

Draft 14 January 2021

ASIFMA AMG Feedback on SFC's Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers

On behalf of the Asset Management Group ("AAMG") of Asia Securities Industry & Financial Markets Association ("ASIFMA")¹, we would like to submit our responses to the Securities and Futures Commission's ("SFC") Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers.

Q1. Do you have any comments on the SFC's proposal to focus on climate change or should a broader spectrum of sustainable finance should be considered in developing the requirements? Please explain your view.

Climate change is a matter of significant urgency that must be addressed by all industries, and regulators such as the SFC can play a significant role in compelling fund managers to focus on climate change risks and mitigation in their portfolios. This focus can, in turn, foster a greater awareness and understanding of these issues by end investors, as well as encourage increased engagement activities with portfolio companies to manage climate risks in their businesses. We are broadly supportive of the SFC's proposal to focus on climate change.

Many of our members are global asset managers and owners who already take sustainability, including broader environmental and social issues into account in their portfolios. Whilst some of our members believe that the SFC proposal should not be limited to climate change and climate-related risks, we believe it is reasonable to initially focus on this aspect of sustainability rather than be overly ambitious at the outset, especially given the implications for end users and portfolio companies.

We would however ask the SFC to allow fund managers the flexibility to adopt and make reference to a broader approach on sustainability risk integration, incorporating environmental and other sustainability factors (i.e. social and governance), if the manager chooses to do so.

¹ [ASIFMA](#) is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, professional and consulting firms, and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. AAMG advocates stable, innovative and competitive Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the [GFMA](#) alliance with [SIFMA](#) in the United States and [AFME](#) in Europe, AAMG also provides insights on global best practice and standards to benefit the region.

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Q2. Do you agree that at the initial stage, the SFC's proposed requirements should apply to the management of CISs but not discretionary accounts?

Our members agree that the proposed requirements should initially apply to the management of CISs and only discretionary accounts with an investment mandate that requires consideration of climate-related risks.

In the case of discretionary accounts, whilst the manager's discretionary authority is limited by the investment objectives and guidelines of the client mandate, we recognise that such clients, which are typically institutional clients, are increasingly aware of climate risks. We would anticipate that over time the investment mandates of such discretionary accounts will in turn take climate-related risks into account, such that most discretionary accounts will ultimately fall within scope of these proposed requirements.

Separately, Paragraph 35 of the Consultation Paper makes reference to the situation where a fund manager, which is a sub-investment manager of a fund with full discretion over the investment management function, "would be required to observe the proposed requirements applicable to its role". According to Appendix 3, we believe that where a sub-investment manager is NOT responsible for the overall operation of the fund (ROOF), then the disclosure requirements will not apply. We would prefer that Paragraph 35 make explicit reference to the requirements applicable to sub-investment managers.

Q3. Do you agree that the SFC should make reference to the TCFD Recommendations in developing the proposed requirements so as to minimise fund managers' compliance burden and foster the development of a more consistent disclosure framework? Other than the TCFD reporting framework, is there any other standard or framework which in your opinion would be appropriate for the SFC to refer to in developing the proposed requirements?

Many of our members are already aligning with the TCFD Recommendations as the most comprehensive and widely recognised framework in relation to addressing climate risks in investments. Given the SFC's focus on climate change, we agree that the TCFD Recommendations is the most appropriate framework for the SFC to make reference to in developing proposed climate risk requirements for fund managers. Applying TCFD Recommendations would minimise fund managers' compliance burden and foster the development of more internationally consistent conduct and disclosure frameworks. Whilst we do not propose any other standard or framework at this point in time, we would hope that the SFC will continue to adopt the principle of using globally recognised standards in its regulatory efforts, rather than developing idiosyncratic approaches.

Q4. Do you have any comments on the proposed basis for determining the threshold for Large Fund Managers, i.e. HK\$4 billion, and the basis for reporting? Please explain your view.

We believe that HK\$4 billion is a reasonable threshold for determining Large Fund Managers. It would however be helpful if the SFC can explain the rationale for including discretionary accounts' assets under management ("AUM") in the calculation of monthly AUM for the purpose of the threshold calculation yet generally excluding discretionary accounts in the proposed requirements. We would also ask the SFC to explain why this threshold is an "indicative number for reference only" and what other factors (if any) the SFC will take into account in determining a Large Fund Manager.

According to Footnote 26, we understand that only (portions of) funds and discretionary accounts delegated to the fund manager will be included in the threshold calculation. Given that many licensed corporations (“LCs”) are the overseas subsidiaries of global asset managers, often with sub-delegation arrangements for example, it would also be helpful for the SFC to provide more explicit guidance and/or examples on which parts of AUM will be included in the calculation.

Q5. Do you have any comments on the proposed amendment to the FMCC requirements, baseline requirements and enhanced standards? Please explain your view.

FMCC requirements

Our members are broadly supportive of the requirements that investment managers must follow to integrate ESG effectively into their governance, investment and risk management processes. We especially appreciate the SFC’s allowance that fund managers with overseas parents and affiliate companies may make reference to group policies and practices, where they are subject to similar or higher standards than the SFC’s proposed requirements. However we strongly urge the SFC to make this clear in the actual revised text of the FMCC and/or the proposed circular, that the locally licensed corporation may rely on group policies and practices to satisfy the SFC’s requirements, including that issues associated with climate-related risks may be subject to oversight at the group/parent entity level rather than at the level of the board and senior management of the local entity.

Practices

Industry practices are highlighted throughout the consultation paper to contextualise the proposed requirements. We would advise against being overly prescriptive in, for example, Practice 6, describing all the different committees that a fund manager has set up. It appears to prescribe exactly how a given fund manager must structure its ESG research and integration efforts. In particular, it seems to regard ESG ratings as being something centralised rather than strategy- or style-dependent, and this approach would perhaps fit best in asset managers where ESG research fulfils more of a compliance function. We welcome the sharing of industry practices but are wary that examples highlighted by the SFC are seen as best-in-class or ‘preferred’. We would be keen for the SFC to point out upfront that all practices highlighted are only examples and other approaches may exist.

Enhanced standards

The TCFD Recommendations provide a principles-based framework, and the examples of suggested metrics provided therewith include weighted average carbon intensity (“WACI”), portfolio carbon footprint, and total carbon emissions, amongst other metrics. Our members believe that the FMCC enhanced disclosure requirements for Large Fund Managers should not be prescribing a particular metric, but allowing Large Fund Managers the flexibility to assess and disclose the most appropriate metrics. This is especially pertinent given current limitations in data availability. We also note in the TCFD 2020 Status Report that WACI has the lowest percentage of responses across a range of carbon footprint and exposure metrics.

Should the SFC push ahead with mandating WACI, we would ask the SFC to clarify what it deems as “reasonable efforts” for Large Fund Managers to acquire or estimate the WACI of Scope 1 and 2 greenhouse gas (“GHG”) emissions for disclosures. We also suggest amending this requirement to align with the recommended disclosure in the Annex to the TCFD Recommendations in relation to GHG emissions: “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) which are assessed or covered.” Note that the Annex to the TCFD Recommendations only refers to “... GHG emissions and associated metrics should be provided for historical periods to allow for trend analysis. In addition, where not apparent, organizations should provide a description of methodologies used to calculate or estimate the metrics”, and better alignment with TCFD wording would help relieve compliance burden for fund managers as data providers providing WACI metrics also align their methodologies and associated disclosures with TCFD requirements.

Additionally, we note that the Appendix 2 Disclosure requirements for Enhanced standards do not mention the format, manner and frequency of enhanced entity and fund level disclosures. We would ask that the SFC advise its expectations on enhanced disclosure whilst noting that standardised format and reporting frequency can allow investors to compare how climate-related risks affect the assets across fund managers and/or funds.

Relevance of climate-related risks

We agree that passive strategies should not automatically be carved out from the requirements wholesale. In particular, enhanced disclosure on the management of relevant and material climate-related risks across both active and passive funds is ultimately for the benefit of the end consumer to make informed choices, and consistent disclosure facilitates comparability. Moreover, we appreciate the SFC’s acknowledgement that certain funds which adopt a full replication strategy, in respect of which climate-related risks are considered by the manager as being irrelevant, may justify being carved out from the requirements.

However, our members who manage passive funds are concerned about the way the SFC has in Paragraph 54 suggested that for partial replication and enhanced passive strategies, passive fund managers can identify investee companies with high sustainability risks or poor ESG ratings and adjust the weights of portfolio constituents accordingly, or else exclude them from the portfolio within an acceptable tracking error range. Assuming the SFC adopts the PRI’s definition of “partial replication” and “enhanced passive” strategies, it is important to note that, even for a partial replication or enhanced passive fund, unless that fund’s offering document expressly informs investors that the manager will take ESG considerations into account to ‘mis-weight’ or exclude constituents (which runs the risk of increasing tracking error), it would be misleading to investors and counter to the manager’s fiduciary obligation to do so.

A passive index fund – whether fully replicating or partial replicating – has an objective of providing exposure to an underlying index and in doing so minimising tracking error. An enhanced passive fund is in fact not entirely passive, as it adopts restricted active strategies with the objective to either reduce downside risk relative to the index or beat the index’s performance and will often have an explicit tracking error tolerance level. In either case, the fund’s disclosure must be clear about what considerations are taken into account to construct the fund’s portfolio. Accordingly, for an existing index fund product, we do not see it as appropriate for the SFC to suggest or encourage the manager to inject additional considerations into the portfolio construction process. Of course this does not preclude a manager from deciding to amend the investment objective and strategy of an index fund (with the required approval from the SFC, appropriate updates to the offering documents and advanced notice to investors), but any such amendment to investment strategy should be a decision for the manager, which may or may not be motivated by investor demand, rather than being compelled to do so by regulation.

Although passive funds have limited scope to factor climate-related considerations into the portfolio construction process as discussed above, our passive fund manager members wish to point out that ESG considerations can still be relevant to passive funds in several ways. Managers may consider it appropriate to use voting proxies and engagement with investee companies or index providers to manage material ESG risks, though not all managers will decide to do so. Again, any adjustment to engagement strategies should be a decision for the manager, and not due to regulation.

Finally, in order to pursue climate-related and/or ESG objectives, passive managers may also choose to launch index funds that track an ESG index (where ESG considerations are embedded into the index methodology) or change the underlying index of an existing fund to an ESG index.

Implementation by passive funds

As stated above, our members agree that climate-related risks are not always irrelevant to passive funds, and thus passive funds should not enjoy an automatic carve-out from all requirements (i.e. the carve-out should only apply where the manager has assessed that climate-related risks are irrelevant). However, as illustrated by the discussion above, even where the manager considers climate-related risks to be relevant, passive funds have limited scope to factor climate-related considerations into the portfolio construction process, and as a result these managers will encounter difficulty in complying with the prescriptive requirements set out in the “Investment Management” section of the proposed baseline requirements. Similarly, passive managers find it challenging to fulfil the “Risk Management” requirements due to the prescriptive nature of how they have been drafted. We therefore suggest that the SFC takes reference from the Singapore MAS’ approach and include in the proposed circular, an express acknowledgement, or similar wording, as follows:

“Note: Fund managers’ approach to managing environmental risk could be influenced by the investment objective and strategy (active versus passive) of the fund that they manage. Passive managers have limited leeway in their research and portfolio construction process beyond benchmark selection and engagement of index providers on universe of sustainable indexes. Similarly, active managers may be constrained in the extent to which they can deviate from a reference benchmark or index. Where such constraints exist, fund managers are expected to implement the requirements under the Investment Management and Risk Management sections (and corresponding requirements in the Disclosure section) of this circular in a way that is appropriate to and commensurate with the fund’s strategy.”

Specific drafting comments

Proposed new Paragraph E under Appendix 2 of the FMCC: Paragraph E2 should be amended as follows: *“A Fund Manager should establish and maintain effective systems, policies and procedures to: (i) identify relevant and material climate-related risks...” This would better align with wording of Paragraph 3.11.1 of the FMCC, which refers to risks which are both relevant and material.*

Given that the SFC is minded to primarily make reference to the TCFD Recommendations, we suggest amending as follows for better alignment with the wording of the TCFD Recommendations:

- Governance – Baseline – Board’s and management’s roles and responsibilities, 3rd bullet: “~~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 of the status of incorporating climate-related considerations into the investment and risk management processes through appropriate reporting and escalation~~ about climate-related issues”.
- Disclosure – Baseline – Governance 2nd bullet: “~~the process and frequency by which the board or the board committee is informed of the status of incorporating climate-related considerations into the investment and risk management processes~~ about climate-related issues”.

Disclosure – Baseline – Manner and frequency of disclosures, 3rd bullet: We suggest amending the requirement to “~~review and update disclosures at least annually and inform fund investors of any material changes made as soon as practicable~~ update disclosures where considered appropriate.” Whilst an annual review may be reasonable, disclosures should only be required to be update when considered appropriate and necessary by the manager. More importantly, it does not make sense to inform fund investors every time material changes are made to firm-wide policies and processes, especially in a nascent area such as sustainability which is expected to evolve, where changes could well be material but not decision-useful. Managers should be able to exercise their own judgement as to whether and how investors are notified of changes to such policies and procedures.

- Q6. To provide a clear picture to investors on whether a fund manager has integrated climate-related considerations into its investment strategies or funds, do you agree that if the fund manager considers that climate-related risks are irrelevant to certain investment strategies or funds, it should make disclosures and maintain appropriate records to explain the rationale for its assessment?**

We believe it is reasonable that fund managers should make disclosures and maintain appropriate records to explain the rationale for its assessment.

- Q7. Do you agree that climate-related disclosures (except for the disclosure of WACI) to investors should be made at an entity level at a minimum and supplemented with disclosures at a strategy or fund level to reduce burden on fund managers?**

We agree that climate-related disclosures (except WACI) should be made at the entity level at a minimum and supplemented with disclosures at the strategy or fund level. We also note that there will be updates to the Green or ESG Funds circular which will impose additional disclosure requirements for Green or ESG Funds, including Climate Funds, regardless of the managers’ AUM.

- Q8. Do you agree that disclosures of quantitative climate-related data such as WACI should only be applicable to Large Fund Managers having regard to the resources required and the size of assets covered? Do you agree that at the initial stage the disclosure of the WACI should be made at the fund level instead of the entity level?**

As mentioned in Question 5 Enhanced standards, some of our members do not believe that the proposed requirements should prescribe WACI in preference to other metrics which are suggested by the TCFD Recommendations.

Notwithstanding this, the general view is that significant issues with the WACI calculation remain. For example, although we can see from the formula how it would apply to corporate fixed income issuance, it is less clear for rates and sovereigns, or securitized assets such as mortgage-backed securities, for instance, for a pool of residential mortgages. It is also unclear if short positions or credit default swap (“CDS”) would constitute negative positions in the calculation. Any attempt to disclose WACI at the entity level would potentially be further complicated by consolidation issues.

Product-level information is most useful for investors because it can help inform their decisions about whether to choose a particular product. We believe that quantitative entity level disclosures are useful but secondary information. If SFC proceeds with the enhanced disclosure requirement for WACI, we agree that WACI should only be made at the fund level. We do not believe entity level WACI metrics are decision-useful and object to their becoming a regulatory requirement initially or in the future.

Q9. Do you think the following transition periods are appropriate?

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

If not, what do you think would be an appropriate transition period? Please set out your reasons.

We believe that the proposed implementation period is too aggressive. We are cognisant of the implementation timeline (and Covid-19 related delays in implementation) of similar sustainable finance regulation in the EU which many of our members are also subject to. We would prefer a 12-month and 18-month transition period for large fund managers to comply with baseline requirements and enhanced standards respectively and an 18-month transition period for other fund managers, especially as the SFC proposal allows reference to group-based policies and practices, which most of our members are still fine-tuning in response to the aforementioned developments in the EU.