Circular

20 August 2021

**Circular to licensed corporations**

**Management and disclosure of climate-related risks by fund managers**

## Introduction

1. The Securities and Futures Commission (SFC) today issued Consultation Conclusions on the Management and Disclosure of Climate-related Risks by Fund Managers and will amend the Fund Manager Code of Conduct (FMCC) to require Fund Managers managing collective investment schemes (CIS) to take climate-related risks into consideration in their investment and risk management processes and make appropriate disclosures. The requirements cover four key elements, namely governance, investment management, risk management and disclosure.

2. This circular sets out the expected standards for complying with the amended FMCC. These include (i) baseline requirements for all those managing CIS[1] (Fund Managers) and (ii) enhanced standards for Fund Managers with CIS under management which equal or exceed $8 billion[2] in fund assets for any three months in the previous reporting year (Large Fund Managers). A flowchart illustrating the applicability of the requirements can be found in Appendix 1.

3. Appendix 2 includes practical examples for Fund Managers' reference when considering how to comply with the requirements. Fund Managers should note that these sample practices are for illustrative purposes only and not intended to be exhaustive or be regarded as regulatory requirements. Fund Managers should develop governance structures, policies and procedures which are commensurate with the nature, size, complexity and risk profiles of their firms and the investment strategies adopted by each fund under their management[3].

4. This circular is accompanied by Frequently Asked Questions (FAQs) to provide guidance to the industry on the implementation of the requirements.

5. The SFC keeps abreast of the development of local and international regulations and standards in this area and will refine its requirements and provide further guidance when necessary.

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[1] The requirements set out in this circular are not mandatory for discretionary account managers. For details, please refer to Appendix 1 of the FMCC under "Particular requirements in the Code which are not applicable to Discretionary Account Managers".

[2] For the avoidance of doubt, the threshold does not include assets under discretionary account management.

[3] Paragraph 1.2(d) of the FMCC.

## Scope and applicability

6. To determine the scope and applicability of the requirements, Fund Managers should first consider whether they have discretion over the investment management processes as illustrated in the Flowchart in Appendix 1. The SFC's requirements are applicable based on the relevance and materiality of climate-related risks to the investment strategies and funds managed by the Fund Managers as well as their roles. Fund Managers should apply the principle of proportionality[4] in determining how to comply with the requirements. Where Fund Managers delegate the investment management function to sub-managers, they retain the overall responsibility for complying with the SFC's requirements.

7. 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 SFC's requirements.

8. Fund Managers may leverage on group resources and staff, adopt group policies and procedures, and rely on group disclosures to satisfy the SFC's requirements provided that they are subject to similar or higher standards than our requirements. The local management retain the responsibility to ensure that the LCs are in compliance with the SFC's requirements.

## Baseline requirements and enhanced standards

9. For the purpose of complying with the requirements under the FMCC, fund managers are expected to observe the following baseline requirements and enhanced standards.

   **Governance** – paragraphs 1.2(a) – (d), 1.6 and 1.8 of the FMCC

10. <u>Baseline requirements on board's roles and responsibilities:</u>

    (i) define the board's or the board committee's role in overseeing the incorporation of climate-related considerations into the investment and risk management processes;

    (ii) oversee progress against goals for addressing climate-related issues; and

    (iii) determine how the 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.

11. <u>Baseline requirements on management's roles and responsibilities:</u>

    (i) 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;

[4] Assessing the nature, size, complexity and risk profiles of the Fund Managers and the investment strategies adopted by each fund under their management.

(ii) determine how the management (through specific positions or management committees) will monitor the status and progress of efforts to manage climate-related risks;

(iii) establish a process for the management to be regularly informed about the status and progress of efforts to manage climate-related risks;

(iv) devote sufficient human and technical resources for the proper performance of the duty to manage climate-related risks (eg, provide training to staff, engage subject experts and acquire climate-related data from external sources);

(v) 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; and

(vi) set goals for addressing climate-related issues and develop action plans for managing climate-related risks.

12. Please see the examples in Section B1 of Appendix 2 for reference.

**Investment management** – paragraph 3.1A of the FMCC

13. Baseline requirements:

(i) identify relevant and material physical and transition climate-related risks for each investment strategy and fund it manages;

(ii) 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; and

(iii) take reasonable steps to assess the impact of these risks on the performance of underlying investments.

14. As set out under paragraph 25 below, 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.

15. For the avoidance of doubt, the above requirements shall not prohibit or restrict a Fund Manager from complying with applicable laws and discharging their fiduciary duties.

16. Please see the examples in Section B2 of Appendix 2 for reference.

**Risk management** – paragraph 1.7.1, paragraph 3.11.1(b), and paragraph F under Appendix 2 to the FMCC

17. Baseline requirements

    (i) *Risk management*

    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 fund it manages.

    (ii) *Tools and metrics*

    Apply appropriate tools and metrics to assess and quantify climate-related risks.

18. Enhanced standards – Tools and metrics

    Large Fund Managers, to the extent climate-related risks are assessed to be relevant and material to an investment strategy or a fund they manage, are also required to follow the standards below:

    (i) 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

    (ii) if climate-related risks are assessed to be relevant and material, take reasonable steps to identify the portfolio carbon footprints 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 the calculation methodology and underlying assumptions.

19. Portfolio carbon footprint is a representation of carbon emissions normalised by the portfolio's market value and expressed in tons of carbon dioxide equivalent emissions ($CO_2e$) per million dollars invested. Below is the formula for the calculation of portfolio carbon footprint:

$$\sum_{N}^{i} \left( \frac{\dfrac{\textit{Current value of investment}_i}{\textit{Investee company's enterprise value}_i} \times \textit{Investee company's Scope 1 and Scope 2 GHG emissions}_i{}^{@}}{\textit{Current portfolio value (\$ million)}} \right)$$

@ *Fund managers are encouraged to include Scope 3 GHG emissions if data is available.*

20. Large Fund Managers can make reference to the PCAF Standard[5] which provides guidance on methods to estimate and calculate the GHG emissions of various asset classes.

21. Please see the examples in Section B3 of Appendix 2 for reference.

**Disclosure** – paragraph 6.2A of the FMCC

22. Manner and frequency of disclosures

Fund Managers, who are responsible for the overall operation of funds[6], should make appropriate disclosures to investors via various channels such as websites, newsletters or reports and ensure investors' attention is drawn to the information. They should provide cross-references to help investors find relevant information. They should also observe the following when making the disclosures:

(i) adopt a proportionate approach, ie, the information disclosed should be proportionate to the degree climate-related risks are considered in the investment and risk management processes;

(ii) make adequate disclosures of information in writing and communicate to fund investors through electronic or other means (eg, on the company website); and

(iii) review disclosures at least annually, update disclosures where considered appropriate and inform fund investors of any material changes as soon as practicable.

23. Baseline requirements on governance related disclosures at entity level:

(i) describe the governance structure;

(ii) describe the board's roles and oversight, 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; and

(iii) 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.

5 Global GHG Accounting & Reporting Standard of the Partnership for Carbon Accounting Financials (PCAF Standard).

6 For the meaning of a Fund Manager which is responsible for the overall operation of a fund, please see answer to Question 1 of FAQs on the FMCC.

24. Baseline requirements on investment management and risk management related disclosures at entity level:

    (i) disclose the steps taken to incorporate relevant and material climate-related risks into the investment management process; and

    (ii) describe the processes for identifying, assessing, managing and monitoring climate-related risks, including the key tools and metrics used.

25. If climate-related risks have been assessed to be irrelevant to certain types of investment strategies or funds under their management, Fund Managers are required to disclose such exceptions at the entity or fund level.

26. Enhanced standards on risk management related disclosures at entity or fund level:

    (i) 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; and

    (ii) 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 (eg, in terms of the net asset value of funds) which are assessed or covered.

27. Further to paragraph 8 above, 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.

28. The requirement to make disclosures regarding governance, investment management and risk management at the entity level is designed to reduce the compliance burden of Fund Managers to disclose information if the same policies and processes apply consistently across different strategies and funds. Fund Managers may disclose at the fund level if it is more appropriate.

29. Please see the examples in Section B4 of Appendix 2 for reference.

**Implementation timeline**

30. Following the issuance of the consultation conclusions today, the regulatory requirements for climate-related risks will become effective after the following transition periods:

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

    (ii) a 15-month transition period for other Fund Managers to comply with the baseline requirements (ie, until 20 November 2022).

31. The disclosures relating to the baseline requirements and enhanced standards must be made after the transition periods specified in paragraph 30 above, except for the portfolio carbon footprint disclosure (see below).

32. For funds with a financial year-end date after the effective date of the enhanced standards on 20 November 2022, Large Fund Managers are required to disclose to fund investors the portfolio carbon footprints calculated based on the positions as of the financial year end. The disclosure of this metric should be made through an appropriate channel not 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). Large Fund Managers can choose to disclose the portfolio carbon footprints of funds more frequently and supplement with additional metrics as appropriate.

Should you have any queries regarding the contents of this circular, please contact Ms Kammy Kwok at 2231 1455 or your case officer.

Intermediaries Supervision Department
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Securities and Futures Commission

Enclosure

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