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# SFC Consults on Climate-risk Requirements for Fund Managers

On 29 October 2020, Hong Kong's Securities and Futures Commission (**SFC**) published a consultation paper on the management and disclosure of climate-related risks by fund managers[1] (the **Consultation Paper**) outlining proposed amendments to the Fund Manager Code of Conduct (**SFC Fund Manager Code of Conduct**) which have been developed with reference to the Task Force on Climate-related Financial Disclosures (**TCFD**) Recommendations. The proposed amendments would require SFC-licensed fund managers to take climate-related risks into consideration in their investment risk management processes and make appropriate disclosures to meet investor demand for climate risk information and combat greenwashing.

This feeds into the larger effort to develop green finance in Hong Kong, which has included, among other initiatives, the SFC's September 2018 Strategic Framework for Green Finance[2] and the Stock Exchange of Hong Kong's (**HKEx**) amendments to the ESG reporting guide and related listing rules in December 2019. In June 2020, the HKEx also announced[3] plans to launch the HKEx Sustainable and Green Exchange (**STAGE**), a new information platform for sustainable and green finance investments in the Asia Pacific region. For further information about STAGE, please see Charltons' June 2020 newsletter.[4]

The consultation on SFC-licensed fund managers' obligations in relation to climate-related risks will remain open until 15 January 2021.

## 1. Proposed Requirements for SFC-licensed Fund Managers

Broadly speaking, the proposed requirements would apply to SFC-licensed fund managers managing collective investment schemes (**CISs**), but would not initially be mandatory for fund managers managing discretionary accounts (in the form of an investment mandate or a pre-defined model portfolio).

The proposed requirements cover four elements: governance, investment management, risk management and disclosure. The disclosure requirements would only apply to SFC-licensed fund managers responsible for the overall operation of a fund and would not apply to those managing only part of a fund. The governance, investment management and risk management requirements would apply to SFC-licensed fund managers with discretion over investment management and risk management processes irrespective of whether they have overall responsibility for a fund's management or manage part of a fund.

1 https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=20CP5
2 https://www.sfc.hk/-/media/TC/files/ER/PDF/SFCs-Strategic-Framework-for-Green-Finance---Final-Report-21-Sept-2018.pdf
3 https://www.hkex.com.hk/News/News-Release/2020/200618news?sc_lang=en
4 https://www.charltonslaw.com/hkex-to-launch-new-sustainable-and-green-exchange/

The SFC proposes to adopt a two-tier system, with Large Fund Managers (fund managers with AUM of HK$4 billion or above) being required to adopt enhanced standards, while all other fund managers (to which the requirements apply) would be required to meet the baseline requirements. The SFC estimates that around 200 of the 1,800 firms licensed by the SFC to conduct asset management activities would be classified as Large Fund Managers (representing 80% of total reported AUM).

The SFC received responses during soft consultations outlining concerns that a two-tier approach may segment the market, however the SFC has chosen to proceed with this approach on the basis that Large Fund Managers have more resources to implement enhanced standards and that a blanket approach would be a disproportionate burden on small fund managers.

## 2. Proposed Climate-risk Requirements

a. Governance

In recognition of the importance of board and management involvement to ensure the integration of climate-related risks across an organisation, the SFC has proposed the following requirements, with specific governance-related requirements to be set out in an SFC circular.

| Responsible Party | Requirement |
|---|---|
| **The board** | • must oversee the incorporation of climate-related considerations into investment and risk management processes; and<br>• must oversee progress against goals for addressing climate-related issues. |
| **Management** | • must maintain an appropriate management structure for managing climate-related risks and reporting to the board;<br>• must develop action plans (adopting either a qualitative or quantitative approach), establish controls and procedures and devote sufficient resources for the proper performance of their duty to manage climate-related risks; and<br>• must set goals (adopting either a qualitative or quantitative approach) for addressing climate-related issues. |

b. Investment Management

The SFC proposes to amend the SFC Fund Manager Code of Conduct to require fund managers to ensure climate-related risks are taken into account in the investment management process. This will broadly require SFC-licensed fund managers to:

| Requirements | Practical Steps |
|---|---|
| **Identify climate-related risks** | • consider physical risks, transition risks and liability risks relevant to their investment strategies and the funds they manage;<br>• assess the impact of the identified risks; and<br>• prioritise material risks in the investment management process. |

<table>
<tr><th>Requirements</th><th colspan="3">Practical Steps</th></tr>
<tr><td rowspan="2">Assess materiality and relevance of climate-related risks</td><td colspan="3">• adopt processes to identify the relevance and materiality of climate-related risks (which may be qualitative or quantitative); and<br>• maintain appropriate internal records to demonstrate the materiality of risks that have been assessed.</td></tr>
<tr><td><u>If risks are considered to be immaterial</u><br>• comply with the proposed governance and disclosure requirements and re-evaluate the assessment periodically; and<br>• consider how risks will affect strategies and can be factored into the investment management process if they become material over time.</td><td><u>If risks are considered to be material</u><br>• comply with the proposed requirements for governance, investment management, risk management and applicable disclosure requirements.</td><td><u>If risks are considered to be irrelevant</u><br>• ensure conclusions are justifiable and appropriate records are maintained outlining why such risks are irrelevant; and<br>• disclose the types of investment strategies or funds for which climate-related risks are considered irrelevant.</td></tr>
<tr><td>Factor material climate-related risks into the investment process</td><td colspan="3">• take material climate-related risks into consideration in the portfolio construction process; and<br>• fund managers responsible for the overall operation of the funds should disclose to investors how they consider material climate-related risks in the portfolio construction process and clearly explain if and in what ways this differs across investment strategies and funds.</td></tr>
</table>

c. <u>Climate-related Risk Management</u>

The SFC proposes a two-tier approach to risk management, with all SFC-licensed fund managers (to which the requirements apply) being subject to baseline requirements. Large Fund Managers would be subject to enhanced requirements, in addition to the baseline requirements.

| Requirements | Practical Steps |
|---|---|
| **Implement adequate procedures for identifying, assessing, managing and monitoring climate-related risks** | <u>baseline requirement</u> - apply appropriate tools and metrics to assess and quantify climate-related risks<br><br><u>enhanced requirement</u> – use commonly adopted quantitative metrics to identify and assess the impact of climate-related risks on underlying investments |

| Requirements | Practical Steps | |
|---|---|---|
| | *if risks are assessed to be material*<br><br>baseline requirement:<br><br>• adopt appropriate measures to manage risks (such as reallocation of assets under management, exercise stewardship through active engagement, voting or collaboration with other stakeholders)<br><br>enhanced requirement:<br><br>• make reasonable efforts to acquire or estimate the Weighted Average Carbon Intensity (**WACI**) of Scope 1 and Scope 2 GHG emissions for funds under management | *if risks are assessed to be relevant but immaterial*<br><br>baseline requirement:<br><br>• monitor risks on an ongoing basis and re-evaluate materiality assessments from time-to-time and take appropriate steps to manage the risk if it becomes material<br><br>enhanced requirement(s):<br><br>• assess the relevance and utility of scenario analysis for evaluating the resilience of investment strategies to climate-related risks and keep internal records; and<br><br>• develop a plan to implement scenario analysis within a reasonable timeframe if the assessment process proves to be relevant and useful. |

d. Climate-related Risk Disclosure

The SFC also proposes a two-tier approach to disclosure, with Large Fund Managers subject to enhanced requirements on the basis of proportionality.

| Requirements | Practical Steps |
|---|---|
| **Make adequate disclosures covering governing arrangements for the oversight of climate-related risks and how climate-related risks are taken into account during the investment and risk management processes**<br><br>*Note: the appropriate disclosures should be made at an entity level (except the WACI, which should be disclosed at fund level).* | baseline requirement – disclose governance structure and risk management processes as long as climate-related risks are relevant to the investment strategy of the fund<br><br>enhanced requirement – make reasonable efforts to disclose available Scope 1 and Scope 2 GHG emissions data and calculation methodology, underlying assumptions, limitations and proportion of investments assessed or covered<br><br>enhanced requirement – disclose other relevant metrics to supplement WACI of a portfolio as appropriate |

<table>
<tr><th>Requirements</th><th colspan="2">Practical Steps</th></tr>
<tr><td></td><td><u>if risks are assessed to be material</u><br><br><u>baseline requirement:</u><br><ul><li>make disclosures as to how these risks are being factored into the portfolio construction process and of key tools and metrics used in the investment and risk management process.</li></ul><u>enhanced requirement(s):</u><br><ul><li>describe engagement policy; and</li><li>disclose WACI at a fund-level.</li></ul></td><td><u>if risks are assessed to be irrelevant</u><br><ul><li>disclose the types of investment strategies or funds under management for which risks have been assessed to be irrelevant;</li><li>ensure conclusions are justifiable and maintain appropriate internal records; and</li><li>re-evaluate assessment from time-to-time to ensure they remain appropriate.</li></ul></td></tr>
</table>

As for the manner of disclosure, the SFC outlines that SFC-licensed fund managers should adopt a proportionate approach by disclosing information proportionate to the degree climate-related risks are properly considered in their investment and risk management processes. Disclosure should be in writing and communicated to fund investors, for example by display on a website. Fund managers would be required to review and update disclosures at least annually, and to inform fund investors of any material changes as soon as practicable.

The SFC, mindful of a possible increased reporting burden on fund managers which are subsidiaries of overseas fund management groups, states that group policies and practices may be cross-referenced when preparing disclosures, provided the SFC's requirements are fulfilled and an explanation of how the group's policies and practices are adopted by the fund managers is included.

## 3. Proposed Transition Periods

The SFC is proposing a nine-month and a 12-month transition period for Large Fund Managers to comply with the baseline requirements and enhanced requirements, respectively. Other fund managers would have a 12-month transition period to comply with the baseline requirements.

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