CLIENTALERT

STEPHENSON HARWOOD
罗夏信律师事务所

The SFC adopts a firmer approach to ESG funds

Deadly wildfires in Canada and Cyprus. Devastating landslides in Japan. These happened recently and prove, if there was ever any doubt before, that severe climate change is not only real, it is a clear and present danger. Like any key industry, the financial sector has to prepare itself for any negative impact resulting from climate change on businesses and clients, and play a critical role In mitigating such risks by, among other things, modifying and reshaping its products and services.

In Hong Kong, the city's Securities and Futures Commission issued on June 29, 2021 a circular to management companies of SFC-authorized unit trusts and mutual funds (the "**Circular**") that sets out guidelines for funds that build in ESG factors in their investment processes.

This notice will supersede the 2019 equivalent on January 1, 2022, and while it only applies to the abovementioned SFC-authorised unit trusts and mutual funds, any fund manager looking to establish an ESG Fund would do well to take its lead. As we will see below, the Circular takes its 2019 version and supersizes it as the SFC adopts a firmer approach to ESG this time round:

1. Name of the Fund

This should not be misleading and the same applies to related marketing materials, which should accurately and appropriately reflect the ESG factors against other features of the fund. Suffice to say, there should be no overstating or excessive highlighting of ESG Factors, as the last thing the market needs is widespread greenwashing.

The 2021 notice however removes the previous stipulation that an ESG Fund invests at least 70% of its total net asset value in securities or other investments reflecting the ESG investment focus. Instead, it sets out the need to state the expected or minimum proportion of asset allocation that are "commensurate with the fund's ESG focus".

2. Disclosure in offering documents

The Circular provides, like its 2019 version, fundamental disclosure requirements, including a description of the fund's ESG focus such as sustainability, low carbon footprint or climate change. The fund should also list the criteria – filters, indicators, ratings, third party certification, etc. – that are being used to ensure that it meets this focus.

The latest notice also goes further to provide additional guidance for funds with a climate-related focus. Examples of climate-related indicators, it says, includes carbon footprint, weighted average carbon intensity, greenhouse gas emission, or financial benchmarks such as revenue or profit generated from activities with a positive impact on climate change.

A climate fund should also disclose clearly how it measures climate indicators such as, where relevant, the metrics used, their calculation basis or formulas, relevant data sources, as well as assumptions and estimations along with limitations. It could also detail its achievement of its climate-related focus by comparing its climate indicator against those of the previous assessment period, its reference benchmark or its investment universe, just to name a few.

3. Additional complementary information

The Circular has also, compared to the 2019 version, fleshed out in finer detail how an ESG fund should disclose additional information wherever appropriate. These include descriptions of how the ESG focus is measured and monitored throughout the lifecycle of the fund, and the related internal or external control mechanisms, as well as of the methodologies adopted to measure the stated ESG focus above and the fund's achievement of the focus.

4. Periodic assessment and reporting

Similarly, there is now, compared to the 2019 notice, a more detailed section on periodic monitoring and evaluation. These include appropriate means such as annual reports that may set out a description of how the fund has attained its ESG focus during the assessment period, the actual proportion of underlying investments that tie in with the fund's ESG focus, and the actual proportion of the investment universe that was removed or picked as a result of the fund's ESG-related screening.

Get in touch

Penelope Shen
Partner
T: +852 3166 6936
Email: Penelope.Shen@shlegal.com

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