

Green Finance Association ESG Work Group members' comments on SFC Draft revised circular on ESG funds

The following is a summary of the views of the 40-strong GFA WG, which consists of representatives from fund managers, asset owners, service providers, academia as well as other parties in the value chain.

High level comments –

- The objective should be to raise investors' understanding of what fund managers are doing, and allow them to make informed decisions as to how they want their funds to be managed. Labelling and greater transparency are ways to achieve this objective; but just focusing on these would not be sufficient. In fact, a labelling-only approach could be seen to conflict with the PRI's broader mission: where ESG risks are/can be material, funds should incorporate ESG issues into their investment processes as part of a prudent risk management framework, and disclose their approach on ESG issues in the fund offering documents (or similar). The PRI would encourage regulators to more broadly look at requiring all funds to incorporate material ESG issues (not just "ESG funds") and to clarify fiduciary duty around this concept. ESG integration should be embedded across the full spectrum of funds, regardless of labels. To go with this, there should be a robust reporting process that applies across the board.
- ESG integration is the key: fund managers incorporate material ESG issues when assessing investment opportunities. Yet, ESG integration only shows up once in the draft revision; thus it seems there is a de-link. Also, what ESG means is engagement and voting. Again, the "how" part is missing in the draft.

Specific comments on the proposed revisions –

The following discussion is based on the understanding that the focus of the proposed revisions is primarily on thematic funds, rather than on all types of funds. And our discussion is premised on this:

(1) Minimum threshold ("MT"):

- Members generally opine that it is helpful (according to the SFC UT Code requirement, i.e. 70%) to have the MT.
- Though one area that needs clarification is what MT would mean because "E", "S" and "G" are distinct in themselves and whether SFC would require an underlying fund to provide where they're having a specific focus within these three criteria. Suggest that SFC should not be prescriptive on this, and at most, encourage them to consider providing more granular information if deemed appropriate.

(2) Mixed views re negative screening/exclusionary strategies -

- *Believe that negative screening/exclusion does not suffice:*
 - ✚ In Europe, more and more investors would not consider a fund a ESG fund if it is purely exclusionary because it is simple and too basic. The trend is that from the client side and the regulator side, if you name a fund as an ESG fund, you're dealing with ESG integration and not just about exclusion. We have the upcoming regulations in Europe with a number of sustainable related finance disclosure requirements, which would make it even stricter and much clearer in terms of definitions.
 - ✚ Exclusions has always been there, and financial institutions already have a standard. There is no compelling reason why it needs to be specifically put forward as an ESG criteria.
 - ✚ Reports by Morningstar – in the universe of Sustainable finance funds, MS excludes funds which only have exclusion, i.e. only include funds which are doing more than just excluding.
- *Negative screening/exclusion should suffice:*
 - Negative screening does have some value based underlying principles to them. Also, make sense, especially for new comers.
 - ✚ Positive screening and negative screening have the same logic. Screening out the “bad” cos makes the fund greener. In that sense, a fund that does negative screening should be qualified as an ESG fund.

Investor/allocators have mixed views on this subject.

There are a variety of approaches being taken by managers in terms of their how they incorporate ESG into their investment process, and some just have the exclusionary factors. It seems that more members opine that exclusionary screening and ESG integration are just the baseline, and should not be eligible to be called ESG funds. Most of the funds are already doing integration, so a ESG fund should be integration plus to stand out from the peck.

While there is more support to set a higher bar for the definition of ESG, a balance should be struck because ultimately, we hope that ESG can be embraced by all managers, and the bar should not be set too high to deter new comers.

Meanwhile, we wish to better understand the expectations of the SFC, i.e. does SFC wish to only deem the following funds eligible for the purposes of the Circular, i.e. funds go beyond the standard form of responsible investment and seek to create a positive impact – akin to the European regulation (Article 8 and Article 9). Helpful if SFC can explain its policy intent.

(3) Other observations/comments:

- Re 2b, under minimum requirements, SFC said that “ESG related factors should be the key considerations in the fund investment selection process among other traditional financial factors”. But this part is a bit unclear and it is important to clarify because this is the foundation of the consultation. It seems to imply that managers should place less importance on traditional factors – is it a “should” or “can”? If there are two similar investments, are managers expected to gravitate towards one that has higher ESG scores? But what about if a fund that says that it integrates ESG but is less explicit about the relative weight of ESG vs. traditional factors, will these funds fail to meet the eligibility test? And what if the fund strategy is to invest in companies that have lower ESG scores but have a clear path to enhance the scores ... Thus, there are different nuances. One suggestion is to remove “the” and just have “should be key considerations”. Helpful if SFC can elaborate on its expectations.
- We must also be mindful of the size of the universe. There is a very large universe in Europe (20,000) but not in Asia. As far as exclusionary is concerned, one may exclude but how many of those left in your universe are really ESG? If you limit yourself too much, you would end up having many funds which look the same with the top-notch names (top 20-25 names) – concentration risks?

(4) Labelling:

- Re Q4, the SFC proposed wordings could lead to confusion - a fund may call itself ESG but does not meet the minimum requirements. Most believe that either you are an ESG focused fund with ESG within your key investment criteria or you're not. And that probably takes care of greenwashing as opposed to having ESG in the name, but having a disclaimer that says it's not the key investment focus.

As an alternative – to be mindful of the practical reality that some UCITS ESG funds may not meet the minimum requirements: instead of using that the proposed phrase “ESG is not a key investment focus and consideration” which is confusing, we suggest to put a note immediately below the name to qualify the scope.

- For funds that use the simple negative screening approach,
- (1) fund can still retain “ESG” in its name, but
 - (2) add a footnote to qualify that it is “exclusionary strategy only”

Something as follows:

XXXX ESG Fund (exclusionary strategy only)	XXXX ESG 基金 (只採用剔除策略)
XXXX ESG Fund (negative screening only)	

- Q5(a), (b) suggest to allow more flexibility so that more managers can come on board.

(5) Disclosure:

- If the disclosure approach is primarily narrative based, it can be very difficult for clients to have the resources to properly scrutinize these different narratives, as well as to compare between funds that more broadly integrate ESG issues, funds that are going to pursue sustainability objectives, and labelled themselves as ESG/green, etc funds. In this case, the taxonomy is important because it provides a much clearer way for funds to disclose alignment of portfolios with specific sustainability goals.
- In the absence of a taxonomy that is fit for purpose for this Region, members opine that there should be at least some guidance or encouragement for fund managers to be very clear about the criteria that their funds use to assess the environmental credentials of the companies that are being invested in. Given that the taxonomy has been developed in the EU, and is already in place for climate mitigation and adaptation activities, members suggest to reference that as a resource. But the application should be at the principle-level rather than going into the industry specific benchmarks or metrics. This is an approach that clients of members have been adopting.
- In addition, there are a range of science-based multi-stakeholder certifications and standards that can be referenced as well for other issues beyond climate.
- Re Q9, would be helpful to have examples to understand what are the disclosure requirements that ESG fund is expecting from the entities that it invests in, as well as any high-level policy direction on what happens in case of entities that deviate from the funds focus or ESG strategy requirements.
- Disclosure in general from companies can be a lot better, but we don't think it is necessary to require all companies to disclose at a certain level before one is able to invest in an ESG fund. Especially for investors that are looking at smaller companies that may not be so good at public disclosures, they can reach out to the company management and make an assessment on what's material and decision-useful.

(End)