Investment Management Alert

Akin Gump
STRAUSS HAUER & FELD LLP

SFC Issues Consultation Conclusions on the Management and Disclosure of Climate-related Risks by Fund Managers

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Key Points

- The Fund Manager Code of Conduct will be amended to require fund managers managing collective investment schemes to take climate-related risks into consideration in their investment and risk management processes and make appropriate disclosures to investors.
- The SFC adopts a two-tier approach, namely (i) baseline requirements for Fund Managers (as defined below) and (ii) enhanced standards for Large Fund Managers (as defined below).
- The SFC will allow fund managers other than Large Fund Managers a longer transitional period to review their systems and controls and arrange the necessary operational support to comply with the baseline requirements. The new disclosure requirements will become effective after the relevant transitional periods.
- The SFC has had regard, in developing these requirements, to the Task Force on Climate-related Financial Disclosures Recommendations and the United Nations supported Principles for Responsible Investment and has appointed the Climate Change Technical Expert Group.

Introduction

Following consultation paper on the management and disclosure of climate-related risks published on October 29, 2020 (the "Consultation Paper"), on August 20, 2021, the Securities and Futures Commission (SFC) published the consultation conclusions on its earlier proposals to require fund managers managing collective investment schemes (CISs) to take climate-related risks into consideration in their investment and risk management processes and make appropriate disclosures by amending the Fund Manager Code of Conduct (FMCC) to provide high-level principles ("Consultation Conclusion"). On the same day, the SFC issued a circular to licensed corporations to set out expected standards for complying with the FMCC. The requirements cover four key elements, namely governance, investment management, risk management and

Contact Information

If you have any questions concerning this alert, please contact:

Anne-Marie Godfrey
Partner
anne-marie.godfrey@akingump.com
Hong Kong
+852 3694.3040

Dan Morrissey
Counsel
Dan.Morrissey@akingump.com
Hong Kong
+852 3694.3089

Ruby Ho
Associate
ruby.ho@akingump.com
Hong Kong
+852 3694.3068

disclosure. The key requirements relating to climate-related risks ("New Requirements") are outlined below.

Scope and applicability

The SFC, in developing the New Requirements, has taken a two-tier approach, namely (i) **baseline requirements**, which will be applicable to all SFC licensed fund managers managing CISs ("Fund Managers") and (ii) **enhanced standards**, which will be applicable to only Fund Managers with CISs under management that equal or exceed HK$8 billion (excluding assets under discretionary account management) in fund assets for any three months in the previous reporting year ("Large Fund Managers"). One should note that in the Consultation Paper, the SFC proposed that Large Fund Managers should comprise fund managers who have monthly total assets under management equal to or exceeding HK$4 billion for any three months during the past 12 months. However, after industry feedback the SFC determined that only fund managers with assets under management of HK$8 billion should be required to adopt the enhanced standards.

Fund Managers have discretion over the investment management process regardless of whether they have overall responsibility for the management of the fund. The new requirements will not initially apply to discretionary managed accounts. If a licensed corporation (LC) solely provides investment advice to a separate team of an affiliate or acts as a distributor of funds with no investment management discretion, the LC will not be expected to comply with the New Requirements.

The New Requirements comprise requirements relating to governance, the investment management process, risk management and disclosure.

If a Fund Manager, after an internal assessment, 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, it is acceptable for the Fund Manager to adopt its group disclosures. When a Fund Manager chooses to adopt its group disclosures, it should make the disclosures in accordance with the Hong Kong regulatory requirements. If 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.

New Requirements

A. Governance

Baseline requirements:

- The Fund Manager must define the board's or a committee of the board's role in overseeing the incorporation of climate-related considerations into the investment and risk management processes.
- The board of the Fund Manager is required to oversee progress against goals for addressing climate-related issues.
- The board of the Fund Manager is required to determine how the Fund Manager's board or the board committee executes this role, including the process and frequency by which the board or the board committee is informed about climate-related issues.

- The management of the Fund Manager is required to assign roles and responsibilities for managing climate-related risks to management-level positions or management committees which report to the board or the board committee, and determine the appropriate management structure.
- The management of the Fund Manager is required to determine how the management (through specific positions or management committees) will monitor the status and progress of efforts to manage climate-related risks.
- The management of the Fund Manager is required to establish a process for the management to be regularly informed about the status and progress of efforts to manage climate-related risks.
- The management of the Fund Manager is required to devote sufficient human and technical resources for the proper performance of the duty to manage climate-related risks (e.g., provide training to staff, engage subject experts and acquire climate-related data from external sources).
- The management of the Fund Manager is required to establish satisfactory internal controls and written procedures to ensure compliance with internal policies and procedures as well as regulatory requirements related to the management of climate-related risks.
- The management of the Fund Manager is required to set goals for addressing climate-related issues and develop action plans for managing climate-related risks.

B. Investment management

Baseline requirements:

- Identify relevant and material physical and transition climate-related risks for each investment strategy and fund it manages.
- Where relevant, factor the material climate-related risks into the investment management process. For example, include climate-related risks in the investment philosophy and investment strategies and incorporate climate-related data into the research and analysis process.
- Take reasonable steps to assess the impact of these risks on the performance of underlying investments.

Where a Fund Manager assesses 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. It should also maintain appropriate records which explain why climate-related risks are irrelevant.

CISs adopting a passive investment strategy will not automatically be carved out from the New Requirements. While Fund Managers may be limited by the relevant reference benchmark or index in their investment processes, they should manage the material climate-related risks of the underlying investments in various ways such as through exercising stewardship (e.g., proxy voting) or engaging with index providers to enhance environmental, social and governance (ESG) considerations in index design.

C. Risk Management

Baseline requirements:

- Take climate-related risks into consideration in risk management procedures 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 CIS it manages.
- Apply appropriate tools and metrics to assess and quantify climate-related risks.

Enhanced standards for Large Fund Managers:

- Assess the relevance and utility of scenario analysis[1] in evaluating the resilience of investment strategies to climate-related risks under different pathways. If the assessment result is deemed to be relevant and useful, Large Fund Managers are required to develop a plan to implement scenario analysis within a reasonable timeframe.
- Where climate-related risks are assessed to be relevant and material, take reasonable steps to identify the **portfolio carbon footprints** (explained below) of the Scope 1 (i.e., all direct emissions) and Scope 2 (i.e., indirect emissions from the consumption of purchased electricity, heat or steam) greenhouse gas (GHG) emissions associated with the funds' underlying investments, where data is available or can be reasonably estimated, and define the calculation methodology and underlying assumptions.

Portfolio carbon footprint is a representation of carbon emissions relative to the portfolio's market value and expressed in tons of carbon dioxide equivalent emissions (CO_2e) per million dollars invested. Here is the formula for the calculation of portfolio carbon footprint provided by the SFC.

D. Disclosure

Fund Managers, who are responsible for the overall operation of the CISs, should make appropriate disclosures to investors via various channels such as websites, newsletters or reports and ensure investors' attention is drawn to climate-related information. They should provide cross-references to help investors find relevant climate-related information and observe the following when making the disclosures:

- Adopt a proportionate approach, i.e., the information disclosed should be proportionate to the degree climate-related risks are considered in the investment and risk management processes.
- Review disclosures at least annually, update disclosures where considered appropriate and inform fund investors of any material changes as soon as practicable.

Baseline requirements:

- Describe the governance structure of the Fund Manager.
- Describe the board's role and oversight of climate-related disclosure, including (a) whether the board or the board committee will review the risk management framework covering climate-related risks; and (b) the process and frequency by which the board or the board committee is informed about climate-related issues.

- Describe the management's roles and responsibilities, including (a) how the management will monitor the status and progress of efforts to manage climate-related risks; and (b) the process for the management to be regularly informed about the status and progress of efforts to manage climate-related risks.
- Disclose the steps taken to incorporate relevant and material climate-related risks into the investment management process.
- Describe the processes for identifying, assessing, managing and monitoring climate-related risks, including the key tools and metrics used.

Enhanced standards for Large Fund Managers:

- Specific to the Large Fund Managers, describe the engagement policy at the entity level and preferably provide examples to illustrate how material climate-related risks are managed in practice, including how the engagement policy is implemented.
- Specific to the CISs managed by the Large Fund Managers, at a minimum, provide the portfolio carbon footprints of the Scope 1 and Scope 2 GHG emissions associated with the funds' underlying investments at the fund level, where data is available or can be reasonably estimated, and indicate the calculation methodology, underlying assumptions and limitations, and the proportion of investments (e.g., in terms of the net asset value of funds) that are assessed or covered.

Implementation timeline

The New Requirements will become effective after the following transitional periods:

- A 12-month transitional period for Large Fund Managers to comply with the baseline requirements (i.e., until August 20, 2022) and a contemporaneous 15-month transitional period for them to comply with the enhanced standards (i.e., until November 20, 2022).
- A 15-month transitional period for all other Fund Managers to comply with the baseline requirements (i.e., until November 20, 2022).

The disclosures relating to the baseline requirements and enhanced standards must be made after the transitional periods specified above, except for the portfolio carbon footprint disclosure, which must be disclosed during the financial year ending on or after November 20, 2022.

For CISs managed by Large Fund Managers having a financial year-end date after the effective date of the enhanced standards (i.e., November 20, 2022), Large Fund Managers are required to disclose to fund investors the portfolio carbon footprints calculated based on the positions as of the relevant financial year end. The disclosure of this metric should be made through an appropriate channel not later than the usual due date of the CISs' audited accounts or annual reports (which is usually between three and six months after the financial year end).

Conclusion

The New Requirements are considered to be a timely step to bringing the Hong Kong regulatory framework relating to ESG more in line with international regulations such as the European Union's Sustainable Finance Disclosure Regulation and to meeting investors' growing demand for climate risk information. In line with the industry feedback to the consultation, the SFC adopts a more pragmatic approach by assessing Fund Managers' compliance with the requirements, which will allow flexibility for Fund Managers to carrying out their risk assessment as appropriate.

One should note that the New Requirements are intended to apply to Hong Kong-based SFC licensed fund managers generally as opposed to solely products that are considered to be ESG funds. As the proposed requirements are mandatory, they are expected to have a significant impact on Fund Managers in the industry. Given the complexity of climate-related risk management methodologies and the wide variety of fund investment strategies pursued by fund managers in Hong Kong, Fund Managers should begin their internal review to determine what additional policies they require, what additional disclosures they are required to make to the investors and what the appropriate form for doing so is.

[1] Scenario analysis is a process which helps fund managers assess how portfolios may be affected by risks and opportunities arising from climate change and evaluate the resilience of investment strategies to climate-related risks under different pathways.

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