Management and disclosure of climate-related risks by Hong Kong fund managers

DENTONS

November 8, 2021

On 5 November 2021, Hong Kong Green and Sustainable Finance Cross-Agency Steering Group expressed its support on the goals of COP26 and reaffirmed its commitment to strengthen Hong Kong's financial ecosystem for a green and more sustainable future. With global attention on COP26 this month and Hong Kong as a key international capital markets, asset management and funds centre, it is apt that we draw attention to the requirements on Hong Kong fund managers in the management and disclosure of climate-related risks.

Under Hong Kong's green and sustainable finance policy agenda, in October 2020 the Hong Kong Securities & Futures Commission (**SFC**) launched a "Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers", which proposed new requirements for Hong Kong managers of collective investment schemes to take into account climate-related risks in the investment and risk management processes and make appropriate disclosures to meet investors' growing demand for climate risk information and to combat greenwashing. Our team submitted a detailed consultation response to the SFC, which acknowledged and addressed several key points we raised in the consultation conclusions published in August 2021. Under the consultation conclusions, the SFC issued the final form of amendments to the Fund Manager Code of Conduct (**FMCC**) to introduce the new requirements, together with a circular to licensed corporations on management and disclosure of climate-related risks by fund managers (**Climate-related Risks Circular**) setting out the expected standards for complying with the new FMCC requirements.

The FMCC requirements on climate-related risks cover four key elements, namely governance, investment management, risk management and disclosure, which have been developed with reference to the Recommendations of the Taskforce for Climate-related Financial Disclosures (**TCFD**) of the Financial Stability Board, the international body for the global financial system. Hong Kong's expressed policy intention is to have mandatory TCFD disclosures for all relevant sectors by 2025. The Climate-related Risks Circular outlines the expected compliance standards involving baseline requirements for all fund managers of collective investment schemes, whereas those with collective investment schemes which equal or exceed HK$8 billion in fund assets for any three months in the previous reporting year (**Large Fund Managers**) are further subject to enhanced standards.

The requirements apply to fund managers that have discretion over investment management processes, although where fund managers delegate the investment management function to sub-managers, they retain the overall responsibility for complying with the SFC's requirements. Discretionary account managers are out of scope under the new FMCC requirements.

Baseline requirements with respect to governance include having to define the board's or the board committee's role in oversight of the incorporation of climate-related considerations into the investment and risk management processes, and to assign roles and responsibilities to management-level positions or management committees for managing climate-related risks. There are also requirements, among others, to determine how to monitor and to regularly inform management regarding the status and progress of efforts to manage climate-related risks, and to set goals and develop action plans to address and manage them.

In the area of investment management, baseline requirements include having to identify relevant and material physical and transition climate-related risks, liability risks that may be triggered by physical or transition risks that should also be taken into account and, in addition, where climate-related risks may have implications for other financial risks. The requirements are applicable subject to the relevance and materiality of climate-related risks to the investment strategies and funds managed by the fund managers, as well as to their roles. Fund managers will need to identify relevant and material climate-related risks for each investment strategy and fund they manage and, where relevant, factor material climate-related risks into the investment management process. This may involve including such risks in the investment philosophy and strategies, and incorporating the climate-related data into research and analysis processes. If climate-related risks are assessed to be irrelevant to certain investment strategies or funds, the fund manager should disclose this and maintain appropriate records explaining why they are irrelevant.

In relation to risk management, the baseline requirements include taking climate-related risks into consideration in risk management processes and to 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 managed, and to apply appropriate tools and metrics to assess and quantify climate-related risks.

To the extent where climate-related risks are assessed to be relevant and material to an investment strategy or a fund managed by a Large Fund Manager, enhanced standards would apply, which involve assessing the relevance and utility of scenario analysis in evaluating the resilience of investment strategies to climate-related risks under different pathways and taking 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, and to define the calculation methodology and underlying assumptions. Fund managers are encouraged to include Scope 3 GHG emissions if data is available.

Disclosure requirements apply to fund managers who are responsible for the overall operation of the funds, with baseline requirements for disclosures at entity level on the governance structure, the board's roles and oversight, the management's roles and responsibilities, and the investment and risk management framework and processes. Large Fund Managers are further subject to enhanced standards which involve disclosing the engagement policy at the entity level and implementation, as well as the portfolio carbon footprints of the Scope 1 and Scope 2 GHG emissions associated with the funds' underlying investments at the fund level, the calculation methodology, underlying assumptions and limitations, and the proportion of investments which are assessed or covered. Disclosures should be reviewed at least annually (including the relevance and materiality of climate-related risks if earlier assessed and disclosed to be irrelevant), with updates where considered appropriate, and fund investors should be informed of any material changes as soon as possible.

Where applicable, fund managers may leverage on group resources and staff, adopt group policies and procedures, and rely on group disclosures to satisfy the FMCC requirements, provided they are subject to similar or higher standards. The local Hong Kong management retain responsibility to ensure compliance with the SFC requirements.

There is a transition period of 12 months (i.e. August 2022 for Large Fund Managers) to 15 months (i.e. November 2022 for other fund managers and for enhanced standards applicable to Large Fund Managers) to comply with the new FMCC requirements on climate-related risks.

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