strategy: Best-in-class / positive screening

What are the ESG factors used in assessing the company / issuer of the underlying investment?

- To disclose in the KFS the types of ESG factors and metrics being assessed (e.g. carbon footprint, water intensity, social and employee matters, respect for human rights, anti-corruption matters, etc.) in deriving the ESG related scores / ratings (e.g. overall ESG perspective or focus on any particular aspect) of the company / issuer

What is the proportion of companies in the investment universe that is subject to the ESG assessment?

- We expect all of the companies in the investment universe (except for certain assets where ESG may not be relevant such as cash or money market instruments) would be subject to the ESG assessment

ESG strategy: Best-in-class / positive screening

How would the ESG assessment outcome affect the stock selection decision?

Selection based on ESG ratings

- The fund should primarily invest in companies with high ESG ratings (or above certain threshold) within the investment universe
  - Disclose in the KFS the proportion (e.g. at least 20%) of companies that will be removed from the investment universe

- If companies with low ESG ratings would still be invested by the fund as ancillary investments
  - Explain and disclose in the KFS the rationale (e.g. companies showing improvement in ESG ratings and there are ongoing assessment of the improvement)

ESG strategy: Best-in-class / positive screening

How would the ESG assessment outcome affect the stock selection decision?

Upgrading the overall ESG rating at the portfolio level

- To disclose in the KFS the expected or minimum improvement of overall ESG rating of the fund's portfolio as compared to the investment universe / reference benchmark (e.g. at least 20% better than the investment universe / reference benchmark; OR better than the investment universe / reference benchmark after removing the bottom 20% such comparable reference)
- No particular restriction on investing in low ESG ratings companies
- A fund with a particular geographical / sector focus is expected to compare its ESG rating against a comparable investment universe or benchmark relevant to the fund's particular focus

ESG strategy: Best-in-class / positive screening

Illustrative examples of KFS disclosure

Example 1 – Selection based on ESG ratings

- The fund manager uses its proprietary assessment model to assess the ESG performance of companies within the fund's investment universe based on a variety of ESG factors including carbon footprint, water intensity, social and employee matters, respect for human rights, anti-corruption / anti-bribery matters or other governance matters, etc.
- Each companies in the investment universe would be assessed and assigned with a proprietary ESG score (i.e. from 1 to 10) and those among the worst 3 scores would not be invested, representing at least XX% reduction of the investment universe
- The fund invests primarily (i.e. at least XX% of its net asset value) in companies based on the above best-in-class approach, except for cash held on an ancillary basis and companies with low but improving ESG score….

ESG strategy: Best-in-class / positive screening

Illustrative examples of KFS disclosure

Example 2 – Upgrading the overall ESG rating at the portfolio level

- Information about the ESG rating methodology (same as previous slide)
- The fund's portfolio is then constructed so that the average ESG score of the portfolio would be higher than the average ESG score of the investment universe after eliminating at least the bottom XX% of the lowest ESG rating securities in the investment universe

ESG strategy: Impact investing

Whether the fund’s investments intend to generate positive and measurable ESG impact?

Please refer to the updated slide on page 25.

ESG strategy: Others

Index tracking funds

Please refer to the updated slide on page 26.

Fund of funds

- To disclose how the underlying funds are considered as ESG funds. i.e. incorporating ESG factors as their key investment focus (same expectation as to any other ESG funds)
- The level of disclosure shall be the same as in other active ESG funds

Examples of funds not eligible as ESG funds

Investment themes not clearly linked to sustainability goals

- Broad spectrum themes where certain themes only demonstrate a remote relationship with the sustainability goals (e.g. artificial intelligence / robotics / subscription-based business)

ESG factors do not have significant influence to the stock selection process

- Remove 5-10% worst performing companies in the investment universe by way of the fund’s best-in-class strategy

- The overall ESG scores of the fund’s portfolio is comparable or better (with no particular threshold) than the reference benchmark (e.g. MSCI World Index)

Examples of funds not eligible as ESG funds

The reference benchmark for ESG comparison is not comparable

- An Asia focused fund commits to achieve an average ESG score of its portfolio that is at least 20% better than a reference benchmark of which is MSCI World Index

ESG factors are not binding elements

- ESG factors are considered during investment analysis but don’t have any binding or significant impact on the ultimate investment decision
- Lengthy disclosure in the investment strategies about the fund manager’s ESG investment philosophy but lack of substance

Operational matters

Application process

- Complexity and uniqueness of ESG theme / strategy – encourage early discussion with the SFC
- Direct dialogue with the portfolio managers may be required to better understand the ESG strategy
- Disclosures may vary
- SFC’s requisitions are specific to a case aimed to address case-specific issues

Ongoing monitoring and periodic assessment

- Fund managers should regularly monitor how the ESG fund has attained its ESG focus
- All ESG funds (including UCITS ESG funds) should disclose its periodic assessment results to investors

Section B

2nd workshop on 12 January 2023

ESG strategy: Thematic

What are the criteria for assessing whether a company/ investment is related to themes with future ESG targets?

- For example, to achieve carbon neutral and net zero emissions by investing in companies that:
  - will deliver improvements in sustainable profile (e.g. reducing carbon emissions) overtime
  - will engage in provision of climate solutions overtime

- In view of the uncertainty of the future targets and goals, fund managers are expected to explain and disclose the following:
  - clear and measurable targets / goals, including periodic targets (if any)
  - metrics to measure these targets / goals, including the objectivity and reliability of such metrics
  - ongoing monitoring process and how the relevant assessment will influence the investment decisions, etc.

ESG strategy: Best-in-class / positive screening

How would the ESG assessment outcome affect the stock selection decision?

Selection based on ESG ratings should have a "significant" influence on the fund's selection of underlying assets

- For example, at least 20% of companies will be removed from the investment universe; OR the portfolio's ESG rating is at least 20% better than that of investment universe / reference benchmark
- **Investment universe** – the fund's original investment universe before applying the ESG-related screening (based on the fund's investment focus)
- **Reference benchmark** – the benchmark index is comparable with the fund's intended investment universe (in terms of geographical location or sector)

ESG strategy: Best-in-class / positive screening

How would the ESG assessment outcome affect the stock selection decision?

Sovereign debts / money market instruments

- ESG assessment on certain asset classes could be less straightforward due to:
  - Data constraints – more difficult to source relevant ESG data and data coverage is less readily available (e.g. sovereign debts)
  - ESG performance of the issuers may not have a direct and significant linkage to the instruments (e.g. money market instruments like treasury bills, short-term bank deposits) from ESG perspective

The SFC is closely monitoring this evolving space and fund managers are welcome to discuss with us on how ESG factors would have a significant influence for your specific case

ESG strategy: Impact investing

How can an ESG fund claim to be an "Impact Investing" fund?

- The underlying investments of the fund themselves should generate positive and measurable ESG impact, for example:
  - green bonds that are subject to ongoing assessment such as the (i) use of proceeds, (ii) process for project evaluation and selection, (iii) management of proceeds, and (iv) reporting, etc.

- The positive ESG impact of the fund's investment should also be measurable at the fund level

- Fund managers are expected to disclose in:
  - offering documents: how the fund measures its ESG impact
  - periodic assessment: (i) the ESG impact achieved by the fund, and (ii) the methodology to measure such ESG impact

ESG strategy: Index tracking

How are ESG fund requirements applied to passive strategies such as index tracking?

- To disclose how ESG factors are incorporated in the ESG index's construction methodology and considered as a key investment focus
- Same logic and requirements as in other active ESG funds adopting thematic, best-in-class and/or positive screening strategies (e.g. index construction resembles active fund's stock selection process)
- Representative sampling[1] – how does the fund's portfolio achieve the same ESG focus and features as represented by the ESG index
- Synthetic replication[2] – what are the indirect exposure through FDIs (e.g. nature of collaterals, related hedge positions of the FDI counterparties)

[1] Investing in a portfolio featuring high correlation with the index and may invest in other securities that are not included in the index

[2] Track the performance of an index through investment in financial derivative instruments (FDIs), for example futures, swap or market access products or similar arrangements

Operational matters

Periodic assessment

- All ESG funds (including UCITS ESG funds) should disclose its periodic assessment results to investors by appropriate means (e.g. annual report, website, or fact sheets, separate report, etc.)

- Periodic assessment should be conducted <u>at least annually</u>

  – Where an ESG fund decides to disclose its periodic assessment results for its financial year in the annual report, we may accept the assessment period to cover an extended reporting period in cases when the fund is first launched or upon its termination

Operational matters

Enhanced disclosure in offering documents for SFDR compliance

- Enhanced disclosure in offering document(s), including the insertion of SFDR template information, would not alter the status of the fund in Hong Kong, i.e. if the UCITs SFDR Article 8/9 fund is not an SFC ESG fund, it would continue to be the case
- Generally, these enhanced disclosure does not trigger amendments which require SFC's prior approval
- Fund managers should ensure the fund's Hong Kong offering document(s) is/are consistent with its overseas offering document(s)

Section C

Q&As

Q & As – Q1

Q: Whether an ESG fund must invest primarily in ESG-related investments and what is the threshold of primary investment?

A: An ESG fund should invest primarily in investments according to the fund's ESG investment objective and/or strategy(ies). For funds primarily regulated by the SFC, "invest primarily" means 70% or more of the fund's NAV. For UCITS funds, this means at least two thirds of the fund's NAV, which is generally understood to be the minimum investment threshold for primary investment.

In general, most ESG investment strategies would be able to demonstrate that the fund's primary investments meet the minimum investment threshold. For certain strategies such as the "Upgrading the overall ESG rating at the portfolio level" as mentioned on page 13 above, we understand that the ESG commitment is reflected at portfolio level rather than at individual security level and hence the minimum threshold for primary investment may not be applicable.

Given the evolving nature of ESG funds, fund managers are encouraged to contact us if they have any questions regarding any specific ESG strategies or funds.

Q & As – Q2

Q: Can a fund which does not fall under the scope of ESG funds pursuant to the SFC's circular on ESG funds dated 29 June 2021 ("Non-ESG Fund") include reference to "ESG" or "sustainable" or other similar terms (collectively "ESG Terms") in its fund name?

A: As an overarching principle, a product's name should not be misleading. We would generally not expect a Non-ESG fund to have any reference to ESG Terms in its name but exceptions are permitted on a case-by-case basis. In light of the diversity and rapid development of funds, exceptions would be assessed in each case taking into account the specific situation of the fund and explanations provided by the fund manager as to how the 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.

… to be continued

Q & As – Q2 (Continued)

A: For example, for certain UCITS funds which are Non-ESG Funds in Hong Kong but include a reference to ESG Terms in their names, we may allow exceptions for these funds to retain the ESG Terms if the relevant fund manager is able to justify to the SFC that (i) the fund name will not be misleading to investors; and (ii) a change of its name (in particular, the English name) will be unduly burdensome (for example, a change of name could affect the sales or marketing efforts across various markets, etc.).

Where an exception is allowed, we expect appropriate disclosure to be in place to avoid misleading investors. As such, the Non-ESG Funds in these cases must include a prominent warning statement against their names to the effect that the fund is not classified as an ESG fund in Hong Kong. To the extent practicable, in formulating their Chinese fund names, the Non-ESG funds are expected not to include the ESG Terms.

Fund managers who wish to seek for exception should consult the SFC in advance regarding any case-specific issue.

Q & As – Q3

Q: Pursuant to the EU SFDR regulatory technical standard, UCITS funds that are classified as falling under SFDR Article 8 and 9 are required to append the pre-contractual disclosures template (on a per product basis) ("SFDR Template Information") to their prospectuses.

For UCITS SFDR Article 8 and 9 funds that are authorized by the SFC in Hong Kong ("Relevant Funds"), is it an option not to include the SFDR Template Information in their Hong Kong offering documents ("HKOD")?

A: As far as the HKOD is concerned, regardless of whether the Relevant Funds are ESG funds pursuant to the SFC's circular on ESG funds dated 29 June 2021, the overarching principle is that the HKOD must contain the information that is necessary for investors to make an informed judgement of the investment.

… to be continued

Q & As – Q3 (Continued)

A: In respect of the SFDR Template Information, managers of Relevant Funds have the discretion to decide whether or not to include such information in the Relevant Funds' HKOD.

If the fund manager decides to include the SFDR Template Information in the HKOD of a Relevant Fund, these enhanced disclosures generally do not trigger amendments which require SFC's prior approval and the updated bilingual HKOD should be filed with the SFC in accordance with 11.1B of the UT Code.

If the fund manager decides not to include the SFDR Template Information in the HKOD of a Relevant Fund, the SFDR Template Information should be provided to investors upon their request. The HKOD of the Relevant Fund must disclose how investors can make such request and in which language the SFDR Template Information will be available.

Thank you.

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