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LEGAL UPDATE

SFC Consultation Paper on Fund Managers' Management and Disclosure of Climate-related Risks

On 29 October 2020, the Securities and Futures Commission of Hong Kong (**SFC**) launched a ***"Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers"*** (Consultation Paper), which proposes to introduce new and specific requirements for Hong Kong SFC licensed fund managers to consider climate-related risks in their investment and risk management processes, and to make appropriate disclosures to meet investors' growing demand for climate risk information and combat greenwashing.

The Consultation Paper outlines recent global developments in green finance that lays foundation for the proposals and its areas of focus, and sets out the proposed requirements for climate related risks together with the proposed implementation timeline.

The proposed requirements set out in the Consultation Paper are two-fold:

- Proposed amendments to the Fund Manager Code of Conduct (FMCC) (as set out in Appendix 1 of the Consultation Paper) to incorporate high level principles, and

- Proposed issuance of a circular on the baseline requirements and standards to facilitate fund managers' compliance (as set out in Appendix 2 of the Consultation Paper). It proposes a set of baseline requirements for all fund managers, coupled with enhanced standards for bigger asset managers with assets under management (AUM) of HK$4 billion or above (**Large Fund Managers**).

Regulatory focus on Climate-related Risks

The Consultation Paper is issued in furtherance of the objectives set out in SFC's Strategic Framework for Green Finance issued in September 2018, and takes into account latest international developments, including growing regulatory focus on managing climate risks, the increasing adoption of the Task Force on Climate related Financial Disclosures (TCFD), and SFC's regulatory objectives and intention to align with international standards and its aims to collaborate with international and Hong Kong local financial regulators and the industry in meeting those objectives.

SFC acknowledges the importance of promoting sustainable development, in both ESG or sustainability factors, and climate change or environmental factors. However, SFC focuses on climate-related risks having regard to various factors, such as urgency to take action and promotion of industry awareness.

Accordingly, with respect to the potential financial impact of climate-related risks, SFC refers to the following three main types of risks associated with climate change which could have adverse impact on the value of a wide range of financial assets and may affect asset values **(climate-related risks):**

(a) *Physical risks:* direct impact of extreme climate-related weather events and progressive, longer-term shifts in climate patterns may have financial implications for companies, which can damage assets, disrupt supply chain or reduced productivity;

(b) *Transition risks*: risks associated with the ongoing viability of a business in the transition from a high-carbon economy to a low-carbon economy (eg, reduced demand for commodities, goods and services with a high carbon footprint owing to changing consumer preferences or government policies); and

(c) Liability risks: responsibility to compensate a person or company who may seek compensation for losses caused by climate change.

Proposed requirements for managing climate-related risks

With reference to the anticipated scope or nature of climate-related risks, the Consultation Paper goes on to outline the expectations on fund managers to address such risks, and to align with global regulatory trends, the proposals set out under the Consultation Paper cover four key elements: (a) governance, (b) investment management, (c) risk management and (d) disclosure. For each key element, the Consultation Paper provides examples on how these key elements can be adopted or applied in practice.

At the initial stage, the requirements proposed under the Consultation Paper will apply to fund managers which manage collective investment scheme (**CISs**) but are proposed as not mandatory for fund managers which manage discretionary mandates (in the form of an investment mandate or a pre-defined model portfolio). Appendix 3 of the Consultation Paper set out a flowchart on the applicability of the proposed requirement.

Among the four elements, the proposed disclosure requirements would be applicable only to a fund manager which is responsible for the overall operation of a fund, i.e. they are not applicable to those who manage only part of a fund. However, the proposed conduct requirements in relation to the other three elements i.e. governance, investment management and risk management would apply to all fund managers which have discretion over investment management and risk management processes, irrespective of whether they are overall responsible or manage only part of a fund.

Where the fund manager is responsible for the overall operation of a fund, it should make adequate disclosures of information in relation to climate-related risks to allow fund investors to make an informed judgement about their investments in the fund, including: (a) its governance arrangement for oversight of climate-related risks; and (b) how it takes climate-related risks into account in its investment and risk management processes, including the tools and metrics used to identify, assess, manage and monitor the risks.

Proposed Requirements

We outline further details on the four key elements below. It should be noted that these four key elements are baseline requirements that are applicable to all fund managers, and for certain key elements, there are enhanced standards to be implemented by Large Fund Managers. In cases where climate-related risks are irrelevant, such as for a fund manager of a forex fund, justification should be recorded and disclosed. Global fund managers with group-wide policies may adopt group policies, to the extent that the standards of such group policies are subject to similar or higher standards.

1. *Governance.* The board and management would need to fulfill new requirements in addressing climate-related risks, which ranges from overseeing (a) the incorporation of climate-related considerations into investment and risk management processes and (b) the organisation's progress against goals for addressing climate-related issues, to maintaining an appropriate management structure for maintaining climate-related risks and reporting to the board, to setting action plans and goals for addressing climate-related risks.

2. *Investment management.* The fund manager should ensure that climate-related risks are taken into account of in its investment management process for funds:

2.1 *Identifying climate-related risks.* Fund managers should identify climate-related risks which are relevant to their investment strategies and the funds they manage, assess their impact and prioritize material risks in their investment management processes.

2.2 *Relevance and materiality assessment of climate-related risks*. Fund managers would also be required to disclose the types of investment strategies or funds under their management for which climate-related risks have been assessed to be irrelevant. Further, they should maintain appropriate records which explain why climate-related risks are irrelevant. In assessing the materiality of the impact of climate-related risks on the investment portfolio, fund managers should adopt an appropriate approach proportionate to their circumstances, taking into account their expertise and resources. The approach could be qualitative, quantitative or combination of both.

2.3 *Factoring material climate-related risks into investment process.* Fund managers can adopt different methods and strategies including exclusionary screening, best-in-class screening, norms-based screening and impact investing to address the climate-related risk in the portfolio construction process.

3. *Risk management.* It is proposed that fund managers should incorporate climate-related risks into their existing risk management framework. There should be adequate procedures for identifying, assessing, managing and monitoring material climate-related risks.

3.1 *Tools and metrics.* Fund managers can apply appropriate tools and metrics to assess and quantify climate-related risks. Carbon footprint related metrics (eg. weighted average carbon intensity (**WACI**), which is a representation of an investment portfolio's exposure to carbon-intensive companies, and is one of the Recommendations of the widely endorsed Task Force on Climate-related Financial Disclosures **(TCFD)** for quantitative disclosure), greenhouse gas emissions (**GHG**) data (GHG data, which is a commonly used metric used by the industry to assess the impact on an investment of the transition to a low-carbon economy), emissions relative or attribution analysis, forward-looking metrics or physical climate-related metrics, are among some of the tools and metrics adopted by the industry.

3.2 *Enhanced standards*. Large Fund Managers are also required to assess the relevance and utility of scenario analysis 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, fund managers are required to develop a plan to implement scenario analysis within a reasonable timeframe; and if climate-related risks are assessed to be material, take reasonable steps to identify the WACI intensity of Scope 1 (direct) and Scope 2 (indirect) 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.

4. *Disclosures.* As mentioned above, where the fund manager is responsible for the overall operation of a fund (i.e. they are not applicable to those who manage only part of a fund), it should make adequate disclosures of information in relation to climate-related risks including (a) its governance arrangement for oversight of climate-related risks; and (b) how it takes climate-related risks into account in its investment and risk management processes to identify, assess, manage and monitor the risks. Fund managers are not expected to provide details of their investment strategies, but it is proposed that they provide concrete examples to illustrate how they implement their governance, investment and risk management policies and procedures. Fund managers would also be required to disclose the types of investment strategies or funds under their management for which climate-related risks have been assessed to be irrelevant. These disclosure requirements regarding governance, investment and risk management are applicable to all fund managers at an entity level.

4.1 *Enhanced Standards – fund level disclosures.* Large Fund Managers would be subject to enhanced standards and would be required to make more detailed disclosures, e.g. they are required to describe their engagement in climate policy, which is useful for investors in understanding how the Large Fund Managers manage the climate-related risks. At a minimum, Large Fund Managers should provide the WACI intensity of Scope 1 and Scope 2 GHG emissions associated with the funds' underlying investments at a fund level (where climate-related risks are assessed to be material), and indicate the calculation methodology, underlying assumptions and limitations as well as the proportion of investments assessed or being covered. It is not mandatory for a fund manager to disclose WACI for funds where climate-related risks are assessed to be immaterial. The SFC indicates that Large Fund Managers are encouraged to disclose other relevant metrics (eg. Leadership in Energy and Environmental Design (LEED) rating and National Australian Built Environmental Rating System (NABERS) for real estate) to supplement the WACI of a portfolio as appropriate

4.2 *Format and frequency of disclosures.* Disclosures are expected to be reviewed and updated at least annually, with material changes made as soon as practicable. Disclosures can be communicated electronically through website or be incorporated in reports. Cross referencing to group policies or integrated reports are also allowed to lessen the reporting burden.

Proposed transition period

The Consultation Paper proposes:

(a) a nine-month period for Large Fund Managers to comply with the baseline requirements and a 12-month transition period to comply with the enhanced standards respectively; and
(b) a 12 month period for other fund managers to comply with the baseline requirements.

Consultation period

The SFC welcomes comments on the proposals made in the consultation paper to be submitted by 15 January 2021 when the consultation period will end.

Contact

If you would like to learn more or to discuss the subjects covered in this publication, please contact the following people or your usual contact at our firm.

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