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ESG Series - SFC Circular on ESG Funds to become effective on 1 January 2022

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On 29 June 2021, the Securities and Futures Commission ("SFC") issued a circular[1] to set out its expectations on SFC-authorized unit trusts and mutual funds which incorporate environmental, social and governance ("ESG"), climate change and/or sustainability factors ("ESG factors") as their key investment focus ("ESG Funds") with a view to improve their comparability, transparency, and visibility (the "Circular").

From 1 January 2022, the Circular will become effective and supersede an earlier circular issued by the SFC in April 2019 (the "**2019 Circular**"). In this article, we will revisit the applicability of the Circular and the key enhanced disclosure and reporting requirements imposed under it.

Which type of funds does the Circular apply to?

The Circular applies to ESG funds, which are defined to be SFC-authorized funds which incorporate ESG factors as their key investment focus and which reflect such focus in their investment objectives and/or strategies.

Undertakings for Collective Investment in Transferable Securities (also known as UCITS) will also fall within the scope of the Circular if they incorporate ESG factors as their key investment focus and which reflect such focus in their investment objectives and/or strategies. However, they will be deemed to have complied with the requirements imposed under the Circular if they meet the disclosure and reporting requirements applicable to Article 8 or Article 9 funds under the European regulation on sustainability-related disclosures in the financial services sectors.

The SFC maintains a publicly accessible central database of all ESG Funds, including UCITS ESG Funds, on its website[2] (the

[1] https://apps.sfc.hk/edistributionWeb/api/circular/openFile?lang=EN&refNo=21EC27

[2] https://www.sfc.hk/en/Regulatory-functions/Products/List-of-green-and-ESG-funds

"**Database**"). Key features of all ESG Funds will be listed in the Database after the Circular becomes effective to increase transparency.

Name of fund

The name of a fund or a product shall not be misleading. For an ESG Fund, the reference to ESG or similar terms in its name should accurately and proportionately reflect the ESG features but not to overstate such features. A fund which is not an ESG Fund should not carry a name or market itself as an ESG Fund, except with the SFC's permission which may be granted on a case-by-case basis.

What are the enhanced disclosure requirements?

Pursuant to Code 6.1 of the Code on Unit Trusts and Mutual Funds issued by the SFC in January 2019, an offering document should contain sufficient information to allow investors to make informed investment decisions.

Following such principle, the Circular requires an ESG Fund to disclose in its offering document information regarding (i) its ESG focus, (ii) its ESG investment strategy, (iii) its expected or minimum proportion of ESG investment in terms of net asset value, (iv) any reference benchmark, and (v) related risks and limitations.

An ESG Fund is also required to describe the following information on the offering documents, its website or through other means:

a) how its ESG focus is measured and monitored through its lifecycle;

b) methodology for measuring its ESG focus and its attainment of the same;

c) due diligence carried out in respect of the ESG-related attributes of its assets;

d) any engagement policies, including proxy voting policies; and

e) sources and processing of ESG data or assumptions made where no such data is available.

Such information should be reviewed and updated from time to time in order to ensure accuracy.

Periodic assessment and reporting requirements

The Circular requires an ESG Fund to conduct periodic assessment of the attainment of its ESG focus at least annually and disclose the result of such assessment to its investors through appropriate means, for example in its annual report. The disclosure should cover how it has attained its ESG focus during the assessment period, the basis of the assessment performed (including any estimations and limitations), and comparison between the current and at least the previous assessment period.

Fund managers' duty to monitor ESG Funds on an ongoing basis

The Circular requires the fund manager of an ESG Fund to monitor and evaluate investments made by the ESG Fund to ensure that its ESG focus is achieved and the Circular is complied with. If an ESG Fund ceases to pursue an ESG focus, the fund manager must inform investors and the SFC as soon as practicable.

Additional guidance for climate funds

The Circular provides additional guidance for ESG Funds with a climate-related focus. The following economic activities are given as examples of a climate-related focus:

(i) contribute to climate change mitigation or adaptation;

(ii) seek lower carbon footprint as compared to reference benchmark;

(iii) contribute to reduction of greenhouse gas emission;

(iv) achieve positive impact to mitigate or adapt to climate change; or

(v) facilitate transition to a low carbon economy.

The Circular also gives examples on climate-related indicators, disclosures of designated climate benchmarks, and methodologies of measuring climate indicators.

Consequence of failing to comply with the Circular

If an ESG Fund fails to meet the requirements imposed under the Circular, it will be removed from the Database. More importantly, the SFC may take appropriate regulatory actions against it for compliance breaches, such as failure to meet the investment objective and/or strategy stated in its offering documents.

Next step

The Circular will take effect and supersede the 2019 Circular on 1 January 2022 (the "**Effective Date**"). Existing ESG Funds (i.e. those that are already listed on the Database) should review their current disclosures and make any necessary updates and revisions by the Effective Date. Applications for new ESG Funds should comply with the requirements under the Circular from the Effective Date, including the submission of a confirmation of compliance.

Going forward, ESG will gain increasing attention. It is likely that more applications for ESG Funds will be made in the future. However, fund managers should ensure its staff and management receive the necessary training for understanding the enhanced disclosure requirements set out in the Circular. The SFC may take any breach of the Circular by an ESG Fund seriously in order to combat greenwashing.

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