HONG KONG'S ESG REGULATORY PRIORITIES AND IMPACT ON HONG KONG LISTED AND OTHER COMPANIES

With Hong Kong's role as an international capital hub for Mainland Chinese businesses, ESG regulations in Hong Kong can have a global impact, particularly on the transition to net zero. This briefing outlines the regulatory priorities for Hong Kong in the ESG space, their direction of travel and practical implications for companies. Hong Kong listed companies and the financial sector will feel the most direct impact, but many corporates will also feel the knock-on effect of the increasing regulatory requirements upon, and expectations from, institutional investors and lenders on ESG issues.

Regulatory landscape

The current ESG regulatory landscape in Hong Kong focuses on listed companies, banks and asset managers[1]. Hong Kong listed companies are required to report on various aspects of the three elements of ESG – environmental, social and governance - primarily on a comply-or-explain basis, while initial steps have been taken by financial regulators to require banks and certain asset managers to start managing climate-related risks and make climate disclosures.

Hong Kong regulators have been alerting the market to ESG regulatory developments on the horizon. Two recent instances are referenced in more detail below: (1) a speech given by Ashley Alder (CEO of the Hong Kong Securities and Futures Commission (**SFC**) and chairman of the International Organization of Securities Commissions (**IOSCO**)) on 27 May 2022 (the **SFC Speech**), which highlighted ESG regulatory priorities and how international developments may be adopted in Hong Kong; and (2) the June 2022 **Listing Newsletter** from the Hong Kong Stock Exchange (**HKEX**), in which the HKEX advised listed companies on the actions they should take now in preparation for new requirements on climate disclosures.

Regulatory priorities

1. Sustainability reporting

1.1 The SFC Speech highlighted the urgent need for comparable and reliable sustainability reporting, especially at the corporate level, to enable investors to direct capital to sustainable investments and for lenders to finance the journey towards net zero. Regulators around the world are keeping an eye on the progress of the ISSB standards (more detail below) which are expected to be finalised at the end of this year. In Hong Kong, the immediate focus will be to enhance climate reporting.

1.2 TCFD climate-reporting: the reporting framework of the Taskforce on Climate-related Financial Disclosures[2] (**TCFD**) is becoming the conceptual foundation for climate disclosure policy around the world, including in Hong Kong.

1.3 Hong Kong's Green and Sustainable Cross-Agency Steering Group (**CASG**) announced climate-related disclosures aligned with TCFD recommendations will be mandatory across "relevant sectors" by 2025. This is expected to encompass banks, asset managers, insurance companies, pension trustees and listed entities. The HKEX stated it

[1] For more detail on ESG-related requirements for Hong Kong listed companies, see our publication from January 2022. Authorized institutions and asset managers of collective investment schemes with investment discretion are or will soon be required to manage and disclose climate-related risks, with "large asset managers" (those with AUM of HK$8 billion or more) subject to enhanced requirements such as the disclosure of portfolio carbon footprint (Scope 1 and 2 emissions). Product-level requirements apply to SFC-authorised ESG funds.

[2] The TCFD framework comprises four pillars (governance, strategy, risk management, and metrics & targets), with 11 recommendations associated with those pillars. There is guidance which informs implementation of the recommendations but is not part of the formal recommendations.

will review its ESG reporting guide this year to further align it with TCFD recommendations. We can also expect listed entities to move from comply-or explain to mandatory climate reporting on a phased basis.

1.4 **UK** and **Singapore** will require mandatory TCFD-aligned climate reporting for listed entities, with the UK rules also applying to large *private* companies. This points to hardening expectations for larger private companies to prevent what Larry Fink called "the largest capital arbitrage in our lifetime" - the shifting of problematic assets from public to private hands.

1.5 ISSB sustainability reporting: a global baseline in sustainability reporting is emerging in the form of the standards being developed by the International Sustainability Standards Board (**ISSB**). The ISSB, part of the IFRS Foundation, released two **exposure drafts** – one for general sustainability disclosures and one specifically for climate disclosures (the **ISSB Climate Standard**). The scope covers significant sustainability matters which may reasonably impact a company's enterprise value[3]. The standards leverage the TCFD framework and SASB's industry-specific disclosures, but go beyond them in certain respects as described below.

1.6 Although the ISSB has widespread support, the precise extent of domestic adoption remains to be seen. A promising sign is that representatives from China, US, EU, UK, Japan and the ISSB have formed a **working group** to discuss compatibility between local and ISSB standards, with the ISSB speaking of a "building-blocks" approach to facilitate jurisdiction-specific requirements.

1.7 Hong Kong's CASG announced its support and will evaluate the adoption of the standards once finalised, and the SFC and HKEX will assess how to implement them for Hong Kong listed companies. Given a large proportion of them are Mainland businesses, Mr. Alder commented it would be difficult for them to be in compliance with all aspects from day one, and noted ISSB adoption in Hong Kong should be "proportional and practical" and properly synchorised with Mainland standards. This points to a potentially more pragmatic and phased approach towards ISSB adoption in Hong Kong (for example, around Scope 3 corporate value chain emissions data). Nonetheless, the HKEX's recent Listing Newsletter asks listed companies to start identifying gaps in internal policies and practices against the ISSB Climate Standard in preparation for new reporting requirements.

2. Independent assurance of sustainability information

2.1 The SFC Speech highlighted a key aspect of future reporting will be the independent assurance of sustainability information, with Hong Kong regulators assessing how audit and assurance professionals can play a role.

2.2 International developments in this area include the US SEC's **draft rules,** which propose to require certain US listed entities to obtain external assurance (not necessarily from auditors) on Scope 1 and Scope 2 emissions, with the level of assurance initially on a "limited assurance" basis and upgrading to a "reasonable assurance" standard. There would be a safe harbour from disclosure liability for Scope 3 data. The EU's proposal calls for a similar phased approach to mandatory assurance, though the scope of information to be assured is not yet clear. The Singapore stock exchange recently **concluded** mandatory external assurance will not be introduced at this juncture due to challenges around assurance standards. In this respect, the International Auditing and Assurance Standards Board is **evaluating** the development of sustainability assurance standards (leveraging off existing standards and guidance that deal with the assurance of non-financial information more broadly).

3. Voluntary carbon markets

3.1 Voluntary carbon markets have seen rapid growth as an increasing number of corporates set net zero targets. Hong Kong's CASG is **assessing the feasibility** of a voluntary carbon market for Hong Kong and the Greater Bay Area, and the HKEX has **announced** the formation of an International Carbon Market Council. However, carbon markets remain largely unregulated and the credibility of carbon credits has been a focus of greenwashing concerns. The SFC Speech highlighted the potential regulation of carbon markets as an IOSCO regulatory priority, and the CASG feasibility paper notes any regulations for Hong Kong can leverage the work being done by The Integrity Council on

[3] The ISSB's exposure drafts require companies to provide all material information related to significant sustainability matters that are relevant to investors' decision-making. Materiality is assessed by reference to impact on enterprise value over the short, medium and long term, with industry-specific guidance identifying the sustainability topics most relevant to enterprise value for a typical company in an industry.

Voluntary Carbon Markets, which is due to issue a set of **Core Carbon Principles and Assessment Framework** in Q4 2022, following a public consultation in July.

4. ESG ratings

4.1 The SFC Speech noted another priority is greater regulatory focus on ESG ratings and data providers. IOSCO had issued **recommendations** to national regulators to evaluate issues such as transparency of methodology and conflicts of interest. The UK Financial Conduct Authority recently **stated** it sees a clear rationale for regulatory oversight informed by IOSCO's recommendations. The EU issued a **consultation** on the ESG ratings market, with a view to propose a policy initiative to foster the reliability and comparability of ESG ratings by early 2023.

Practical Implications

1. Companies should take action in anticipation of more robust requirements on climate reporting.

1.1 TCFD - in light of Hong Kong regulators' commitment to move towards mandatory TCFD reporting by 2025, Hong Kong listed companies and the financial sector should, at a minimum, assess any gaps between current practices and the TCFD recommendations (with TCFD guidance containing implementation detail), and start addressing those gaps. The HKEX issued a **Guidance on Climate Disclosures** to assist with TCFD-aligned reporting as the Listing Rules incorporate certain but not all elements of TCFD.

1.2 ISSB Climate Standard - the trend towards ISSB climate reporting means companies should review the draft standard (which is expected to be finalised at the end of this year), produce a work plan for compliance, and give directors and relevant employees training on this topic.

1.3 The ISSB issued a **comparison** highlighting the key differences with the TCFD recommendations and guidance[4]. The ISSB Climate Standard is more quantitative and specific than the TCFD framework, with more granular detail around Scope 3 emissions data, transition plans, use of carbon credits and impact on financial position / performance.

1.4 Enhanced disclosures are likely to drive substantive behavioural change: the HKEX's Listing Newsletter recommends companies have a net zero plan and start considering employing (and providing disclosures on) infrastructure or technology to reduce carbon emissions, and assessing the whole value chain. Listed companies are currently required, on a "comply or explain" basis, to disclose Scope 1 and 2 emissions, while the ISSB Climate Standard extends to Scope 3.

1.5 The financial industry should also take note of the draft industry-specific disclosures in Appendix B to the ISSB Climate Standard, which propose the disclosure of financed emissions disclosures along the following lines:

INDUSTRY	METRIC
Commercial Banking Insurance	• Exposure to carbon related industries • Financed emissions (Scope 1, 2 & 3) at industry and asset class level
Investment Banking and Brokerage	• Facilitated emissions (Scope 1, 2 & 3) by business line and industry • Revenue generated by business line and industry

[4] Some key differences under the ISSB Climate Standard include: (i) the disclosure of Scope 3 emissions (which is not subject to materiality) and the approach towards financed emissions; (ii) for Scope 1 and Scope 2 data, a separate disclosure is required under the ISSB Climate Standard for associates, joint ventures and unconsolidated subsidiaries not included in the consolidated accounting group; (iii) in the disclosure of transition plans, more explicit requirements around disclosure of emission reduction targets and use of carbon offsets; and (iv) more granular detail on the impact of significant climate risks on the entity's financial position, performance and cash flows for the reporting period, and the anticipated financial effects over time of its climate strategy (reflecting investment plans and sources of funding).

Asset Management and Custody Activities	Financed emissions at AUM level

Source: ***ISSB***

2. Companies should enhance consistency and connectivity between financial statements and sustainability reporting.

2.1 The SFC Speech alerted auditors and CFOs to pay more attention to the relevance of sustainability disclosures to financial statements. It is recognised that this is a challenging area and more guidance will be needed, but it is nonetheless important to investors that companies start connecting the two areas, such as capital expenditure for emissions reduction or purchase of carbon offsets.

2.2 The ISSB's proposals do not change how sustainability-related risks and opportunities are considered in preparing financial statements[5], but are intended to give additional information to investors in their assessment of enterprise value. To enhance connectivity, ISSB requires companies to: (i) explain linkages in information; (ii) use consistent assumptions when relevant; and (iii) publish financial statements and sustainability disclosures at the same time, using the same presentation currency, and covering the same reporting period and reporting entity (noting enterprise value can be affected by factors across an entity's value chain).

3. Collaboration is needed at all levels within corporate organisations.

3.1 The Listing Newsletter emphasised action and collaboration are needed at all levels. The board should integrate climate risks and opportunities into its strategy and decision-making process, and monitor the progress toward targets set. The sustainability team should work closely with finance and communications: with the sustainability team working on infrastructure planning and validating the evidence, the finance team conducting the financial impact assessment, and the communications team facilitating investors' understanding of the company's sustainability strategy and actions in a manner which minimises the risk of greenwashing.

To sum up, Hong Kong regulators are engaged in a concerted effort to push forward the sustainability agenda; and will introduce increasingly robust regulations in light of hardening expectations from international stakeholders, but this will be done in a proportionate and pragmatic way given the composition of the Hong Kong capital markets.

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[5] The IFRS Foundation published educational materials setting out how climate-related risks and opportunities should be considered in preparing financial statements in accordance with IFRS Accounting Standard.