INVESTMENT COMPANY INSTITUTE

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Asia ESG: HK SFC Finalizes Requirements on the Management and Disclosure of Climate-Related Risks by Fund Managers

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TO: ESG Task Force
Global Regulated Funds Committee
Global Regulated Funds Committee - Asia RE: Asia ESG: HK SFC Finalizes Requirements on the Management and Disclosure of Climate-Related Risks by Fund Managers

On 20 August 2021, the Hong Kong Securities and Futures Commission (SFC) published the Consultation Conclusions[1] to its October 2020 Consultation on the Management and Disclosure of Climate-related Risks by Fund Managers (Consultation)[2] The Consultation proposed amendments to the Fund Manager Code of Conduct (FMCC) that would require fund managers to take climate-related risks into consideration in their investment and risk management process and make appropriate disclosures. The SFC also issued the Circular to licensed corporations - Management and disclosure of climate-related risks by fund managers (Circular),[3] along with a set of Frequently Asked Questions (FAQs),[4] setting out the expected standards and requirements for complying with the amended FMCC. The requirements cover four key areas: governance, investment management, risk management, and disclosures.

ICI Global submitted a response[5] to the Consultation in January 2021, and we are pleased that the Circular has addressed many of our comments.

This memorandum provides a brief summary of the requirements set out in the Circular.

1. Scope of Requirements

The Circular applies to fund managers that manage collective investment schemes (CIS), regardless of whether they have delegated their investment management function to other intermediaries. As with the FMCC, the Circular covers managers of authorized and unauthorized CIS. At this stage, the requirements in the Circular do not apply to the management of discretionary accounts.[6] The SFC has clarified that if a client has requested a discretionary account manager to take climate-related risks into consideration in the investment mandate, the manager is expected to do so in accordance with the client's preference, but the Circular's requirements are not mandatory in this case.

The Circular's requirements on governance, investment management, and risk management will apply to fund managers that have discretion over the investment and risk management processes, regardless of whether they are overall responsible for, or manage only part of, a fund. On the other hand, the disclosure requirements are applicable to fund managers only where they are responsible for the overall operation of a fund.[7] The SFC adopted ICI Global's recommendation and clarified that local fund managers may leverage group resources and staff, adopt group policies and procedures, and rely on group disclosures to satisfy the Circular's requirements, provided they are subject to similar or higher standards than the SFC's requirements. The local management is responsible for ensuring that they are in compliance with the SFC's requirements.

The SFC further provides clarity on the scope or degree of applicability of the Circular's requirements to fund managers performing different roles.[8] A fund manager that is delegated investment management discretion for a portion of a CIS should comply with the Circular's requirements proportionate to its circumstances, i.e., limited to the portion of assets under its management and the role assigned to it. If a licensed corporation (LC) acts as an investment advisor or a distributor of a CIS without having any investment management discretion, the LC will not be expected to comply with the Circular's requirements.

2. Baseline Requirements and Enhanced Standards

The SFC has adopted a two-tiered approach: all fund managers must comply with the baseline requirements, and fund managers with assets under management (AUM) that equal or exceed a specified threshold described below (Large Fund Managers) are additionally subject to enhanced standards. If a fund manager no longer meets the threshold for a Large Fund Manager, it is not required to comply with the enhanced standards in the following reporting year. However, the fund manager is still encouraged to observe the enhanced standards voluntarily to maintain consistency and to facilitate comparison.

A fund manager is classified as a "Large Fund Manager" if the monthly AUM of its CIS equals or exceeds HK$8 billion for any three months in the previous reporting year. The SFC has raised the threshold for Large Fund Managers from HK$4 billion (as proposed in the consultation) to HK$8 billion. It also clarified that the threshold does not include assets under discretionary account management. Regarding delegation arrangements, the AUM of that portion of the fund for which the fund manager has discretion over the investment management process should be taken into account in the calculation.

3. Baseline Requirements - Governance

The Circular sets out the roles and responsibilities of the Board of Directors and management. These requirements largely follow the proposals in the consultation. The SFC adopted ICI Global's recommendation and amended the language in the Circular to clarify the roles of the Board and the management. In particular, the Board or Board committee should have oversight of climate change issues for the purpose of setting the tone from the top. Management will be required to supervise and monitor the integration of climate-related considerations into the investment and risk management processes. These include setting goals, developing action plans, establishing controls and procedures, as well as overseeing progress against goals for addressing climate-related issues.

4. Baseline Requirements - Investment Management

Fund managers are required to identify relevant and material physical and transition climate-related risks for each investment strategy and each fund that it manages. Where relevant, fund managers should factor the material climate-related risks into the investment management process. The SFC stressed that fund managers should conduct reviews or assessments on a regular basis and when triggered by any major changes such as changes to a fund's investment strategy.[9] It also clarified that these requirements do not prohibit or restrict a fund manager from complying with applicable laws and discharging their fiduciary duties.

Application to Passive Strategies

Index funds that adopt a full replication methodology may be able to justify a carve-out. The SFC suggested in the FAQs that fund managers could adopt different methodologies for partial replication methodologies and enhanced passive strategies and cited, as an example, the United Nations-supported Principles for Responsible Investment (PRI), which suggests that passive fund managers could identify investee companies with high sustainability risks or poor ESG ratings and adjust the weights of portfolio constituents accordingly, or exclude them from the portfolio within an acceptable tracking error range. According to the FAQs, fund managers may adopt this type of methodology to the extent permitted under the fund's mandates and restrictions. Further, where fund managers are constrained from deviating from a reference benchmark or index in their investment process, they may manage the material climate-related risks of the underlying investments in various ways such as through exercising stewardship or engaging with index providers to enhance ESG considerations in index design.[10]

Application to Funds Where Climate Risks are Irrelevant

Where a fund manager has assessed that climate-related risks are irrelevant to certain types of investment strategies or funds under its management, the fund manager should disclose these exceptions when it discloses how it incorporates climate-related risks into its investment and risk management processes. The fund manager should also maintain appropriate records explaining why climate-related risks are irrelevant.

5. Baseline Requirements and Enhanced Standards - Risk Management

Baseline Requirements for All Fund Managers

Fund managers should take climate-related risks into consideration in the risk management process and ensure that appropriate steps have been taken to identify, assess, manage, and monitor the relevant and material climate-related risks for each investment strategy and each fund that it manages. Furthermore, fund managers are required to apply appropriate tools and metrics to assess and quantify climate-related risks.

Enhanced Standards for Large Fund Managers

To the extent that climate-related risks are assessed to be relevant and material to an investment strategy or a fund they manage, Large Fund Managers are required to assess the relevance and utility of scenario analysis for evaluating the resilience of their investment strategies to climate-related risks under different pathways. If the assessment result prove to be relevant and useful, the Large Fund Managers should develop a plan to implement scenario analysis that is commensurate with their size and the nature of their business within a reasonable timeframe.

If climate-related risks are assessed to be material, Large Fund Managers are required to take reasonable steps to identify the portfolio carbon footprints, instead of the proposed weighted average carbon intensity (WACI), of the Scope 1 and Scope 2 greenhouse gas (GHG) emissions associated with the funds' underlying investments, where data is available or can be reasonably estimated, and define its calculation methodology and underlying assumptions.[11] Although ICI Global and many other respondents had urged the SFC to provide Large Fund Managers with the flexibility to use other metrics as appropriate, the SFC highlights that mandating a single metric would provide investors with comparable information across different portfolios. Along with portfolio carbon footprint, Large Fund Managers may supplement with additional climate-related metrics as they see appropriate.

6. Baseline Requirements and Enhanced Standards - Disclosure

Format and Frequency of Disclosures

Fund managers who are responsible for the overall operation of funds should make adequate disclosures to investors in relation to climate-related risks. Fund managers have the flexibility to disclose the required information to investors via various channels, such as websites, newsletters, or reports.

Information disclosed should be proportionate to the degree climate-related risks are considered in the investment and risk management processes. Fund managers should also review the disclosures at least annually and update the disclosures whenever appropriate. They should inform investors of any material change as soon as practicable.

As noted in section 1, a fund manager may adopt its group disclosure if it confirms that group-wide policies and procedures are applied consistently in its operations in Hong Kong, and they meet or exceed the SFC's requirements. Where local adoption deviates from its group policies, procedures or disclosures, the fund manager should supplement the group disclosures with additional information at the local level.

Baseline Requirements for All Fund Managers

All fund managers should make disclosures at the entity level on (i) the governance arrangement for oversight of climate-related risks, e.g., the roles of the Board and management in relation to the oversight on climate-related risks, and (ii) how the climate-related risks are taken into account in the investment and risk management processes, including key tools and metrics used to identify, assess, manage and monitor the risks.

As mentioned in section 4, fund managers should disclose the types of investment strategies or funds for which climate-related risks are assessed to be irrelevant. Fund managers have the flexibility to make the disclosure either at the entity or fund level. To strike a balance between costs and benefits, for compliance review purposes the SFC considers it sufficient for a fund manager to maintain internal records which clearly illustrate the rationale for its assessment and to explain it to investors when asked.

Enhanced Standards for Large Fund Managers

For entity-level disclosure, Large Fund Managers are required to describe their engagement policy, preferably with examples to illustrates how material climate-related risks are managed in practice.

Further, Large Fund Managers should disclose portfolio carbon footprints of the Scope 1 and Scope 2 GHG emissions associated with the funds' underlying investments at the fund level, provided that data is available or can be reasonably estimated. Large Fund Managers should also indicate the calculation methodology, underlying assumptions and limitations, and the proportion of investments that are assessed or covered.

7. Implementation Timeline

The SFC has extended the transition periods as follows:

- a 12-month transition period for Large Fund Managers to comply with the baseline requirements (i.e., until 20 August 2022) and a 15-month transition period for enhanced standards (i.e., until 20 November 2022);
- a 15-month transition period for other fund managers to comply with the baseline requirements (i.e., until 20 November 2022).

The disclosures relating to baseline requirements and enhanced standards must be made after the transition period specified above, except for the portfolio carbon footprint disclosures, which must be published after the end of the fund's next financial year-end. For funds managed by Large Fund Managers with a financial year-end date after 20 November 2022, they should calculate the portfolio carbon footprint based on the positions as of the financial year-end and disclose to fund investors by no later than the usual due date of the funds' audited accounts or annual reports (which is usually between three and six months after the financial year-end).[12]

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endnotes

[1] See Consultation Conclusions on the Management and Disclosure of Climate-related Risks by Fund Managers (August 2021), available at https://apps.sfc.hk/edistributionWeb/api/consultation/conclusion?lang=EN&refNo=20CP5.

[2] See Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers (October 2020), available at https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=20CP5.

[3] See Circular to licensed corporations - Management and disclosure of climate-related risks by fund managers (20 August 2021), available at

https://apps.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=21EC31.

[4] See Frequently Asked Questions (FAQs) on climate-related risks requirements under the Fund Manager Code of Conduct, available at https://www.sfc.hk/en/faqs/intermediaries/supervision/Application-of-the-climate-related-risks-requirements-under-the-Fund-Manager-Code-of-Conduct/Application-of-the-climate-related-risks-requirements-under-the-Fund-Manager-Code-of-Conduct.

[5] See ICI Memorandum No. 33048, 15 January 2021, available at https://www.ici.org/memo33048.

[6] SFC states that it may expand the Circular requirements to uniformly cover the management of all discretionary accounts at a later stage, while acknowledges that additional assessments and further consultations may be required in light of the bespoke nature of the investment mandates in discretionary accounts. See Consultation Conclusion, supra note 1., at paragraph 38.

[7] See Circular, supra note 3, at Appendix 1.

[8] See FAQs, supra note 4, at Question 1.

[9] See Consultation Conclusion, supra note 1, at paragraph 97.

[10] See FAQs, supra note 4, at Question 4.

[11] SFC has recognized that "portfolio carbon footprint", an enterprise value-based metric, is more commonly used than the WACI, a revenue-based metric. SFC took reference to the 2020 Status Report published by the Task Force on Climate-related Financial Disclosures (TCFD), *available at* https://www.fsb.org/wp-content/uploads/P291020-1.pdf.

[12] See Circular, supra note 3, at paragraph 32, and Consultation Conclusion, supra note 1, at paragraph 158 and 159.
