

Green or ESG Investing - Stewardship & Principles of Responsible Ownership

Background & Introduction

In our previous publication, “*Hong Kong Green or ESG Investing & SFC Authorised Funds*”¹, we focused on green or ESG investing of Hong Kong licensed investment managers, including a reflection on the results of the SFC ESG Survey, and an overview on the current range of SFC authorised green or ESG funds available for public offer, with reference to the SFC requirements on green or ESG funds, and also the range of investment strategies adopted by such funds.

An important element and commonly cited investment approach in green or ESG investment strategies adopted by green or ESG funds is ‘active ownership’. In this publication, we focus on stewardship and the SFC Principles of Responsible Ownership, current market trends and developments, guidelines and standards, and also consider how managers may adopt and implement stewardship and responsible ownership policies.

Stewardship and Responsible Ownership

Stewardship is about the exercise of shareholders or investors rights, and on investment managers or asset owners as institutional investors as stewards of capital, and that it is part of fiduciary duty to vote as investors or engage with investee companies with a view to generating value or return from investments to clients or beneficiaries. There may be different names, such as responsible owner or active ownership, but in essence it is about asset owners and asset managers discharging responsible investment, as stewards of capital.

When the UK Steward Code was first issued in 2010, it was issued as part of an overall corporate governance framework, with corporate governance code as applicable to governance of listed companies on the one hand, and, on the other hand, with stewardship code as applicable to institutional investors as equity investors of listed companies. Various jurisdictions subsequently adopted local codes which model the UK Steward Code, including in Asia, Japan adopting its code in 2014, followed by Hong Kong, Malaysia, Taiwan, Singapore and Korea with their respective forms in 2016, and subsequently Australia in 2018.

SFC Principles of Responsible Ownership

Hong Kong Securities and Futures Commission (SFC) published the Principles of Responsible Ownership (HK PRO) in 2016. The HKPRO was issued with the stated objective to guide and assist investors to determine how best to meet ownership responsibilities, encompassing seven principles:

Principle 1

Investors should establish and report to their stakeholders their policies for discharging their ownership responsibilities

Principle 2

Investors should monitor and engage with their investee companies

Principle 3

¹ Please refer to our update and publication in August 2020:

<http://www.vteu.co/2020/08/02/hong-kong-green-or-esg-investing-sfc-authorised-funds/>

Investors should consider and establish clear policies on when they will escalate their engagement activities

Principle 4

Investors should have clear policies on voting guidance

Principle 5

Investors should be willing to act collectively with other investors where appropriate

Principle 6

Investors should report to their stakeholders on how they have discharged their ownership responsibilities

Principle 7

When investing on behalf of clients, investors should have policies on managing conflicts of interests

Investors are encouraged to “comply-or-explain”. On this, investors are encouraged to adopt the Principles by disclosing to stakeholders that they have done so, and to either apply the Principles in their entirety and disclose how they have done so, or explain why aspects of the Principles do not, or cannot, apply to them. The HKPRO is non-binding and only voluntary.

Market Trends and Developments on ESG & Stewardship

In late 2019 the UK Financial Reporting Council published the updated UK Stewardship Code 2020 (**UK 2020 Stewardship Code**) which took effect on 1 January 2020. The UK 2020 Stewardship Code establishes a new benchmark for stewardship, and among others, defined stewardship as “responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society”.

Principle 2 of the HKPRO (on monitoring and engaging with the investee companies) makes a specific reference to ESG – “Investors should encourage investee companies to have policies on environmental, social and governance (**ESG**) issues and engage with investee companies on significant issues that have the potential to impact on the companies’ goodwill, reputation and performance”.

The SFC issued its **Strategic Framework for Green Finance** in September 2018, covering several action agenda to develop green finance in Hong Kong, which includes enhancing listed companies’ environmental and climate-related disclosures, a focus on investment managers integrating ESG factors, in particular climate risks, in investment and risk analysis process, and the development of a wide range of green-related investments and financial products while combating greenwashing.

Following public consultation, at the end of 2019 the Hong Kong Stock Exchange (**HKEX**) issued the updated ESG Reporting Guide and Related Listing Rules for companies listed on HKEX, which introduced enhanced requirements on the reporting and disclosure by listed companies on ESG, and also requiring mandatory disclosure of board engagement on a corporation’s consideration and reporting of ESG issues in its business activities, including materiality and quantitative assessment, risk management and strategy. On climate, there is now a new requirement for disclosure on the policies and measures to identify and mitigate climate-related issues which have impacted or may significantly impact the listed issuer, and which reflects the Recommendations of the Taskforce on Climate-related Financial Disclosures (**TCFD**)². The disclosure obligation on all social issues have been upgraded from recommended or voluntary disclosures to mandatory “comply or explain” disclosures.

The new ESG Reporting Guide is now effective and apply to financial years commencing on or after July 2020, with the expectation to enhance the availability and quality of ESG reporting and data of HKEX-listed companies, and also better board governance engaging in considering ESG issues that are relevant and material in the business activities, risk management and business strategy of listed companies.

² The TCFD Recommendations were issued in June 2017 under an initiative of the Financial Stability Board, to develop climate-related financial disclosures that would provide the information needed by investors, lenders and insurance underwriters to appropriately assess and price climate-related risks and opportunities.

Separately, the SFC conducted an industry-wide survey (**the ESG Survey**) last year to understand how and to what extent licensed asset management firms and leading institutional asset owners consider ESG in investment decisions and risk management, particularly those relating to climate change. Subsequent to the ESG Survey and findings³, and as global regulatory focus intensifies on climate-related risks as potential financial risks and systemic risks, the SFC set about looking into enhancing fund managers' management and disclosure of climate-related risks.

Further to this, the Hong Kong SFC recently launched a consultation on its proposed new requirements for Hong Kong fund managers to manage and disclose climate-related risks (**SFC ESG Consultation**), which includes requiring fund managers to incorporate assessment of climate-related risks in investment management as well as risk management processes, and which encompass monitoring and managing climate-related risks⁴. The SFC makes a number of references to engagement and voting as examples for fund managers to manage material climate-related risks, and requiring the board of fund managers to determine how they will monitor the status and efforts to manage climate-related risks.

While the SFC ESG Consultation is currently proposing to require fund managers to manage and disclose climate-related risks and not apply such proposed new requirements to discretionary account managers, overall, globally and in Hong Kong, there is increasing regulatory and market expectation for asset managers to manage risks around ESG in investments, and along which the expectation on stewardship and engagement is also increasing.

Active ownership as ESG investing strategy

As we noted above, an important element and a commonly cited investment approach in ESG investment strategies is 'active ownership'.

According to the UN Principles of Responsible Investment (**PRI**), the second of the six key principles is on active ownership. "*Active ownership*" is the use of the rights and position of ownership to influence the activities or behaviour of investee companies. Active ownership can be applied differently in each asset class. For listed equities, it includes engagement and voting activities. "*Shareholder engagement*" captures any interactions between the investor and current or potential investee companies on ESG issues and relevant strategies, with the goal of improving (or identifying the need to influence) ESG practices and/or improving ESG disclosure. It involves a structured process that includes dialogue and continuously monitoring companies, these interactions might be conducted individually or jointly with other investors."

Active ownership is viewed as an effective tool to reduce risks, maximise returns and have a positive impact on society and the environment. It encourages the investors' voice to be heard and help to drive responsible corporate practices.

Asset managers in responsible ownership

According, while the HKPRO issued by the SFC in 2016 is non-binding and only voluntary, Hong Kong asset managers may consider the seven principles of the HKPRO for discharging ownership responsibilities or as part of an ESG investment strategy. The HKPRO refers to "investors" in general, and although the term is not defined, in its context and as detailed, this is relevant to asset owners or asset managers in discharging ownership responsibilities on behalf of clients, fund investors or beneficiaries.

³[Results](#) published in December 2019 available on SFC website; please also see summary in our August publication (footnote 1).

⁴ Please refer to our earlier update and publication:

<https://www.vteu.co/2020/11/07/sfc-consultation-on-proposed-requirements-on-fund-managers-to-manage-and-disclose-climate-related-risks/>

Under the HKPRO, investors (in this case the asset managers) are encouraged to adopt and disclose to their stakeholders (which may be their clients or underlying investors of their funds under management) on their adoption of the HKPRO, and explain the extent such principles are not applicable or relevant.

We outline below some key considerations for asset managers in adopting responsible ownership, or in exercising active ownership as part of their investment strategies to promote ESG focus:

(a) Putting policies in place

The first step to be taken by an asset manager for responsible or active ownership is to develop and adopt relevant policies, which may in the form of a stand-alone policy document, or a combination of several policies.

Generally speaking, the policies will need to reflect or align with the asset manager's investment strategies, and its overall view on risks, returns and any specific ESG or impact strategy. The policies will cover or refer to the applicable stewardship principles and codes, assets covered, expectations and objectives, organisational structure and resources dedicated, and on addressing conflicts of interest.

Such policies will likely include specific policy around engagement, which may cover any specific issues of interest or concern for engagement, which may specific ESG considerations or focus, the due diligence and monitoring process, prioritisation, methods of engagement, escalation strategies and transparency. Sometimes the policies will contain details on proxy voting, which may outline structure or information on proxy voting decision-making processes, regional practices, filing resolutions, engagement or communications with investee company pre or post vote, reporting and transparency. There may also be specific details regarding voting policy with respect to any securities lending.

An asset manager may outsource certain responsible or active ownership activities to specialised service providers, and may reflect the policies of engagement and voting that guide the relationship with such service providers and the appointment, monitoring and evaluation of such providers. According to the SFC with respect to the HKPRO: *"Investors may choose to appoint external service providers to help them perform some of their shareholder engagement activities but cannot delegate their responsibilities as shareholders to the service providers. In particular, investors remain responsible for ensuring those activities are carried out in a manner consistent with their own policies"*.

(b) Developing an engagement programme

With the responsible or active ownership policies in place, the asset manager may consider developing an engagement programme as well.

The engagement programme can include identifying target companies for engagement and considerations and/or process for initiating a dialogue with such companies. Engagement actions can include, for example, contacting or communications with the board or company management, issuing a public statement or using media strategies, exercising the right to speak and vote at general meetings, considering potential divestment and using influence or leverage in this regard, or even seeking legal remedies. The HKPRO also encourages investors to be willing to act collectively with other investors.

(c) Establishing proxy voting practices

One important component of responsible or active ownership is voting, which the HKPRO refers to as "the exercise of the right to speak and vote on matters that can influence the way in which a business is conducted".

As asset managers hold numerous companies in their portfolios, asset managers may outsource voting activities to proxy advisers, who advise asset managers how to vote on corporate governance issues and sometimes cast ballots on behalf of asset managers. This arrangement may work well in the case of routine governance matters, but when it comes to certain corporate action decisions, especially for

asset managers who adopt active ownership as part of an ESG investment strategy, the asset managers will likely take into account its internal policies, internal and external research and analysis, decisions of the portfolio managers or governance committees along specific ESG investment considerations.

Other than research and casting votes, voting and engagement may involve communicating with the investee companies before and after general meetings. Where possible, investors may raise concerns with the companies before voting for or against or deciding to abstain. On occasions, asset managers may publicly share the rationale for their votes against management or abstentions and explain their view.

(d) Disclosure and Reporting

As noted above, under the HKPRO, asset managers are encouraged to not only adopt but also disclose to clients or fund investors on their adoption of the HKPRO, and explain the extent such principles are not applicable or relevant. Asset managers who have adopted responsible or active ownership policies should disclose or report to its clients or stakeholders on how and where ownership responsibilities are being discharged.

While most stewardship codes are voluntary and regarded as aspirational standards for adopting policies as the first step to responsible ownership, the UK 2020 Stewardship Code has adopted a new standard of ‘apply and explain’, intended to raise the effectiveness of stewardship codes by focusing on implementation and outcome.

Principle 12 of the UK 2020 Stewardship Code on “Signatories actively exercise their rights and responsibilities” provides that signatories should:

- disclose voting policy, including any house policies and the extent of any fund-specific policies;
- state the extent of using default recommendations of proxy advisers;
- report the extent to which clients may override a house policy;
- disclose policy on allowing clients to direct voting in segregated and pooled accounts; and
- state the approach to stock lending, recalling lent stock for voting and how to mitigate ‘empty voting’.

Conclusions

Asset managers would increasingly need to have in place comprehensive framework and policies around stewardship, including adopting a set of voting guidelines, engagement programme, establishing proxy voting practices, also consider how they would work with proxy advisers, deciding where on case-by-case depending on the investment strategies or the specific matter, whether to adopt the proxy advice or determine based on its own policies, internal research or engagement activities.

In exercising active ownership as part of an ESG investment strategy, asset managers adopt and disclose stewardship policies on specific ESG considerations or issues on which they take a stance, often detailed and catered for specific scenarios. These policies often disclose the use of proxy advisors whilst maintaining the ultimate full and independent discretion by the asset manager with proxy voting decisions, and may tend to provide disclosure or reports on proxy voting statistics as well providing a clear picture to end investors as to when there is departure from proxy advisors’ recommendation.

Given market and regulatory developments, the industry trend may be quickly moving towards enhanced disclosure in relation to stewardship, engagement and proxy voting. Enhanced disclosures will also allow end investors to be better informed in relation to an asset manager’s stance, investment management process and decision-making on ESG issues.

Contact

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Vivien Teu is the founding and managing partner of Vivien Teu & Co LLP. She has extensive, in-depth experience as a corporate and commercial lawyer, specialising in the financial services sector, funds and wealth management matters. Vivien has diverse legal practice experience with top-tier and magic circle firms in the areas of tax, trusts, banking and financial services, investment funds, securities regulatory and corporate commercial matters. Along with significant in-house counsel experience at a global investment firm, Vivien offers unique insights and practical commercial approaches in her practice, with extensive China knowledge. Combining in-depth Hong Kong and international legal practice experience with deep and broad knowledge of China and regional markets, Vivien regularly advises on cross-border matters, including local and international clients establishing or operating asset management platforms in Hong Kong, as well as on fund formation across asset classes, retail and private funds offerings, and on the legal, regulatory and market environment in Hong Kong for asset management and investment funds.. Driven by a passionate belief in responsible capital and sustainable finance, Vivien has strengthened an ESG and impact focus within the firm's practice areas.

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Vivien Teu & Co LLP is a Hong Kong corporate and commercial law firm with particular focus on investment funds, asset management and financial services, securities and regulatory, tax and trusts. The firm has been highly rated for technical ability and innovation, with its lawyers having in-depth Hong Kong and international legal practice experience, combined with deep and broad knowledge of China and regional markets.

The legal practice areas at Vivien Teu & Co LLP encompass providing corporate and commercial law advice, as well as on securities law and financial regulatory advice in local and international transactions, and typically a go-to firm for corporate transactions, funds formation and clients seeking legal and regulatory advice involving Mainland China and Hong Kong elements. The firm has gained a reputation of offering seamless support on cross-border Hong Kong and Mainland China matters in the areas of asset management, investment funds, cross-border securities and investments, inbound and outbound mergers & acquisitions, China market entry strategies.

Besides an enviable corporate and institutional client-base including global and regional investment management firms and financial institutions, the firm is also increasingly serving private clients and high net worth entrepreneurs, in its wider financial services, private wealth, tax and trusts practice. As a strong believer in responsible capital and social finance, the firm has strengthened the ESG and sustainability focus of its investment funds and corporate practice, as well as advising and working with family offices, charities, foundations and social enterprises in the areas of philanthropy and impact.

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