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Hong Kong Regulatory Update – Consultation Conclusions on the Management and Disclosure of Climate-related Risks for Fund Managers (20 August 2021)

Introduction

On 20 August 2021, the Securities and Futures Commission ("SFC") issued its long-awaited Consultation Conclusions ("Conclusions") on the Management and Disclosure of Climate-related Risks by Fund Managers ("Managers and/or Licensed Corporations").

As part of its conclusions, the SFC has made amendments to the Fund Manager Code of Conduct ("FMCC") which will now require Licensed Corporations ("LCs") that manage collective investment schemes ("fund(s)") to take into consideration climate-related risks during the investment and risk management processes. The SFC has not mandated a specific international framework to be applied in Hong Kong but makes it clear that its primary reference point is the Task Force on Climate-Related Financial Disclosures ("TCFD") recommendations.

The Conclusions followed a consultation period that commenced in October 2020. The Consultation Paper will remain highly relevant to Managers as the SFC refers back in the Consultation Conclusions back to paragraphs of the Consultation Paper as being examples of how Managers can implement the requirements of the FMCC albeit that those requirements have not been directly incorporated into the FMCC amendments.

In this regulatory update we have summarised the key updates made to the FMCC and outlined how these changes impact SFC Licensed Fund Managers and their affiliated entities.

Scope

The requirements apply to all funds managed by Managers based in Hong Kong, regardless of whether those funds are authorised by the SFC for distribution in Hong Kong or not. This means Managers of funds incorporated in the Cayman Islands or other offshore jurisdictions are within the scope of the amendments. These requirements do not apply to Managers who exclusively manage discretionary segregated or managed accounts.

The SFC has specifically stated that a "comply or explain" approach will not be considered for the purpose of the proposed requirements. However, Managers may apply a measured approach to implementation assessing the nature, size, complexity and risk profile of their operations and the investment strategies adopted by each fund under their management.

In its FAQs the SFC has noted that when identifying climate-related risks Managers should look beyond their usual investment horizon, in particular when portfolio assets are reinvested in similar investments. Physical and transition risks that are not likely to have a material impact in the short term may become material at a later date if portfolio assets are reinvested in similar sectors or asset classes. Managers should take into consideration how these risks may impact their strategies and how they can be factored into their investment management processes if they eventually become material.

Managers may assess that climate-related risks are irrelevant to its investment and risk management processes due to the nature of the investment or strategy adopted (e.g. a quantitative fund, macro strategy fund index tracking fund, forex fund, managed futures fund or a

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fund that trades on a daily basis). These exceptions must be disclosed and appropriate records supporting the decision must be maintained.

Role of Hong Kong Type 9 Licensed Corporations

As a preliminary step, all Managers must assess whether they have discretion over the investment management processes. If the Manager has discretion, the requirements are applicable to the extent of the Managers' role. This is in line with the FMCC's approach to managers who are responsible for the overall operation of a fund ("ROOF") Managers.

Managers in Hong Kong that have been delegated with the overall investment management function for a fund must observe the governance, investment and risk management requirements of the amended FMCC. This applies to all funds even if they are not distributed in Hong Kong.

Hong Kong Managers delegated with investment discretion but subject to a risk management framework implemented at the delegating entity only need to adhere to the governance and investment management requirements, but not the risk management requirements. This would normally be the case of a large international asset management group and the SFC further notes that some Managers may already have group policies or frameworks covering other ESG factors in addition to climate change. These Managers are permitted to follow their group policies to take sustainability risks into account in their investment and risk management processes.

Managers in Hong Kong with delegated investment discretion for a portion of a fund need to adopt the amended FMCC requirements to that portion of the Assets Under Management ("AUM") managed in Hong Kong but are not responsible for managing climate related risks at the overall fund level.

Hong Kong Managers that delegate the investment management function to a sub-manager retain the overall responsibility for complying with the updated FMCC requirements and are responsible for ongoing monitoring of the competence of group entities or delegates.

LCs that solely provide investment advice to an affiliate or separate team or act as distributors of a fund with no investment management discretion are not within the scope of the requirements.

Larger Fund Managers

Managers of funds with an AUM of HK$8 billion or above are subject to further enhanced standards that do not apply to smaller Managers (i.e. with <HK$8b of AUM). The SFC is of the view that larger Managers should have the appropriate resources to adopt such enhanced standards.

It is important to note that the AUM of discretionary accounts is excluded from the calculation of the Manager's total AUM for the purpose of this threshold calculation.

When determining the AUM level, Managers should assess its monthly fund AUM for any three-month period in the previous reporting year. The changed portion of a fund for which a Hong Kong Manager has investment discretion should be taken into account in the calculation.

The enhanced standards apply to Large Fund Managers irrespective of whether they manage funds with an ESG or climate-related focus. The SFC believes that the theme of a fund should not affect the need to integrate proper risk management in investment decisions or to assess and manage the impact of these risks on the underlying investments on an ongoing basis.

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Implementation Timeline

The SFC has allowed for a transitional period to provide Managers sufficient time to ensure they are prepared and have suitable internal controls in place to comply with the baseline requirements and the enhanced standards for larger Managers.

The following transitional periods have been confirmed:

- Smaller Managers have until 20 November 2022 to comply with the baseline requirements.
- Larger Managers have until 20 August 2022 to comply with the baseline requirements and until 20 November 2022 to comply with the enhanced standards.

Lack of Useable Data

The SFC addressed the concerns raised by many respondents about the lack of available climate-related data in Asia Pacific. The SFC has clarified that:

- Managers have the flexibility to adopt the type of tools and metrics they consider appropriate for assessing climate-related risks for the purpose of risk management and they should look to utilise qualitative, quantitative or a mixture of both measures.
- Managers are expected to take into account new standards and metrics as they emerge.
- In complying with the greenhouse gas ("GHG") emissions disclosure requirement, Large Fund Managers are expected to make an effort to collect data where available or can be reasonably estimated.
- Fund managers can make reference to the standards or approaches of international organisations such as the Partnership for Carbon Accounting Financials ("PCAF") in estimating the GHG emissions of investments in different asset classes.
- At the initial stage the SFC only expects Large Fund Managers to assess if scenario analysis is relevant and useful for them in evaluating the resilience of investment strategies to climate-related risks under different pathways. If so, Large Fund Managers are expected to develop a plan to implement scenario analysis within a reasonable timeframe.

Baseline Requirements

The SFC has now introduced the baseline requirements into the FMCC relating to climate-risk and these have been broken down into the following four key elements:

1. Governance;
2. Investment management;
3. Risk management; and
4. Disclosures.

1. Governance

Board of Directors ("Board")

The SFC expects the Board to have overall oversight of climate change, set the tone from the top and be responsible for the implementation and incorporation of climate-related considerations into the investment and risk management processes of the Manager.

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To achieve this, the Board must set clearly defined goals and action plans to address climate related issues. In practice, the Board must document the processes and frequency for how they will remain informed of climate related risks facing the Manager. The SFC has not set specific requirements for climate knowledge or expertise for the Board or management.

The SFC has made it clear that the governance requirements allow for flexibility and take into account the varying roles of the Board. Managers can leverage group resources to help and support managing climate-related risks. However, the responsibility for complying with the baseline requirements remain with the Hong Kong Manager.

Management

To ensure overall implementation of the various baseline requirements, Senior Management should be assigned roles and responsibilities commensurate to their position in relation to the management of climate-related risks. When assigning these roles and responsibilities it is important to take into consideration the management structure of the Manager and to ensure that reporting lines to the Board are clearly identified.

In determining how Senior Management monitors the status and progress of the efforts made in managing climate-related risks, the SFC suggests Managers consider appointing a senior manager to be ultimately responsible for overseeing this process or set up a Climate-risk Management Committee.

As is always the case with the introduction of new regulations, it is important to ensure that sufficient human and technical resources are readily available. Senior Management should consider providing expert training to staff involved in the management of climate-related risks as this will benefit the technical knowledge of the individuals involved.

Setting clearly defined goals for addressing climate-related issues as well as a detailed action plan will provide management with the direction needed to ensure that the baseline requirements are achieved and that climate-related risks are considered throughout the risk management and investment processes.

2. Investment Management

For each investment strategy and each fund under its management, the Manager must identify all relevant and material physical and transition climate-related risks.

Where relevant, managers should factor material climate-related risks into the investment management process. This could be done by including climate-related risks in the investment philosophy and strategies or incorporating climate-related data into the research and analysis processes.

When factoring in the climate-related risks into the investment management process, the Manager must appropriately assess the impact these risks may have on the performance of the underlying investments. A Manager should not only focus on green-related investments but also monitor and manage the climate-related risks associated with high carbon intensity assets to properly manage the overall risk exposures of the fund. The SFC refers Managers back to paragraphs 50 to 55 of the Consultation Paper for guidance on how to identify climate related risks and assess their materiality and relevance.

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The SFC recognises passive Managers' limitations in exercising investment discretion over index funds or funds with specific investment objectives but does reference paragraph 54 of the Consultation Paper for suggestions for passive Managers to consider in relation to climate-related risks. The SFC also notes that if Managers are not able to deviate from a reference benchmark, they can nevertheless exercise stewardship (e.g. through proxy voting or index design engagement).

The SFC has indicated that these requirements must not prohibit or restrict a Manager from complying with applicable laws and discharging their fiduciary duties.

3. Risk Management

Managers must incorporate climate-related risks into their risk management policies and procedures. Managers need to update their policies and procedures to ensure that they can identify, assess, manage and monitor the relevant and material climate-related risks for each investment strategy and fund under management.

It is up to the Manager to apply appropriate tools and metrics to assess and quantify climate-related risks. Managers should take a conservative approach when applying such tools and metrics to ensure they adequately address the various climate-related risks that they are faced with.

Engagement

The SFC encourages Managers to actively engage with investee companies and exercise their proxy voting rights on climate-related issues. Large Fund Managers must disclose their engagement policies to investors but have the discretion to determine their level of engagement having regard to the circumstances of each fund or strategy.

Enhanced Standards

Larger Managers are subject to enhanced standards in relation to the use of tools and metrics. When climate-related risks are deemed relevant and material to an investment strategy or a fund, a Larger Manager must assess the relevance and utility of scenario analysis in evaluating the resilience of investment strategies to climate-related risks under different pathways. If the results are seen as relevant and useful, the Manager must develop a plan to implement scenario analysis within a reasonable timeframe.

In addition, if the climate-related risks are relevant and material, the Manager must take reasonable steps to identify the portfolio carbon footprints of the Scope 1 and Scope 2 GHG emissions associated with the fund's underlying investments, where data is available.

4. Disclosure Requirements

Managers are required to make disclosures on both an entity and a fund level. Disclosures can be made at a group level if the group disclosures meet the SFC's requirements.

The disclosures should be made in writing and communicated to investors electronically via email or published on the Manager's website. Amendments to a fund prospectus or Private Placement Memorandum ("PPM") are not mandatory.

Disclosures should be reviewed annually at a minimum, and updates should be made when considered necessary (i.e. when there are any identifiable changes).

The baseline disclosure requirements at an entity level consist of:

Governance Disclosures: Managers must disclose to investors the overall governance structure adopted, and clearly detail the controls in place for the mitigation of climate-related risks and these functions must be easily identifiable.

Disclosures on Board of Directors involvement: The disclosures must address the role and oversight function of the Board including how the Board reviews the risk management framework for climate-related risks and the frequency that the Board is informed about climate-related issues.

Disclosures on Management's roles and responsibilities: The Manager must outline the roles and responsibilities of management including how management monitors the status and progress of efforts made to manage climate-related risks and how management stay informed about the status and progress of efforts made to manage such risks.

Disclosures on investment management: The Manager must disclose the steps taken to incorporate relevant and material climate-related risks into the investment management process. If any climate-related risks have been assessed and deemed irrelevant to certain strategies or funds, the Manager must disclose these exceptions at either the entity or fund level.

Disclosures on risk management: Managers must set out the methods used for identifying, assessing, managing and monitoring climate-related risks and this should include the key tools and metrics utilised.

Enhanced Standards

Entity Level Disclosures: Larger Managers are expected to describe their engagement policy and provide details of how material climate-related risks are managed in practice and how exactly the engagement policy is implemented.

Fund Level Disclosures: Where data is available or can be reasonably estimated, Larger Managers must 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. This disclosure must indicate the calculation methodology, underlying assumptions and limitations, and the proportion of investments in terms of the NAV of the funds which have been assessed.

GHG Emissions Disclosures: Larger Managers must take reasonable steps to identify the portfolio carbon footprints of the Scope 1 and Scope 2 GHG emissions of funds' underlying investments and to disclose them as enterprise value-based metrics. The SFC decided not to mandate a specific metric such as weighted average carbon intensity (WACI).

Larger Managers may provide the quantitative disclosures with additional metrics if they consider this is appropriate. This could include enterprise value-based, revenue-based, asset class-specific or forward-looking metrics as this can provide more decision-useful information to investors. Appendix E of the Consultation Conclusion outlines the formula, methodology and key points for the calculation of carbon footprint.

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Japan: +81 3 6837 5483 United Kingdom: +44 (0) 20 7236 0921 www.complianceasia.com

How we can help

ComplianceAsia ESG's dedicated team of professionals can assist your firm with complying with the baseline requirements and enhanced standards applicable to your business. We can provide support and guidance to all aspects of the implementation process, from assessing the governance structure in place, providing guidance and support to the board, reviewing and updating risk management policies and procedures, to addressing climate-related risks and providing training and guidance to Senior Management on climate-related risks.

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ComplianceAsia is the longest established compliance consulting firm in Asia Pacific established in 2003 with offices in Hong Kong, Shanghai, Singapore, Tokyo and London. We have an unmatched track record of completing complex compliance consulting projects for financial firms in the APAC region.

With over 70 staff, including compliance experts with experience in dealing with the SFC, HKMA, MAS, CSRC, JFSA and Asian exchanges, we provide independent, unbiased advice on Asian financial industry legislation and regulations. Our international client base consists of asset managers, hedge funds, private equity funds, family offices, broker-dealers, insurers, wealth managers and investment banks.

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ComplianceAsia ESG Consulting is a specialist service to help Asian based financial industry firms deal with the fast-changing regulatory landscape of ESG investing in our region.

ComplianceAsia ESG Consulting offers a broad range of ESG services designed for firms in Asia Pacific starting on their journey towards ESG compliance and investment all delivered in an accessible and cost-effective way.

Whether you are responding to regulatory requirements or investor or stakeholder demands, our team of experts can help you with understanding your ESG obligations now and over the medium to long term.

For more information, please visit www.complianceasiaesg.com.

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Japan: +81 3 6837 5483 United Kingdom: +44 (0) 20 7236 0921 www.complianceasia.com

CA | ESG
ComplianceAsia ESG Consulting

Contact Us Today

HONG KONG SAR
Suite 1102
ChinaChem Tower
34-37 Connaught Road
Central

T: +852 2868 9070

SINGAPORE
137 Telok Ayer Street
#03-06
Singapore 068602

T: +65 6533 8834

MAINLAND CHINA
Room 132, Unit 1301-1308
13/F, Shanghai Tower
No.479 Lujiazui Ring Road
Pudong New Area Shanghai

T: +86 147 1431 1859

JAPAN
Level 2
Marunouchi Nijubashi Building
3-2-2 Marunouchi Chiyoda-ku
Tokyo 100-0005

T: +81 3 6837 5483

UNITED KINGDOM
1 St. Andrew's Hill
London
EC4V 5BY

T: +44 (0) 20 7236 0921
M: +44 (0) 7310 972435

www.complianceasiaesg.com

Philippa Allen
CEO
E: philippa.allen@complianceasia.com

Alex Duperouzel
Managing Director
E: alex.duperouzel@complianceasia.com

Lachlan Chubb
Regional Head of Regulatory Advisory and Projects
E: lachlan.chubb@complianceasia.com

Cherry Chan
Regional Head of Ongoing Support and Client Services
E: cherry.chan@complianceasia.com

Rachel Wu
Regional Head of Business Development and Compliance Manager
E: rachel.wu@complianceasia.com

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