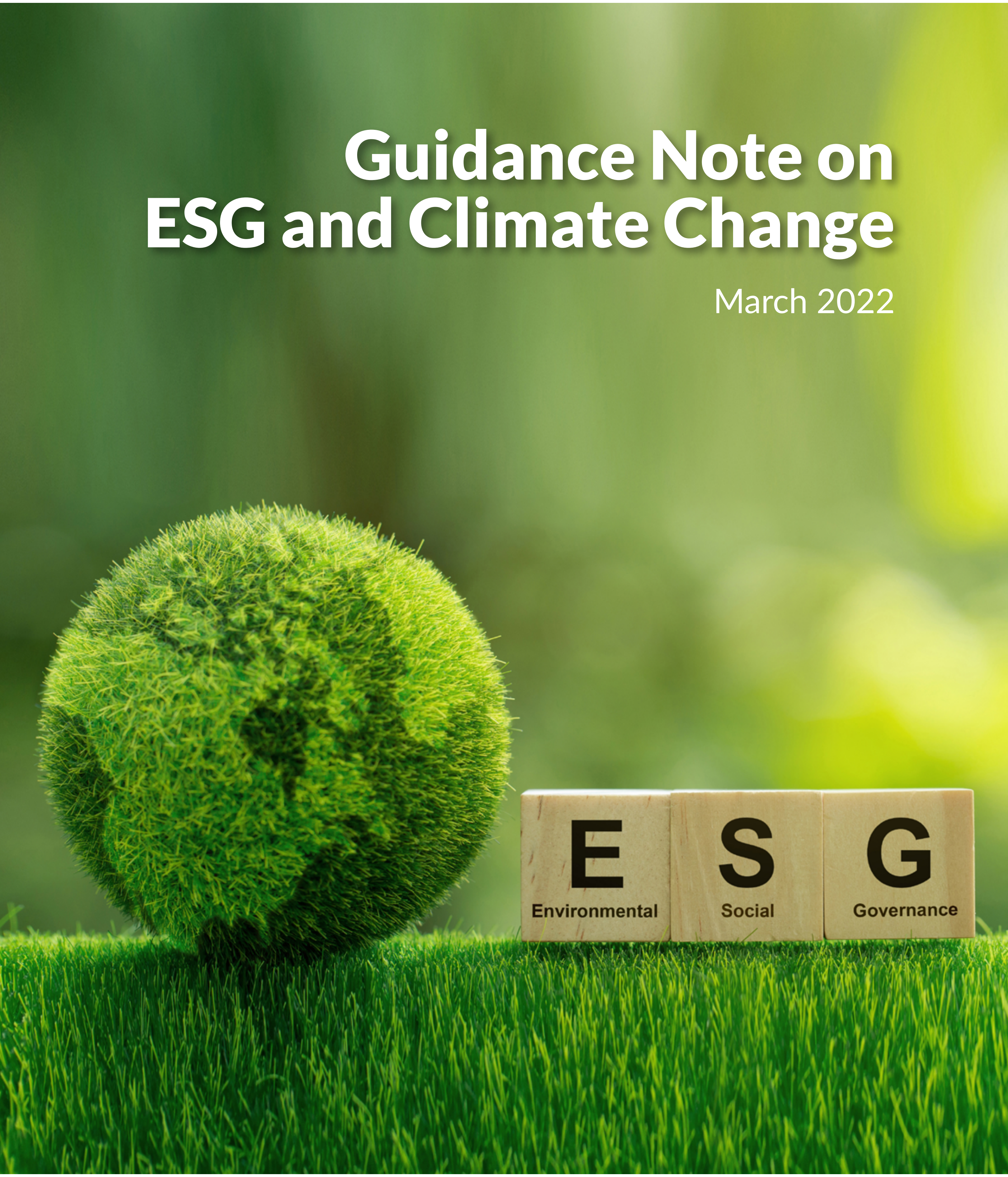
CHARTERED GOVERNANCE
Hong Kong

Guidance Note on ESG and Climate Change

March 2022



Introduction

The governance professional, who serves as the company secretary of a listed issuer, is regarded as part of senior management and responsible for advising the board through the chairman and/or chief executive on governance matters[1].

This responsibility includes advising the board on the major compliance requirements relating to reporting on environmental and social risks and opportunities under the Environmental, Social and Governance (**ESG**) report, as well as emerging climate related concerns.

The aim of this guidance note is to assist the governance professional in being effective in the provision of overall advice on these topics expressed in terms of a conversation with the board.

Listing Rules

The Rules Governing the Listing of Securities (the **Listing Rules**) on The Stock Exchange of Hong Kong Limited (**HKEX**) require all issuers listed on HKEX to publish the ESG report annually for the same period covered in their annual reports[2].

Starting from 1 January 2022, the ESG reports must be published at the same time as publication of annual reports, except that the ESG report for the financial year commenced before 1 January 2022 may be published no later than five months after the end of such financial year[3].

The ESG Reporting Guide in Appendix 27 of the Listing Rules sets out the content requirements for an ESG report, which cover two main subject areas: "E" – environmental and "S" – social.

The "G" – governance is typically dealt with separately under the corporate governance report contained in the annual report, and the contents of which are subject to the requirements of Appendix 14 (Corporate Governance Code) of the Listing Rules rather than Appendix 27.

Each subject area is further divided into various aspects[4], four and eight of which relate to "environmental" and "social" respectively, and each area is subject to certain key performance indicators (KPIs) for issuers to report on in order to demonstrate how they have performed.

Reporting on these aspects should be done on a "comply or explain" basis, meaning that if the issuer does not report on any of these provisions, it must provide considered reasons for the omission in the ESG report. For example, if certain information is not available, a meaningful explanation should describe the specific steps being taken to obtain the information and the expected timeframe for doing so.

If an aspect is considered not material (see "materiality assessment" below) to the issuer, an explanation to that effect may be appropriate.

1 Corporate Governance Code (Appendix 14 of the Listing Rules), Principle C.6
2 Rule 13.91(4) of the Listing Rules
3 See the conclusions to HKEX's consultation on Review of the Corporate Governance Code and Related Listing Rules published on 10 December 2021.
4 (i) The "environmental" aspects of emissions, use of resources, the environment and natural resources, and climate change, which is a new reporting aspect; and (ii) the "social" aspects of employment, health and safety, development and training, labour standards, supply chain management, product responsibility, anti-corruption and community investment.

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Separate from the "comply or explain" requirements, certain disclosure is mandatory for ESG reports. The compulsory disclosure includes the issuer's board statement on:

(i) the board's oversight of ESG issues;

(ii) the board's ESG management approach and strategy, including the process used to evaluate, prioritise and manage material ESG-related issues (including risks to the issuer's business); and

(iii) the board's review of the progress made against ESG goals and targets, with an explanation of how they relate to the issuer's business.

In addition to the ESG report, the directors' report (which usually forms part of the annual report) must also contain a business review that includes a review of the issuer's environmental policies and performance, compliance with the relevant laws and regulations, and the issuer's key relationships with its employees, customers and suppliers.

If the issuer is a Hong Kong-incorporated company, the above requirements for a directors' report are mandated in Schedule 5 to the Companies Ordinance (Cap.622) and non-compliance may result in criminal sanction, including against directors[5].

International standards to bear in mind

Paris Agreement and carbon emissions

Hong Kong has acceded to the Paris Agreement[6] and the Hong Kong government targets to reduce Hong Kong's carbon emissions by 50% before 2035 as compared to the 2005 level and to achieve carbon neutrality before 2050[7]. China is striving towards achieving carbon neutrality before 2060[8].

TCFD

Hong Kong will mandate climate-related disclosures by financial institutions aligned with the Task Force on Climate-related Financial Disclosures (**TCFD**) recommendations no later than 2025[9]. The latest ESG reporting requirements under the Listing Rules have already incorporated certain important elements of the TCFD Recommendations. Other regulators in Hong Kong, including the Hong Kong Monetary Authority (**HKMA**) and the Securities and Futures Commission (**SFC**) are moving to accommodate the TCFD reporting standards within their rules and regulations.

The recommendations of the TCFD provide a framework for the kind of information that must be analyzed and disclosed regarding the impact of climate-related risks and opportunities on financial positions and prospects of business and are structured around four thematic areas[10]: governance, strategy, risk management and metrics.

ISSB

In November 2021, the International Financial Reporting Standards (IFRS) Foundation Trustees announced[11] the formation of the International Sustainability Standards Board (ISSB), which will develop a comprehensive global baseline of sustainability-related disclosure standards that meet the information needs of investors. As part of its initial work, the ISSB will consider the prototype climate and general disclosure requirements published[12] by the Technical Readiness Working Group created by the IFRS Foundation Trustees.

5 ss.388(6) and (7) of the Companies Ordinance.

6 The Paris Agreement is a legally binding international treaty on climate change entered into by 196 parties in 2015. Its goal is to limit global warming to well below 2°C, preferably to 1.5°C, compared to pre-industrial levels.

7 As stated in the Chief Executive's 2021 Policy Address.

8 In an address to the United Nations General Assembly in September 2021, President Xi of the People's Republic of China announced that China would peak GHG emissions before 2030 and achieve carbon neutrality before 2060.

9 Announced in December 2020 by the Green and Sustainable Finance Cross-Agency Steering Group, which is co-chaired by the HKMA and the SFC. Members include the Environment Bureau, Financial Services and the Treasury Bureau, HKEX, the Insurance Authority and the Mandatory Provident Fund Schemes Authority.

10 For further information, please visit the TCFD knowledge hub.

11 See the announcement by the IFRS Foundation on 3 November 2021.

12 The Prototype Climate-related Disclosures Requirements and the Prototype General Requirements for Disclosure of Sustainability-related Financial Information can be accessed here.

Net-zero

Net-zero is the point where human-caused emissions of greenhouse gases to the atmosphere are balanced by removals over a specified period. In order to keep global warming within safe limits, it is widely recognized that net-zero target should be reached by no later than 2050. To align with this global and city-level goal, and to avoid reputational risk, companies should strive to set a plan towards accomplishing net-zero by 2050 or earlier.

Three guiding principles are proposed by the Science Based Targets Initiative (**SBTi**)[13] in the formulation and assessment of net-zero targets:

(i) Reaching net-zero emissions for a company involves achieving a state in which its value chain results in no net accumulation of carbon dioxide in the atmosphere and in no net-impact from other GHG emissions.

(ii) Companies should transition towards net-zero in line with mitigation pathways that are consistent with limiting warming to 1.5°C with no or limited overshoot.

(iii) The mitigation strategy followed by the company should inform long-term strategies and investments that mitigate exposure to climate-related transition risks, ensuring that the business model of the company will continue to be viable in a net-zero economy.

Where do we start? The role of the board on ESG matters

HKEX expects[14] the board of directors to take leadership for and accountability in overseeing the assessment of the company's environmental and social impacts.

The board should understand the potential impact and related risks of ESG issues, enforce an appropriate materiality assessment and align with what investors and regulators expect and require on ESG matters. ESG considerations should be made as part of the business decision-making. The board has overall responsibility for ESG strategy and reporting.

Below are some practical action points for directors[15]:

- **Integrating ESG issues into key governance processes and enhance board-level oversight**

  What should be the ESG governance structure of the company? The board should decide on a governance structure which is most suitable with regard to the issuer's own circumstances. Below are two examples of ESG governance structures:

Integrated Approach	Dedicated Approach
Integrating climate-related considerations into existing board committees and the senior management (e.g. CFO and COO)	Establishing a standalone climate/sustainability committee, which will further lead an ESG working group

HKEX has suggested a Seven-part Framework[16] on how Board oversight can be done in practice, involving steps such as level setting, assessment, integration and evaluation.

13 More details can be found in SBTi's Foundations for Science-based Net-zero Target Setting in the Corporate Sector.
14 See Guide for Board and Directors: Leadership role and accountability in ESG published by HKEX in March 2020.
15 See *Ibid.* for more practical steps.
16 See HKEX's simple diagram on Board's ESG oversight: A Seven Part Framework.

- **Conducting "materiality" assessment**

  Has the board discussed and determined the most important ESG (including climate-related) issues? Materiality assessment should be industry-specific and should be tailored with reference to the circumstances of each company. The key steps are (i) identifying potential material issues; (ii) prioritising and engaging stakeholders[17]; and (iii) validation of the findings of the stakeholder engagement. HKEX's materiality table[18] gives a general idea of which factors may be relevant for businesses in different sectors or industries.

- **Risk management**

  Has the company's existing risk management processes taken account of ESG risks? The board should identify, evaluate and manage material ESG risks and opportunities to its business.

  Apart from the apparent physical risks, such as typhoons and heat waves, the board should also be aware of transition risks such as changes in policies, laws and regulations and market behaviors that may increase operating and compliance costs. ESG risks should therefore be integrated into an applicant's risk management, internal control and long-term planning.

- **Setting goals and monitor performance**

  The board should set "SMART" ESG targets[19], review progress made against targets and make necessary refinements to the implementation plan:

  - Specific: What exactly do you want to achieve? E.g. targets relating to net-zero should ultimately lead to absolute carbon reduction.
  - Measurable: How will you know when you have achieved it? Express targets as an absolute number or a percentage.
  - Attainable: Is it something you have control over? Examine all practical measures and resources in the internal operations and value chain.
  - Relevant: Why is this applicable to your business? Target should at least cover the major operational units of the group.
  - Time Bound: When do you want to achieve your goal? Set a base year and a target year – it could be annual or multiple years – for progress checking.

How do you know if the board is ready?

- ESG governance: HKEX has suggested **six readiness self-assessment questions** to check whether the Board is ready in its ESG governance – for example, does the board know which ESG issues are material to the business, and can the Board talk about the ESG strategy to a certain level of detail?

- Reporting on climate change: HKEX has suggested **four readiness self-assessment questions** in this regard – for example, does the company have any framework to track the progress of managing climate-related risks?

Further materials and resources worth your time

The massive quantity of materials on ESG can be overwhelming. We suggest the following publications and training are a good starting place for directors to progress their understanding of the topic:

- **Guide for Board and Directors: Leadership role and**

17 Please refer to HKEX's How to Prepare an ESG Report – A Step-By-Step Guide to ESG Reporting on how to collect stakeholders' perspective.
18 See "Materiality table – by industry and aspect" in How to Prepare an ESG Report – A Step-By-Step Guide to ESG Reporting, page 24.
19 See "Target setting", *Ibid.*

accountability in ESG published by HKEX in March 2020 is a practical guide for directors, setting out the action steps relating to ESG governance structure and materiality assessment, illustrated with live examples of disclosures made by HKEX-listed issuers.

- HKEX e-learning on **ESG Governance and Reporting** gives an introduction of the board's role in ESG governance, the importance of ESG reporting and how to do it well.

- **Guidance on Climate Disclosures** published by HKEX in November 2021 provides practical tips and step-by-step guidance to assist issuers in preparing TCFD-aligned climate change reporting.

- **Practical Net-Zero Guide for Business** published by HKEX in December 2021 takes you through the necessary processes to develop an appropriate net-zero pathway.

The ESG resources put together by regulators are well worth spending time on:

- HKEX's new centralised ESG educational platform, **ESG Academy**, is the one-stop shop for the Exchange's news releases, guidance materials and e-learning on ESG matters.

- Since December 2021, through its partnership with leading ESG data providers, HKEX now displays Hong Kong-listed companies' ESG metrics under a new equities section on **STAGE** (*Sustainable & Green Exchange*).

- HKMA published in June 2020 the **White Paper on Green and Sustainable Banking**, which highlights the climate-related risks and opportunities to banks in Hong Kong and sets out nine guiding principles on the areas of governance, strategy, risk management and disclosure for authorised institutions (**AIs**) to build climate resilience. HKMA also issued a consultation in July 2021 on a **draft Supervisory Policy Manual** on the management of climate-related risks by AIs.

- The SFC published the **Survey on Integrating Environmental, Social and Governance Factors and Climate Risks in Asset Management**. The SFC conducted a survey in 2019 to understand how and to what extent licensed asset management firms and leading institutional asset owners consider ESG risks, particularly those relating to climate change. This report presents the key findings and discusses the way forward. The SFC subsequently published the consultation **paper** and **conclusions**, in 2020 and 2021 respectively, in relation to the management and disclosure of climate-related risks by fund managers.

The governance professional, by being able to provide effective overall advice on ESG reporting requirements, as well as emerging climate related concerns, will no doubt demonstrate leadership on these important governance topics.

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