



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

Industry Workshop on ESG fund applications

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Investment Products

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

Agenda

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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



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 manager 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? (cont'd)

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?

- The fund's investments themselves should generate positive ESG impact (e.g. investing in green bonds)
- The ESG impact of the fund's investment should also be measurable by the fund
- The measurable impact is expected to be disclosed as part the fund's periodic assessment to demonstrate how the fund has attained its ESG aspiration

ESG strategy: Impact investing



Illustrative example of KFS disclosure

Example

- Invest primarily (i.e. at least XX% of its net asset value) in Green Bonds financing climate change mitigation or adaptation projects or other environmental sustainability projects such as energy efficiency, renewable energy.....
- This includes debt securities and instruments which finance eligible projects meeting the criteria and guidelines of the Green Bond Principles (as published by the International Capital Market Association (ICMA)) which would be subject to assessment on the (i) use of proceeds, (ii) process for project evaluation and selection, (iii) management of proceeds, and (iv) reporting

ESG strategy: Others



Index tracking funds

- 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 as if any active fund's stock selection process)



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

Q & A

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.

A large, stylized teal graphic of a bird in flight, positioned on the left side of the page. The bird's wings are spread wide, and its tail feathers are visible. The graphic is semi-transparent and overlaps with the text.

Thank you.

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