SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers

October 2020

Contents

Foreword

The Securities and Futures Commission (SFC) invites market participants and interested parties to submit written comments on the proposals discussed in this consultation paper or to comment on related matters that might have a significant impact upon the proposals by no later than 15 January 2021. Any person wishing to comment on the proposals on behalf of any organisation should provide details of the organisation whose views they represent.

Please note that the names of the commentators and the contents of their submissions may be published on the SFC's website and in other documents to be published by the SFC. In this connection, please read the Personal Information Collection Statement attached to this consultation paper.

You may not wish your name or submission to be published by the SFC. If this is the case, please state that you wish your name, submission or both to be withheld from publication when you make your submission.

Written comments may be sent as follows:

By mail to:	The Securities and Futures Commission 54/F One Island East 18 Westlands Road Quarry Bay, Hong Kong Re: Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers
By fax to:	(852) 2284-4660
By online submission at:	https://apps.sfc.hk/edistributionWeb/gateway/EN/consultation/
By e-mail to:	2020_Climate_Consultation@sfc.hk

All submissions received before the expiry of the consultation period will be taken into account before the proposals are finalised and a consultation conclusions paper will be published in due course.

Securities and Futures Commission
Hong Kong

October 2020

Personal information collection statement

1. This Personal Information Collection Statement (PICS) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data[1] will be used following collection, what you are agreeing to with respect to the SFC's use of your Personal Data and your rights under the Personal Data (Privacy) Ordinance (Cap. 486) (PDPO).

Purpose of collection

2. The Personal Data provided in your submission to the SFC in response to this consultation paper may be used by the SFC for one or more of the following purposes:

   (a) to administer the relevant provisions[2] and codes and guidelines published pursuant to the powers vested in the SFC;

   (b) in performing the SFC's statutory functions under the relevant provisions;

   (c) for research and statistical purposes; or

   (d) for other purposes permitted by law.

Transfer of Personal Data

3. Personal Data may be disclosed by the SFC to members of the public in Hong Kong and elsewhere as part of this public consultation. The names of persons who submit comments on this consultation paper, together with the whole or any part of their submissions, may be disclosed to members of the public. This will be done by publishing this information on the SFC website and in documents to be published by the SFC during the consultation period or at its conclusion.

Access to data

4. You have the right to request access to and correction of your Personal Data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your Personal Data provided in your submission on this consultation paper. The SFC has the right to charge a reasonable fee for processing any data access request.

Retention

5. Personal Data provided to the SFC in response to this consultation paper will be retained for such period as may be necessary for the proper discharge of the SFC's functions.

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[1] Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance (Cap. 486).

[2] The term "relevant provisions" is defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) and refers to the provisions of that Ordinance together with certain provisions in the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32), the Companies Ordinance (Cap. 622) and the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615).

Enquiries

6. Any enquiries regarding the Personal Data provided in your submission on this consultation paper, or requests for access to Personal Data or correction of Personal Data, should be addressed in writing to:

   The Data Privacy Officer
   The Securities and Futures Commission
   54/F One Island East
   18 Westlands Road
   Quarry Bay, Hong Kong

7. A copy of the Privacy Policy Statement adopted by the SFC is available upon request.

Executive summary

1. In recent years, climate change has increasingly been recognised as a source of extreme risk. It also poses potential financial risks for businesses. Some international organisations project that massive additional energy-related investments will be needed[3] to limit the global average temperature increase to 1.5°C above pre-industrial levels and prevent climate change from causing irreversible damage to ecosystems, societies and economies. These concerns have contributed to the development of green finance.

2. In September 2018, the Securities and Futures Commission (SFC) announced a strategic framework to contribute to the development of green finance in Hong Kong. One priority was to engage with the asset management industry to formulate an appropriate regulatory response to climate change, and as part of this effort the SFC conducted a survey of asset managers and assets owners in Hong Kong. The results, published in December 2019, suggested that most of the asset managers surveyed generally considered environmental, social and governance (ESG) factors, which included the risks arising from climate change, but they did not take a consistent approach to disclosing this information and integrating climate-related risks into their investment decisions. In addition, only a limited number of asset managers had processes in place to manage the financial impact of climate-related risks. These practices may not meet the expectations of asset owners and they are not on par with the latest international developments in this area.

3. The SFC proposes to amend the Fund Manager Code of Conduct (FMCC) (see Appendix 1) to require fund managers to take climate-related risks into consideration in their investment and risk management processes as well as to make appropriate disclosures to meet investors' growing demand for climate risk information and to combat greenwashing[4]. The SFC proposes to issue a circular setting out baseline requirements and enhanced standards for larger fund managers (see Appendix 2). These measures can improve the comparability of information across different fund managers to help investors make more informed decisions.

4. The SFC's proposed requirements would apply to fund managers which manage collective investment schemes (CISs) but at the initial stage they would not be mandatory for fund managers which manage discretionary accounts (in the form of an investment mandate or a pre-defined model portfolio). The proposed requirements would cover four key elements: governance, investment management, risk management and disclosure. The proposed governance, investment management and risk management requirements would apply to fund managers which have discretion over investment management and risk management processes irrespective of whether they are overall responsible or manage only part of a fund. The proposed disclosure requirements would be applicable to fund managers which are responsible for the overall operation of funds[5], ie, they are not applicable to those who manage only part of a fund.

5. While the proposed baseline requirements would apply to all fund managers, their implementation would be subject to the principle of proportionality having regard to factors

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[3] For example, the Intergovernmental Panel on Climate Change estimates that US$830 billion will be required each year.
[4] For example, when asset managers market themselves as "green" or "sustainable" but do not fully integrate these factors into their investment management processes.
[5] For the meaning of a fund manager that is responsible for the overall operation of a fund, see answer to question 1 of FAQs on the FMCC.

such as the size and complexity of a fund manager's business and the investment strategies adopted by the funds under its management. Fund managers with assets under management (AUM)[6] of HK$4 billion or above (Large Fund Managers) would be required to adopt a more robust approach and make more detailed disclosures.

6. The disclosure requirements for all fund managers would be applicable at an entity level[7] to the extent that climate-related risks are considered to be relevant. The SFC acknowledges the importance of providing quantitative information for investors to evaluate the depth of a fund manager's climate-related practices and capabilities. As such, Large Fund Managers would be required to make additional quantitative disclosures of weighted average carbon intensity (WACI) at a fund level (see Appendix 5).

7. To foster the development of a more consistent disclosure framework and minimise the industry's compliance burden, the SFC has made reference to the widely endorsed Task Force on Climate-related Financial Disclosures (TCFD) Recommendations in developing these proposed requirements and standards.

8. In rare instances where fund managers consider that climate-related risks are irrelevant to their investment and risk management processes for certain investment strategies or funds, they should make corresponding disclosures and maintain appropriate records of justifications.

9. Global fund managers which adopt group-wide policies and make a single set of group-wide disclosures may make reference to them to satisfy the SFC's requirements provided that they are subject to similar or higher standards than our proposed requirements and that they explain how the group-wide policies and practices are being adopted locally.

10. The SFC established a Climate Change Technical Expert Group (TEG)[8] in March 2020 to help develop expected standards, practical guidance and industry practices for integrating climate-related risks into fund managers' investment and risk management processes. Two TEG meetings and four sub-committee meetings were held between March and July 2020. The SFC also conducted soft consultations with industry associations and representatives to solicit their views and suggestions on the key proposals, and has taken their comments into account in developing the proposed requirements. The SFC would like to thank members of the TEG and industry associations for their input which has been very helpful in formulating this consultation paper.

11. The SFC invites market participants and interested parties to submit written comments on the proposals and implementation timeline discussed in this consultation paper by 15 January 2021.

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[6] Refers to total fund assets and discretionary account assets managed by a fund manager. This covers cases where the fund manager is responsible for managing the entire fund or discretionary account and where it is being appointed to manage part of the fund or the discretionary account.

[7] Fund managers should make disclosures at an entity level as a minimum and can choose to disclose at a fund level if appropriate.

[8] The TEG comprises technical experts from global asset management companies, information providers and standard-setting bodies.

Developments in green finance

(A) Background

12. A priority in the SFC's strategic framework[9] to contribute to the development of green finance in Hong Kong is to engage with the asset management industry to formulate appropriate policies, codes and guidance, and to work towards obliging fund managers to disclose how and to what extent they consider ESG factors in their investment processes and risk assessments.

13. The SFC engaged an external consultant to conduct a survey of asset managers and asset owners in Hong Kong (ESG survey) which focused on their sustainable investment practices (including their commitment, investment processes, post-investment ownership practices and ESG disclosures). The survey results, published by the SFC in December 2019[10], indicated that while most asset managers generally considered ESG factors, they did not take a consistent approach to integrating these factors into their investment and risk management processes and disclosing them. In addition, only a few asset managers had processes in place to manage the potential financial effects associated with climate-related risks. These practices fell short of the expectations of asset owners and the latest international developments in this area. Setting out regulatory standards for the management and disclosure of climate-related risks by asset managers would help address these concerns.

14. The Stock Exchange of Hong Kong Limited (the Exchange) published consultation conclusions[11] on its review of the ESG reporting guide and related listing rules in December 2019. The Exchange enhanced the ESG reporting framework by (a) mandating that issuers disclose a board statement setting out the board's consideration of ESG matters, follow four reporting principles in preparing ESG reports and disclose the process used to identify specific entities or operations included in the ESG report; and (b) enhancing the disclosure requirements in relation to environmental and social factors (eg, requiring disclosure of significant climate-related issues which have impacted and may impact the issuer). In addition, the Exchange shortened the deadline for listed companies to publish ESG reports and allowed them to be published online.

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[9] *Strategic Framework for Green Finance*, 21 September 2018.
[10] *Survey on Integrating Environmental, Social and Governance Factors and Climate Risks, in Asset Management*, 16 December 2019.
[11] *Consultation Conclusions – Review of the Environmental, Social and Governance Reporting Guide and Related Listing Rules*, 18 December 2019.

(B) Latest international developments

15. Globally, sustainable finance is advocated by a wide range of international organisations and initiatives. Some, including TCFD[12], have developed global standards for financial disclosures. Others, including the Network of Central Banks and Supervisors for Greening the Financial System (NGFS), Sustainable Finance Network of the International Organization of Securities Commissions (IOSCO) and the International Organisation of Pension Supervisors (IOPS), are helping global supervisory authorities to identify and develop principles to address issues relating to sustainability or environmental risks.

16. For instance, in October 2019, IOPS issued supervisory guidelines on the integration of ESG factors in the investment and risk management processes of pension funds and the disclosures of ESG factors in these processes. IOSCO also published a report[13] in April 2020 to provide an overview of existing sustainability and climate change initiatives and key areas for improvement by securities regulators. The report highlighted three recurring issues:

    (i) multiple and diverse sustainability frameworks and standards;

    (ii) a lack of common definitions for sustainable activities; and

    (iii) greenwashing and other investor protection challenges.

Task Force on Climate-related Financial Disclosures

17. Of the international standards, the TCFD Recommendations[14] released in June 2017 are the most widely endorsed by the financial industry and diverse stakeholders including governments, regulators, stock exchanges, banks, insurers and investors.

18. The TCFD Recommendations cover four thematic areas:

    (a) Governance: Disclose the organisation's governance around climate-related risks and opportunities;

    (b) Strategy: Disclose the actual and potential impact of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning, where such information is material;

    (c) Risk management: Disclose how the organisation identifies, assesses and manages climate-related risks; and

    (d) Metrics and targets: Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities, where this information is material.

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[12] The TCFD was established by the Financial Stability Board in December 2015 at the G20's request. It is an industry-led working group tasked with creating a set of comparable and consistent disclosure standards which companies can use to demonstrate climate change resilience to their capital providers.

[13] IOSCO's *Sustainable Finance and the Role of Securities Regulators and IOSCO – Final Report*, April 2020.

[14] The TCFD's *Final Report – Recommendations of the Task Force on Climate-related Financial Disclosures*, June 2017.

Principles of Responsible Investment

19. The United Nations-supported Principles for Responsible Investment[15] (PRI) announced that its high priority is supporting the adoption of the TCFD Recommendations as they provide a global framework for translating climate-related information into financial metrics[16]. The PRI has included climate-related indicators which align with the TCFD Recommendations in its Reporting Framework and published the *PRI Reporting Framework 2020: Strategy and Governance (Climate-related indicators only)*[17] in November 2019 to provide guidance on implementing the TCFD Recommendations.

Latest developments in other jurisdictions

20. Climate-related risks are increasingly cited as a major priority on the global agenda, with calls for immediate action from leaders around the world[18]. Many countries have accelerated the development of legal or regulatory frameworks for sustainable finance. The practices in mainland China, Singapore, the European Union (EU), France, the UK and New Zealand are set out in Appendix 4.

(C) The SFC's green finance initiatives

International

21. The SFC recognises that it is vital to be aligned with international developments in sustainable finance. We are working closely with the NGFS, IOSCO and the PRI and drawing upon the experiences of international counterparts in developing our policy and supervisory approaches.

Local

22. The SFC collaborates with the government, other financial regulators and the industry to promote sustainable finance in Hong Kong. Following the SFC's approval, the Exchange published its amendments to the ESG rules in December 2019. Together with the Hong Kong Monetary Authority (HKMA), the SFC recently launched a Green and Sustainable Finance Cross-Agency Steering Group[19] to coordinate the management of climate and environmental risks facing the financial sector.

23. The SFC also works with the Investor and Financial Education Council, other regulators, industry associations and stakeholders to enhance capacity building and investor awareness of green finance.

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[15] As of March 2020, the PRI had over 3,000 signatories including asset owners, investment managers and service providers.
[16] See PRI's press release "*TCFD-based reporting to become mandatory for PRI signatories in 2020*", February 2019.
[17] *PRI Reporting Framework 2020: Strategy and Governance*, November 2019.
[18] See the *World Economic Forum's Global Risks Report 2020*, January 2020 — for the first time in the Global Risks Perception Survey, environmental concerns dominated the top long-term risks by likelihood and three of the top five risks by impact.
[19] Other members include the Environment Bureau, Financial Services and the Treasury Bureau, Hong Kong Exchanges and Clearing Limited, the Insurance Authority and the Mandatory Provident Fund Schemes Authority.

Figure 1 – Joint work with the Government, local authorities and the industry

Sep 2018
Announced a strategic framework for green finance

Apr 2019
Published a circular to provide disclosure guidance for SFC-authorised funds with green or ESG themes and focus

Dec 2019
Worked with the Exchange on its consultation conclusions on enhancing ESG disclosures by listed issuers

May 2020
Launched a Cross-Agency Steering Group jointly with the HKMA to coordinate the management of climate and environmental risks facing the financial sector

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Proposed area of focus

Climate change

24. Globally, there are two main types of requirements or standards for promoting sustainable development. One focuses on ESG or sustainability factors (eg, the EU regulation on sustainability-related disclosures and IOPS's guidelines on the integration of ESG factors in the investment and risk management of pension funds) while the other focuses on climate change or environmental factors (eg, the TCFD Recommendations). In addition, given the increasing importance of sustainable finance, there has been a notable trend towards adopting reporting obligations for ESG and climate-related information.

25. The SFC acknowledges the importance of ESG factors and we encourage fund managers to consider a broader spectrum of sustainability risks. However, we propose to focus initially on the climate-related risks relevant to each investment strategy and fund having regard to the following:

    (a) It has been widely recognised that continued greenhouse gas (GHG) emissions will cause further warming of the planet and this trend could have disastrous economic and social consequences. Moreover, the impact of climate change, which is measured by the concentration of GHG emissions in the atmosphere, may be irreversible.

    (b) More extreme weather events and global warming have disrupted supply chains, restricted production capacity and increased business costs with consequences for the accurate pricing of financial assets in capital markets. According to the Intergovernmental Panel on Climate Change (IPCC), human activities are estimated to have caused approximately 1°C of global warming above pre-industrial levels, while this may reach 1.5°C between 2030 and 2052 if the present rate of global warming continues[20].

    (c) There is a broad consensus that urgent action is needed to address the threat of climate change. The IPCC estimated that additional energy-related investments of around US$830 billion will be needed each year for the period from 2016 to 2050 in order to keep global warming to 1.5°C. Clearly, public funds alone cannot meet this need and more private capital needs to be channelled into sustainable investments.

    (d) Climate change is regarded as a source of financial risk by the NGFS[21] and it falls squarely within the mandates of financial regulators to ensure the financial system is resilient to these risks. It is therefore appropriate to require fund managers to take climate-related risks into account when managing their investment portfolios.

    (e) The SFC's ESG survey indicated that climate-related risks were not sufficiently appreciated by the industry. Of the asset management firms surveyed which had considered at least one ESG factor when evaluating a company's investment potential, only 23% had processes in place to manage the financial impact of climate-related risks. We consider it imperative to raise the industry's awareness of the importance and relevance of climate-related risks and to urge immediate action to address them.

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[20] *IPCC Special Report on Global Warming of 1.5°C*, IPCC, 2018.
[21] *A call for action – Climate change as a source of financial risk*, NGFS, April 2019.

26. To transition to a low-carbon economy, fund managers should focus not only on green-related investments but also on the management of risks associated with assets which are considered "brown"[22]. Fund managers should understand and monitor how investee companies deal with climate change and, where appropriate, encourage them to develop policies for handling the climate-related risks inherent in their businesses (eg, climate mitigation or climate adaptation) through active engagement rather than merely reducing the fund's exposure to climate-related risks through divestment.

Question:

1. 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.

Definitions of climate-related risks

27. The following major risks associated with climate change may affect asset values:

(a) Physical risks: Extreme climate-related weather events and progressive, longer-term shifts in climate patterns may have financial implications for companies either directly, such as from damage to assets, or indirectly from supply chain disruptions or reduced productivity;

(b) Transition risks: Risks associated with the ongoing viability of a business as the high-carbon economy transitions to a low-carbon economy (eg, reduced demand for commodities, goods and services with a high carbon footprint owing to changing consumer preferences or government policies); and

(c) Liability risks: A person or company may seek compensation for losses caused by climate change.

[22] For example, high carbon and climate-risk inducing investments.

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Proposed requirements for climate-related risks

28. In introducing the proposed requirements for fund managers, the SFC aims to achieve the following objectives:

    (a) increase awareness of the impact of carbon emissions and the associated risks;

    (b) ensure proper handling of climate-related risks, which are a source of financial risk;

    (c) promote clear, comparable and high-quality disclosures so as to provide more useful information for investors to make informed decisions and combat "greenwashing"; and

    (d) develop appropriate regulatory requirements in a constantly evolving environment where different terminologies are in circulation and methodologies are evolving.

29. With these objectives in mind, the SFC proposes to amend the FMCC to provide high-level principles and set out baseline requirements and enhanced standards for complying with the FMCC in a circular to the industry. The proposed requirements are not intended to single out climate-related risks from other investment risks but rather to require fund managers to properly consider climate-related risks during their investment and risk management processes. Please refer to Appendix 1 and Appendix 2 for details of the proposed requirements.

30. The flowchart in Appendix 3 summarises how the proposed requirements are applied under different circumstances.

(A) Proposed scope

31. At the initial stage, the SFC proposes that the requirements be applicable to fund managers which manage a CIS, irrespective of whether they have delegated their investment management function to other intermediaries. This is because CISs account for a significant proportion of the total AUM by licensed corporations (LCs). The requirements focus on managing the climate-related risks of these CISs rather than on LCs' own operational and financial risks posed by climate change.

32. For fund managers which manage discretionary accounts, compliance with the proposed requirements in the FMCC (as well as the baseline requirements and enhanced standards) would not be mandatory in respect of climate-related risks at this stage. Nevertheless, if a client's climate-related investment preference has been incorporated into the investment mandate of a discretionary account or a pre-defined model investment portfolio, the fund manager should ensure that it acts accordingly.

33. The proposed disclosure requirements would apply to the fund manager which is responsible for the overall operation of a fund. The proposed conduct requirements in relation to governance, investment management and risk management would apply to fund managers which have discretion over investment management and risk management processes, irrespective of whether they are overall responsible or manage only part of a fund.

34. In addition, if a fund manager responsible for the investment and risk management of a fund has appointed a third-party delegate to perform this function, the fund manager should

monitor the competence of the delegate on an ongoing basis to ensure that the proposed requirements are followed[23].

35. On the other hand, if a fund manager is a sub-investment manager of a fund with full discretion over the investment management function, it would be required to observe the proposed requirements applicable to its role.

36. A new paragraph will be added to Appendix 1 of the FMCC under "Particular requirements in the Code which are not applicable to Discretionary Account Managers" to clarify that the proposed requirements regarding the integration of climate-related risks into investment and risk management as well as the corresponding disclosure requirements are not mandatory for Discretionary Account Managers.

Paragraph added to Appendix 1 of the FMCC under "Particular requirements in the Code which are not applicable to Discretionary Account Managers"

(a) Climate-related risks

The requirement in relation to the consideration of climate-related risks and the corresponding disclosure requirements are not mandatory for a Discretionary Account Manager, except in cases where the client has requested the Discretionary Account Manager to take climate-related risks into consideration in the investment mandate. (Paragraphs 3.1A, 3.11.1(b) (for climate-related risks only) and 6.2A)

Question:

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

Fund managers adopting group-based policies and practices

37. Fund managers with overseas parent companies whose group-level governance, investment and risk management, and disclosure policies and procedures are subject to similar or higher standards than our proposed requirements can make reference to their group practices to satisfy our requirements as long as they are relevant and applicable to local operations.

38. The SFC acknowledges that some fund managers may be assisted by their overseas affiliates when carrying out supervision, investment or risk management functions (eg, centralised units may conduct ESG research, monitor risks or prepare reports). Fund managers can rely on their group practices as long as the local senior management have taken appropriate measures to ensure that the practices and standards adopted by their overseas affiliates align with our proposed requirements.

[23] Paragraph 1.10 of the FMCC.

(B) Proposed approach

Principles-based

39. When developing the proposed requirements, the SFC has been mindful that climate change-related developments are constantly evolving and we should avoid being overly prescriptive. We consider it appropriate and pragmatic to make reference to the TCFD Recommendations, which are principles-based. Even though the TCFD framework is meant to be voluntary, it has been widely adopted or supported by other jurisdictions.

Principle of proportionality

40. Under the existing FMCC, a fund manager is required to maintain a risk management governance structure and procedures which are commensurate with the nature, size, complexity and risk profile of the firm and the investment strategy adopted by each of the funds under its management[24]. As such, the principle of proportionality would be adopted to comply with the baseline requirements and enhanced standards.

41. The SFC proposes that all fund managers comply with the baseline requirements and Large Fund Managers managing funds which account for a significant market share adopt a more robust approach and make more detailed disclosures. During the soft consultations with industry associations, some respondents suggested not to adopt a two-tier approach due to concerns that this approach may potentially segment the market, with the labelling effect reinforcing the difference. We consider that requiring small fund managers to apply the same standards as Large Fund Managers may entail a disproportionate burden. Also, requiring Large Fund Managers which have more resources to implement enhanced standards would be in line with the principle of proportionality.

42. The SFC proposes that as of the annual reporting date determined by a fund manager[25], it is expected to comply with the enhanced standards until the next annual reporting date if its monthly AUM, ie, total fund assets and discretionary account assets under management[26], equals or exceeds HK$4 billion for any three months during the past 12 months[27]. This threshold is meant to be an indicative number for reference only and is subject to review from time to time to align with market developments.

43. The proposed HK$4 billion threshold was determined based on the following considerations:

    (a) The SFC made reference to overseas regulations. In France, institutions with balance sheets of less than EUR500 million (about HK$4.5 billion) are obliged to provide a general overview of how they integrate ESG factors while institutions with balance sheets of EUR500 million or above are subject to detailed mandatory reporting requirements under Article 173 of the French Law on Energy Transition and Green

[24] Paragraph 1.2(d) of the FMCC.
[25] Please refer to the section "Format and frequency of disclosures" under paragraphs 81-83 for the proposed reporting frequency.
[26] This covers both funds and discretionary accounts which are entirely or partially managed by the fund managers. For partially managed funds and discretionary accounts, only the portions delegated to the fund manager for management are included in the calculation.
[27] In the EU and under Alternative Investment Fund Managers Directive, a fund manager is required to monitor its AUM on an ongoing basis. Should its AUM exceed the reporting threshold for more than three months, the fund manager is required to be authorised by its competent authority and to fully comply with the AIFMD regime.

Growth. Under the Alternative Investment Fund Managers Directive (AIFMD)[28], fund managers which meet certain criteria including with AUM equivalent to or more than EUR500 million are also required to observe all the requirements under the directive, including the proposed requirement for the integration of sustainability risks and corresponding disclosures; and

(b) Based on the latest figures reported by LCs in their financial returns[29], of the 1,800 firms which are licensed by the SFC to conduct asset management activities, about 200 firms (representing 80% of the total reported AUM) would be classified as Large Fund Managers subject to the proposed enhanced standards.

Circular on expected standards

44. The SFC will issue a circular setting out the baseline requirements and enhanced standards for fund managers, together with sample industry practices based on inputs from the TEG members and other standard setters. The circular will provide guidance to the industry on compliance with the proposed requirements under the four key elements: governance, investment management, risk management and disclosures.

Questions:

3. 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?

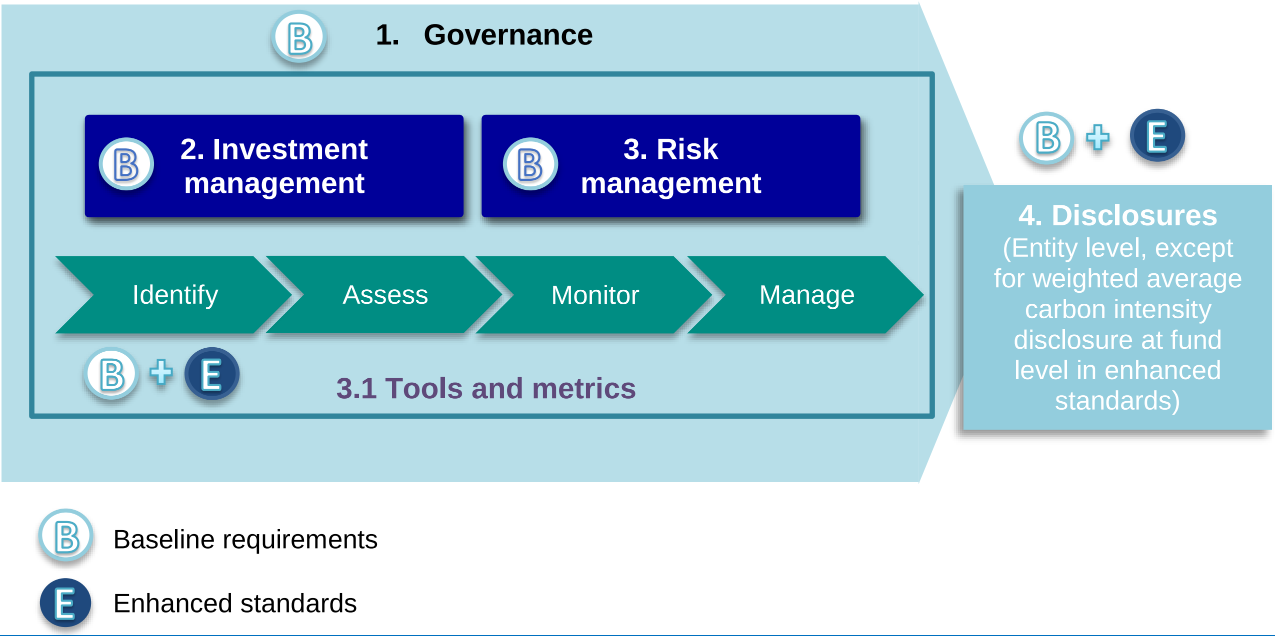
4. Do you have any comments on the proposed basis for determining the threshold for Large Fund Managers, ie, HK$4 billion, and the basis for reporting? Please explain your view.

[28] AIFMD is an EU regulation which applies to hedge funds, private equity funds and real estate funds. Please refer to Article 3(2) of Directive 2011/61/EU.

[29] Financial returns submitted by LCs in accordance with Securities and Futures (Financial Resources) Rules (Cap. 571N) for the month of June 2020.

(C) Proposed requirements

Figure 2 – Framework for the proposed SFC requirements



1. Governance

45. The involvement of the board and management are crucial to ensure the effective integration of climate-related risks across an organisation. Therefore, the SFC proposes to require the board to have oversight of the incorporation of climate-related considerations into investment and risk management processes and oversee progress against goals for addressing climate-related issues.

46. In addition, the SFC proposes to require management to maintain an appropriate management structure for managing climate-related risks and reporting to the board. The management is also required to develop action plans, establish controls and procedures and devote sufficient resources for the proper performance of their duty to manage climate-related risks. The management is also expected to set goals for addressing climate-related issues.

47. The existing provisions under paragraphs 1.2(a) – (d), 1.6 and 1.8 of the FMCC, which govern financial and human resources, internal controls and governance structures, as well as the responsibilities of senior management[30] and the compliance function, would also be applicable to the management of climate-related risks. Proposed specific governance-related requirements would be set out in a circular covering the baseline requirements for compliance with the proposed climate-related risk provisions under the FMCC (see Appendix 2).

[30] "Senior management" is defined in the FMCC as the Managing Director of a Fund Manager or its Board of Directors, Chief Executive Officer or other senior operating management personnel in a position of authority over the Fund Manager's business decisions. This includes Responsible Officers and Managers-In-Charge.

48. In developing action plans and goals, fund managers can adopt a qualitative or quantitative approach which is commensurate with their nature, size, complexity and investment strategy. Below are some industry practices for the governance of climate-related risks:

1.1 Setting action plans and goals for addressing climate-related issues

Practice 1

In a public statement, the Chief Executive Officer (CEO) of a fund manager positions the firm as the asset manager for a changing world and pledges to stay at the forefront of developments. The firm also focuses on providing long-term sustainable returns to the clients. The fund manager commits to using its investments and influence to advocate a low-carbon, environmentally sustainable and inclusive economy. It seeks to deliver long-term sustainable returns including through making better decisions by systematically and explicitly integrating ESG factors into its investment processes.

Practice 2

The Chief Executive of a fund manager states that its key priorities include assisting in the global transition to a low-carbon economy and ESG factors will affect the value of all investments, thus making ESG issues integral to sound investment decisions which preserve clients' capital and deliver long-term growth while supporting the transition to a more sustainable world.

Practice 3

A fund manager sets goals in areas including: (i) engaging with companies and raising the minimum standards set for companies each year; (ii) providing tools and education for clients by incorporating carbon data into some fund factsheets; (iii) providing investment options which address climate-related risks and explore low-carbon opportunities; and (iv) reducing carbon emissions associated with its real estate portfolio by 20% between 2010 and 2020.

Practice 4

A fund manager sets key action plans relating to energy transition, environmental sustainability and equality (3Es) to align investments with the goals of the Paris Agreement by 2025. Indicators such as Primary Energy Mix and Electricity Energy Mix; carbon intensity (gCO_2/kWh); CO_2 emissions per portfolio; green share (%) of AUM or total green investments (sustainable economic activities) would be tracked, monitored and publicly reported.

As part of this commitment, the fund manager also sets a series of near targets and equips its investment teams with a wide range of ESG analyses, tools and techniques. The fund manager arranges formal ESG training for ESG representatives of each team and screens thousands of companies against the UN Global Compact Principles and the OECD Guidelines to drive engagement, determine exclusions and develop sectoral policies addressing environmental risks. For instance, the fund manager introduced an enhanced coal policy to exclude coal-mining companies which derive more than 10% of their revenue from mining thermal coal or account for 1% or more of total global production. It also excludes coal-power generators whose carbon intensity is above the 2017 global average of $491gCO_2/kWh$.

In addition, the fund manager requires its funds to have carbon emissions intensity lower than the benchmark and an overall ESG score higher than the benchmark. Specific funds and strategies have additional requirements such as dedicating a percentage of revenue to environmental objectives or stricter requirements in terms of outperforming the benchmarks by a larger magnitude.

1.2 Governance processes for climate-related risks

Practice 5

A fund manager:
- has its CEO publicly announce the inclusion of sustainable development goals in its social and environmental responsibility policy;
- sets targets to align its investments with the goals of the Paris Agreement by 2025;
- has a sustainability centre involving experienced people from different fields which provides investment teams with company- and sectoral-level sustainability information as well as facilitates the integration of sustainability risks and opportunities into investment strategies; and
- tracks the evolution of its carbon footprint, the temperature pathways of fund portfolios, exposure to high-carbon sectors and each portfolio's green share and brown share to monitor the status of climate-related risk management.

Practice 6

A fund manager has established four committees which are monitored by the CEO and dedicated to different purposes:
- ESG Strategy Committee - Chaired by the CEO, it meets quarterly, defines the firm's global ESG policy and key orientations and validates policies and themes for engagement.
- ESG Rating Committee - Chaired by the Chief Responsible Investment Officer, it meets monthly, defines and validates ESG ratings and the evolution of the exclusion policy and integrates ESG ratings into investment strategies.
- Voting Committee - Chaired by the Chief Responsible Investment Officer who examines and validates the firm's engagement and voting policies and ensures that they relate well to key ESG engagement themes.
- Social Impact Committee - Chaired by the Chief of Social Impact investing, it meets bimonthly and manages investment strategies in social and solidarity investments.

Practice 7

A fund manager has a dedicated team to oversee the firm's sustainable investment efforts globally. This team works together with investment professionals to integrate sustainability considerations across investment processes and drive sustainable investment research. The team's progress is supervised by a designated ESG global head.

In addition, the fund manager has a risk management team which evaluates the risks of all investments, including sustainability risks, for portfolio managers' periodic review. The global executive committee, with members including the global heads of investment, oversees investment processes and consistency across the firm.

2. Investment management

49. The SFC proposes that a new paragraph 3.1A be added to the FMCC to provide that a fund manager should ensure climate-related risks are taken into account in its investment management process for funds.

> *Paragraph 3.1A of the FMCC*
>
> *A Fund Manager should ensure that climate-related risks are taken into account in its investment management process for funds.*

2.1 Identifying climate-related risks

50. Physical risks, transition risks and liability risks could have an adverse impact on the value of a wide range of financial assets. To protect the value of investors' investments, fund managers should identify climate-related risks which are relevant to their investment strategies and the funds they manage, assess their impact and prioritise material risks in their investment management processes.

51. Below are examples of climate-related risks and the potential financial impact:

Type	Climate-related risks[31]	Potential financial impact
Physical risks	Acute ▪ Increased severity of extreme weather events such as cyclones and floods Chronic ▪ Changes in precipitation patterns and extreme variability in weather patterns ▪ Rising mean temperatures ▪ Rising sea levels	▪ Reduced revenue from decreased production capacity (eg, transport difficulties, supply chain interruptions) ▪ Reduced revenue and higher costs from negative impact on workforce (eg, health, safety, absenteeism) ▪ Write-offs and early retirement of existing assets (eg, damage to property and assets in "high-risk" locations) ▪ Increased operating costs (eg, inadequate water supply for hydroelectric plants or to cool nuclear and fossil fuel plants) ▪ Increased capital costs (eg, damage to facilities) ▪ Reduced revenue from lower sales or output ▪ Increased insurance premiums and potential for reduced availability of insurance for assets in "high-risk" locations
Transition risks	Policy and Legal	
	▪ Increased pricing of GHG emissions ▪ Enhanced emissions-reporting obligations ▪ Mandates on and regulation of existing products and services ▪ Exposure to litigation	▪ Increased operating costs (eg, higher compliance costs, increased insurance premiums) ▪ Write-offs, asset impairment and early retirement of existing assets due to policy changes ▪ Increased costs or reduced demand for products and services resulting from fines and judgements

[31] The sub-category risks described under each major category are not mutually exclusive and some overlap.

	Technology	
	▪ Substitution of existing products and services with lower emissions options ▪ Unsuccessful investment in new technologies ▪ Costs to transition to a lower emissions technology	▪ Write-offs and early retirement of existing assets ▪ Reduced demand for products and services ▪ Research and development expenditures for new and alternative technology ▪ Capital investments for technology development ▪ Costs to adopt or deploy new practices and processes
	Market	
	▪ Changing customer behaviour ▪ Uncertain market signals ▪ Increased cost of raw materials	▪ Reduced demand for goods and services due to shifts in consumer preferences ▪ Increased production costs due to changing input prices (eg, energy, water) and output requirements (eg, waste treatment) ▪ Abrupt and unexpected shifts in energy costs ▪ Changes in revenue mix and sources, resulting in decreased revenue ▪ Re-pricing of assets (eg, fossil fuel reserves, land valuations, securities valuations)
	Reputation	
	▪ Shifts in consumer preferences ▪ Stigmatisation of sectors ▪ Increased stakeholder concerns or negative stakeholder feedback	▪ Reduced revenue from decreased demand for goods or services ▪ Reduced revenue from decreased production capacity (eg, delayed planning approvals, supply chain interruptions) ▪ Reduced revenue from negative impact on workforce management and planning (eg, employee attraction and retention) ▪ Reduction in capital availability

Source: Table 1 of the TCFD Recommendations

2.2 Relevance and materiality assessment of climate-related risks

52. All fund managers should adopt processes to identify the relevance and materiality of climate-related risks. When identifying such risks, fund managers are encouraged to look beyond their usual investment horizon because portfolio assets will in most cases be reinvested in similar investments. Physical and transition risks which are not likely to have a material impact in the short term may become material in the medium or long term if the portfolio assets are reinvested in similar sectors or asset classes. Fund managers should consider how such risks will affect their strategies and can be factored into their investment management processes if they may become material over time.

53. In some circumstances, a fund manager may assess that climate-related risks are irrelevant to its investment and risk management processes owing to the nature of a fund's investments or strategy (eg, a quantitative fund, forex fund or futures fund), or the time horizon of the investments (eg, day trading). Under these circumstances, the SFC proposes that the fund manager ensures its conclusions are justifiable and maintain appropriate records explaining why climate-related risks are irrelevant. The SFC also proposes that the fund manager be required to disclose the types of investment strategies or funds for which climate-related risks are considered irrelevant to enable investors to distinguish these funds. This disclosure could be made at an entity or fund level.

54. Funds adopting a passive investment strategy would not automatically be carved out from the proposed requirements. Fund managers should assess the method used to replicate the underlying index. A full replication methodology which requires buying all the index constituents may justify being carved out. However, for partial replication methodologies and enhanced passive strategies, the PRI suggests that passive fund managers 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[32]. In addition, passive fund managers could engage with investee companies which have ESG concerns to manage and monitor sustainability risks, or engage with index providers to exclude companies with high sustainability risks or poor ESG ratings from the overall index[33].

55. When assessing the materiality of the impact of climate-related risks on an investment strategy or a fund, fund managers should adopt an approach which is appropriate and proportionate to their circumstances. The approach can be qualitative, quantitative or some combination of both. Fund managers may consider adopting the methodologies suggested by international reporting frameworks, such as the Sustainability Accounting Standards Board (SASB)[34], PRI[35] and others[36], in assessing the materiality of climate-related risks. Fund managers should maintain appropriate internal records to demonstrate that they have assessed the materiality of the risks.

Qualitative approach

Fund managers may apply a qualitative approach by identifying those sectors (eg, utility and power, mining, oil and gas) which are more likely to be adversely affected by the transition to a low-carbon economy and evaluate whether the investment portfolio is unintentionally skewed towards these sectors. Moreover, the fund managers may consider the second level effects on companies within the value chain of those highly affected sectors.

For example, SASB has identified sustainability issues which would affect the financial condition or operating performance of companies within an industry and categorised them according to how likely they are to have a material impact, eg, environmental issues such as GHG emissions are very likely to have a material impact on extractives and mineral processing industries, but not likely to be material for consumer goods and services industries. Fund managers could focus on the material issues and assess their impact on each investment strategy and fund they manage.

Quantitative approach

Fund managers may also apply a quantitative approach by utilising in-house or third-party data tools to analyse a portfolio's climate-related risks in the context of weather or climate data (eg, five-year history of daily weather variables such as temperature and precipitation, extreme weather events including cyclones, earthquakes and drought) or projected climate conditions (eg, the agreed rate of sea level rise in 10, 20 or 30 years' time) and assess their likely impact on the portfolio.

[32] *A Practical Guide to ESG Integration for Equity Investing*, PRI, 2016.
[33] *Point of No Returns*, ShareAction, March 2020.
[34] See the *SASB Materiality Map®*.
[35] In the report *Implementing the TCFD Recommendations - A Guide for Asset Owners*, 2018, the PRI suggests that when prioritising climate-related risks, fund managers may also consider total portfolio risks, asset class risks, mandate or individual portfolio risks, sector risks, company or asset specific risks.
[36] In the report *Implementing the Recommendations of the TCFD*, June 2017, the TCFD cited various sources of information about sectors and industries which are potentially affected by climate-related risks.

56. If climate-related risks are considered to be material for a strategy or a fund, fund managers should comply with the proposed requirements for governance, investment management and risk management as well as the applicable disclosure requirements. If the climate-related risks identified are not material for all the funds and strategies, fund managers are only subject to the provisions on governance and are required to re-evaluate the assessment of relevance and materiality periodically and comply with the applicable disclosure requirements.

2.3 Factoring material climate-related risks into the investment process

57. If climate-related risks are considered to be material to a strategy or a fund, fund managers should take them into consideration in the portfolio construction process. Fund managers can adopt different methods and strategies including exclusionary screening, best-in-class screening, norms-based screening and impact investing. Fund managers can adopt an approach which they consider the most appropriate for their circumstances, taking into account their expertise and resources.

58. The following are some approaches adopted by the industry:

Practice 8

A fund manager has incorporated climate-related considerations into its investment process by taking steps which include: 1) using ESG scores for insight into risks and opportunities; 2) exercising investment stewardship to enhance its understanding of the investee companies and drive positive changes; 3) identifying responsible business conduct and excluding specific sectors; and 4) focusing on thematic areas such as energy transition, environmental sustainability, social equality and inclusive growth. The fund manager has also adopted sustainable investment approaches such as best-in-class and exclusionary screening.

Practice 9

A fund manager built an in-house tool which provides indicative scores capturing a company's ESG risk exposure and developed an ESG Country Scoring system for consideration by the investment teams when making investment decisions. The tool scores companies by comparing them to their peers on a range of environmental metrics including green revenue, carbon emissions intensity, stranded asset risks, integration of water risks and comprehensiveness of environment policies. At a country level, the fund manager assesses countries' vulnerability to climate-related risks by weighing the resilience of existing infrastructure and their ability to respond using financial and fiscal means. The country score includes climate change exposure and sensitivity, total country GHG emissions as well as exposure to water and heat stress.

Practice 10

A fund manager uses a "traffic light" system to assess the impact of GHG emissions on companies in a sector. For example, Scope 1 and 2 GHG emissions are regarded to have a large impact on cement and steel production companies while they have a mild impact on banks. However, Scope 3 GHG indirect emissions which occur in the upstream and downstream value chains would have a larger impact on banks if they are associated with project financing and facilities given to carbon-intensive sectors or activities.

59. The SFC proposes that the fund managers who are responsible for the overall operation of the funds should disclose to investors how they consider material climate-related risks in the portfolio construction process. If their approaches differ across various investment

strategies and funds, fund managers should explain them clearly in the disclosures. Please refer to Appendix 2 for the proposed requirements in relation to investment management.

3. Risk management

60. Fund managers would be expected to incorporate climate-related risks into their existing risk management framework[37] due to their potential adverse impact on the value of investments and in response to growing concerns of investors about climate change. The SFC proposes that paragraph 3.11.1 of the FMCC be amended to the effect that a fund manager should implement adequate procedures for identifying, assessing, managing and monitoring material climate-related risks.

61. In addition, new paragraphs would be included in *Appendix 2 - Suggested risk-management control techniques and procedures for funds* of the FMCC to elaborate on climate-related risks and our expectations of fund managers. Climate-related risks should be treated in the same manner as other material risks, including market, liquidity and counterparty risks, which a fund is or may be exposed to.

> *<u>Paragraph 3.11.1(b) of the FMCC</u>*
>
> *3.11.1 For risk management at the fund level, a Fund Manager should implement adequate risk management procedures (including risk measurements and reporting methodologies) in order to identify, measure, manage and monitor appropriately all risks:*
>
> *(a) relevant to each investment strategy; and*
>
> *(b) to which each fund is or may be exposed, such as market, liquidity, counterparty* ***<u>and climate-related risks</u>****, and other risks, including operational risks, which may be material for each fund it manages, taking into account the nature, scale and complexity of its businesses and of the investment strategy of each of the funds it manages.*
>
> *<u>New paragraph E under Appendix 2 of the FMCC</u>*
>
> *E. Climate-related risks*
>
> *1. Climate-related risks may represent physical risks which stem from the direct impact of extreme weather events and progressive, longer-term shifts in the climate patterns and transition risks associated with the transition to a low-carbon economy. Liability risks may also be triggered by the responsibility to compensate financial losses related to physical or transition risks. In addition, climate-related risks may have implications for other financial risks such as credit, market and liquidity risks.*
>
> *2. A Fund Manager should establish and maintain effective systems, policies and procedures to: (i) identify relevant climate-related risks; (ii) assess the potential impact of the identified risks on each investment strategy and fund; and (iii) monitor and manage these risks on an ongoing basis.*

[37] Paragraph 1.7.1 of the FMCC.

3.1 Tools and metrics

62. Fund managers can apply appropriate tools and metrics including carbon footprint-related metrics (eg, WACI), forward-looking metrics or physical climate-related metrics (eg, portfolio warming potential and weather-related losses for real assets) to assess and quantify climate-related risks. As stated in paragraph 55, fund managers may consider adopting the methodologies suggested by international reporting frameworks, such as SASB and PRI, in assessing the materiality of climate-related risks.

63. For climate-related risks which are assessed to be material, fund managers are expected to adopt appropriate measures to manage the risks. There are different approaches (eg, to reallocate assets under management, exercise stewardship through active engagement, vote or collaborate with other stakeholders) which fund managers may consider to adopt in managing climate-related risks.

64. If climate-related risks are considered to be relevant but assessed to be immaterial, fund managers are expected to monitor them on an ongoing basis as they do for other risks and re-evaluate their materiality assessments from time to time. Once the risks become material, eg, due to changes in investment focus, climate-related developments, government policies, technology breakthroughs or investor behaviour changes, fund managers should take appropriate steps to manage them.

Practice 11

Some fund managers:

- conduct ongoing assessments of climate-related risks, which include updating ESG scores on a periodic basis and implementing a climate monitoring dashboard with metrics related to physical and transition risks;
- establish appropriate processes for the timely escalation and reporting of significant issues noted during risk monitoring to the board or other appropriate functional units, such as the investment management function; and
- regularly review the effectiveness of their risk management systems to ensure that any potentially significant deterioration in climate-related risk is followed up promptly.

Practice 12

Some fund managers engage with investee companies by:

- establishing policies and internal guidelines which set out engagement priorities and objectives when engaging with investee companies;
- having regular discussions with investee companies to understand their policies and activities to manage climate-related risks and opportunities;
- seeking commitments from investee companies and monitoring their progress in addressing climate-related concerns; and
- using their voting authority to drive investee companies to enhance disclosures and practices related to climate-related matters to make more data available and better assess climate-related risks. This may involve:
  - establishing voting policies and guidelines which set out expectations of investee companies for handling climate-related matters (eg, consistent and decision-useful disclosures which are in line with SASB standards and TCFD Recommendations); and
  - voting against the re-election of the company directors and senior executives of investee companies with poor ESG scores or lacking adequate governance or disclosures for climate-related matters.

65. In addition, Large Fund Managers are expected to adopt a more robust and systematic approach to climate-related risks management. This includes using commonly adopted quantitative metrics to identify and assess the impact of climate-related risks on the underlying investments.

66. GHG emissions data is the most common metric used by the industry to assess the impact on an investment of the transition to a low-carbon economy. A number of global fund managers have adopted GHG emissions data as a metric to monitor climate-related risks in their underlying portfolios and report it in their corporate publications. Specific indicators have been developed or are being developed for different sectors (eg, listed companies, private companies, real estate and fixed income) to provide sector-specific measurements of climate-related risk exposures. At this initial stage, the SFC proposes that Large Fund Managers be required to make reasonable efforts to acquire or estimate the WACI[38] of Scope 1 and Scope 2 GHG emissions for funds under management for risk management purposes if climate-related risks are assessed to be material. The TCFD recommends the disclosure of Scope 1 and Scope 2 GHG emissions and WACI is comparable across portfolios of different sizes and asset classes.

67. The SFC also proposes that, at the initial stage, Large Fund Managers be required to assess the relevance and utility of scenario analysis for evaluating the resilience of their investment strategies to climate-related risks under different pathways, and to keep an internal record of the assessment. If the assessment result proves to be relevant and useful, Large Fund Managers will also be required to develop a plan to implement scenario analysis within a reasonable timeframe. Large Fund Managers may make reference to the climate scenarios and scenario data provided by the NGFS[39] in developing the scenario analysis.

68. Please refer to Appendix 2 for the proposed requirements in relation to risk management. Below are some tools and metrics adopted by the industry:

Theme options	Sample metrics
Carbon footprint related	▪ WACI (Scope 1, 2 or 3) ▪ carbon footprint ▪ carbon intensity and exposure to carbon-related assets
Relative or attribution analysis	▪ comparing carbon footprint-related metrics against benchmarks, other portfolios and peers ▪ breakdown of portfolio's carbon footprint to demonstrate contribution by sector and company
Forward-looking metrics or physical climate-related risk metrics	▪ portfolio warming potential ▪ climate value-at-risk ▪ percentage or absolute value of assets exposed to identified key indicators of physical climate risks in specific geographic areas, including sovereign risk ▪ weather-related potential losses for real assets

[38] WACI represents a portfolio's exposure to carbon-intensive companies, expressed in tons of carbon dioxide equivalent emissions per million dollar revenue generated by the underlying investee companies. Please refer to Appendix 5 for the formula for calculating WACI.
[39] Please refer to the NGFS's press release on 24 June 2020.

Risk analysis

In assessing the impact of climate-related risks on underlying investments, fund managers can make reference to available research and methodologies. For example, the NGFS published[40] an Overview of Environmental Risk Analysis (ERA) by Financial Institutions which provides wide-ranging examples of how to translate environmental risks into financial risks and a review of the tools and methodologies used by financial institutions for ERA, including asset managers. Fund managers can also make reference to the Case Studies of Environmental Risk Analysis Methodologies issued by the NGFS for an in-depth discussion of the tools and methodologies to develop or enhance their own ERAs.

[40] Please refer to the NGFS's press release on 10 September 2020.

4. Disclosure

69. With the increasing international focus on climate change, investors are demanding more information about how climate-related risks affect the performance of assets and how these risks are managed. All of the asset owners canvassed in the SFC's ESG survey agreed that to reduce greenwashing and help identify asset management firms with stronger ESG practices, fund managers needed to provide more disclosures following a prescribed framework[41].

70. In light of the above, the SFC proposes that a new paragraph 6.2A be added to the FMCC to require a fund manager which is responsible for the overall operation of a fund to make adequate disclosures covering its governance arrangements for the oversight of climate-related risks and how climate-related risks are taken into account during the investment and risk management processes. This should enable fund investors to make an informed judgement in this area.

> *Paragraph 6.2A of the FMCC*
>
> *Where a Fund Manager is responsible for the overall operation of a fund, it should make adequate disclosures of information in relation to climate-related risks to allow fund investors to make an informed judgement about their investments in the fund, including:*
>
> *(a) its governance arrangement for oversight of climate-related risks; and*
>
> *(b) how it takes climate-related risks into account in its investment and risk management processes, including the tools and metrics used to identify, assess, manage and monitor the risks.*

71. The SFC proposes that where a fund manager is responsible for the overall operation of a fund, it should disclose its governance structure and risk management processes as long as the climate-related risks are relevant to the investment strategy of the fund. If climate-related risks are assessed to be material to the fund, the fund manager should make disclosures relating to how climate-related risks are being factored into the portfolio construction process as well as the key tools and metrics used in the investment and risk management processes. For Large Fund Managers, we propose to require them to describe their engagement policy which is useful for investors in understanding how the fund managers manage the climate-related risks and encourage better disclosure and practices related to climate-related risks.

72. Fund managers would not be expected to disclose all the details of their investment strategies. However, to help investors better understand the information disclosed, fund managers would be expected to provide concrete examples to illustrate how they implement their governance, investment and risk management policies and procedures.

[41] The disclosures which asset owners find most useful go beyond marketing-style narratives of the ESG philosophy and policy statements. Asset owners look for outcomes and evidence of ESG impact in addition to financial performance, consistency between policies and practices, the rationale behind investment decisions and more analysis of asset-specific ESG risks with supporting evidence as well as the analytical tools used, results of corporate engagement and voting track records.

73. Fund managers would also be required to disclose the types of investment strategies or funds under their management for which climate-related risks have been assessed to be irrelevant. During the SFC's soft consultation with fund associations, some respondents expressed concerns that this disclosure requirement singles out one specific type of risk, as a similar negative statement is not required for other risks. However, we are of the view that climate-related risks are different from other risks, and for investors with a specific interest in climate or ESG, the disclosures are important to distinguish strategies and funds which do not consider climate-related factors.

Practice 13

In its responsible investment statement, a fund manager specifies that there are some strategies for which ESG integration, including climate change analysis, is not applicable due to the nature of the investment style. For example, ESG factors are generally not integrated into quantitative-driven products, passively managed accounts or strategies where the portfolio turnover is high.

74. Fund managers should ensure that their conclusions are justifiable and maintain appropriate internal records which explain why climate-related risks are considered to be irrelevant for these types of investment strategies or funds. Fund managers would be required to re-evaluate their assessments from time-to-time to ensure they remain appropriate.

75. The WACI (see Appendix 5) is one of the TCFD's recommendations for quantitative disclosure. TCFD views this as a first step and expects it to prompt advances in the development of more decision-useful, climate-related risk metrics. The SFC acknowledges the importance of providing more useful and quantitative information for investors to make informed investment decisions and address growing concerns about "greenwashing".

76. During the soft consultations, some respondents expressed concerns about making quantitative disclosures due to the limited availability of data. Some were also concerned that reporting the WACI on an aggregate basis at an entity level may not provide meaningful information to investors.

77. Taking into account the resources required to obtain this information, it may not be proportionate to require smaller fund managers to disclose WACI. We propose that fund-level disclosures of the WACI be included in the enhanced standards for Large Fund Managers at the initial stage to provide decision-useful information about a fund's exposures to potential climate-related risks as well as the fund's own climate impact. It is not mandatory for a fund manager to disclose WACI for those funds where climate-related risks are assessed to be immaterial.

78. To address concerns about the quality and availability of data, the SFC expects Large Fund Managers to make reasonable efforts to disclose available Scope 1 and Scope 2 GHG emissions data together with the calculation methodology, underlying assumptions and limitations as well as the proportion of investments which are assessed or being covered.

79. The SFC notes that for some asset classes, other common metrics provide decision-useful data for investors. Large Fund Managers are encouraged to disclose other relevant metrics

(eg, LEED[42] rating and NABERS[43] for real estate) to supplement the WACI of a portfolio as appropriate. This could facilitate the development of a set of common metrics for climate-related risk disclosures.

80. With the exception of the WACI, which should be disclosed at the fund level, the SFC proposes that at a minimum, fund managers should make appropriate disclosures regarding governance, investment and risk management at an entity level. If different investment and risk management approaches are adopted by different strategies and funds, fund managers should supplement the strategy or fund disclosures accordingly.

Questions:

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

6. 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?

7. 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?

8. 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?

Format and frequency of disclosures

81. A fund manager should provide disclosures in the following manner:

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

(b) make adequate disclosures of information in writing and communicate to fund investors through electronic or other means (eg, on a website rather than individual communications to investors); and

(c) review and update disclosures at least annually and inform fund investors of any material changes made as soon as practicable.

[42] Leadership in Energy and Environmental Design is a green building rating system developed by the U.S. Green Building Council.

[43] National Australian Built Environment Rating System measures a building's energy efficiency, carbon emissions, water consumed, waste produced and compares it to similar buildings. This is a national initiative managed by the New South Wales Department of Planning, Industry and Environment on behalf of the Australian Government and state and territory governments.

82. Disclosures can be made via various channels such as websites, newsletters and reports. If fund managers make disclosures across multiple types of reports (eg, financial filings, annual reports, integrated reports and sustainability reports), they should provide cross-references to help users find the relevant information.

83. To reduce the reporting burden, fund managers which are subsidiaries of overseas fund management groups can cross-reference their group policies and practices when preparing disclosures provided that they fulfil the SFC's requirements (including the identification, assessment, monitoring and management of climate-related risks) and include an explanation of how the group's policies and practices are adopted by the fund managers.

Implementation timeline

84. The SFC's ESG survey found that in terms of ESG practices, local fund managers lag behind their counterparts with overseas-based parent companies. The latter generally have stronger ESG investment processes relating to research and portfolio management, governance and oversight, and an increasing number of them support international initiatives such as the TCFD and PRI. Local fund managers should accord greater priority to the management of climate-related risks.

85. Large Fund Managers have more resources and management capacity to implement the proposed requirements as compared with other fund managers. Hence, to facilitate implementation of the requirements, the SFC proposes a phased implementation under which fund managers other than the Large Fund Managers will be given a longer transition period to adopt the baseline requirements.

Proposed transition periods

86. The proposals set out in this paper will be subject to a public consultation until 15 January 2021. Taking into account the respondents' comments, a consultation conclusions paper will be issued together with the final form of the proposed requirements.

87. The SFC appreciates that the industry may wish to establish or revise systems and controls to align with any final proposals. Accordingly, it is proposed that:

    (a) a nine-month and a 12-month transition period for Large Fund Managers to comply with the baseline requirements and enhanced standards respectively; and

    (b) a 12-month transition period for other fund managers to comply with the baseline requirements.

Seeking comments

88. The SFC welcomes comments from the public and the industry on the proposals made in this consultation paper and the indicative draft of the proposed requirements set out in Appendix 1 and Appendix 2. Please submit comments to the SFC in writing by no later than 15 January 2021.

Question:

9. 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.

Appendix 1 - Proposed changes to the Fund Manager Code of Conduct

Governance	
Existing	▪ Responsibilities of senior management - Paragraph 1.6 of the FMCC ▪ Organisation and resources - Paragraphs 1.2(a), (b) and (d) of the FMCC ▪ Compliance - Paragraphs 1.2(c) and 1.8 of the FMCC
Investment management	
New	<u>Paragraph 3.1A of the FMCC</u> A Fund Manager should ensure that climate-related risks are taken into account in its investment management process for funds.
Risk management	
Existing	▪ Risk management - Paragraph 1.7.1 of the FMCC
Amendment	<u>Paragraph 3.11.1(b) of the FMCC</u> 3.11.1 For risk management at the fund level, a Fund Manager should implement adequate risk management procedures (including risk measurements and reporting methodologies) in order to identify, measure, manage and monitor appropriately all risks: (a) relevant to each investment strategy; and (b) to which each fund is or may be exposed, such as market, liquidity, counterparty **and climate-related risks**, and other risks, including operational risks, which may be material for each fund it manages, taking into account the nature, scale and complexity of its businesses and of the investment strategy of each of the funds it manages.
New	<u>Paragraph E under Appendix 2 of the FMCC – Suggested risk-management control techniques and procedures for funds</u> E. Climate-related risks 1. Climate-related risks may represent physical risks which stem from the direct impact of extreme weather events and progressive, longer-term shifts in the climate patterns and transition risks associated with the transition to a low-carbon economy. Liability risks may also be triggered by the responsibility to compensate financial losses related to physical or transition risks. In addition, climate-related risks may have implications for other financial risks such as credit, market and liquidity risks. 2. A Fund Manager should establish and maintain effective systems, policies and procedures to: (i) identify relevant climate-related risks; (ii) assess the potential impact of the identified risks on each investment strategy and fund; and (iii) monitor and manage these risks on an ongoing basis.

Disclosure requirements	
New	<u>Paragraph 6.2A of the FMCC</u> Where a Fund Manager is responsible for the overall operation of a fund, it should make adequate disclosures of information in relation to climate-related risks to allow fund investors to make an informed judgement about their investments in the fund, including: (a) its governance arrangement for oversight of climate-related risks; and (b) how it takes climate-related risks into account in its investment and risk management processes, including the tools and metrics used to identify, assess, manage and monitor the risks.
Scope of application	
New	<u>Paragraph to Appendix 1 of the FMCC under "Particular requirements in the Code which are not applicable to Discretionary Account Managers"</u> (a) Climate-related risks The requirement in relation to the consideration of climate-related risks and the corresponding disclosure requirements are not mandatory for a Discretionary Account Manager, except in cases where the client has requested the Discretionary Account Manager to take climate-related risks into consideration in the investment mandate. (Paragraphs 3.1A, 3.11.1(b) (for climate-related risks only) and 6.2A)

Appendix 2 – Proposed baseline requirements and enhanced standards

Governance	
Proposed baseline requirements	<u>Board's and management's roles and responsibilities</u> Board ▪ Define the board or the board committee's role in overseeing the incorporation of climate-related considerations into the investment and risk management processes; ▪ oversee progress against goals for addressing climate-related issues; and ▪ 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.
	Management ▪ 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; ▪ determine how the management (through specific positions or management committees) will monitor the status and progress of efforts to manage climate-related risks; ▪ establish a process for the management to be regularly informed about the status and progress of efforts to manage climate-related risks; ▪ 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); ▪ 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 ▪ set goals for addressing climate-related issues and develop action plans for managing climate-related risks.

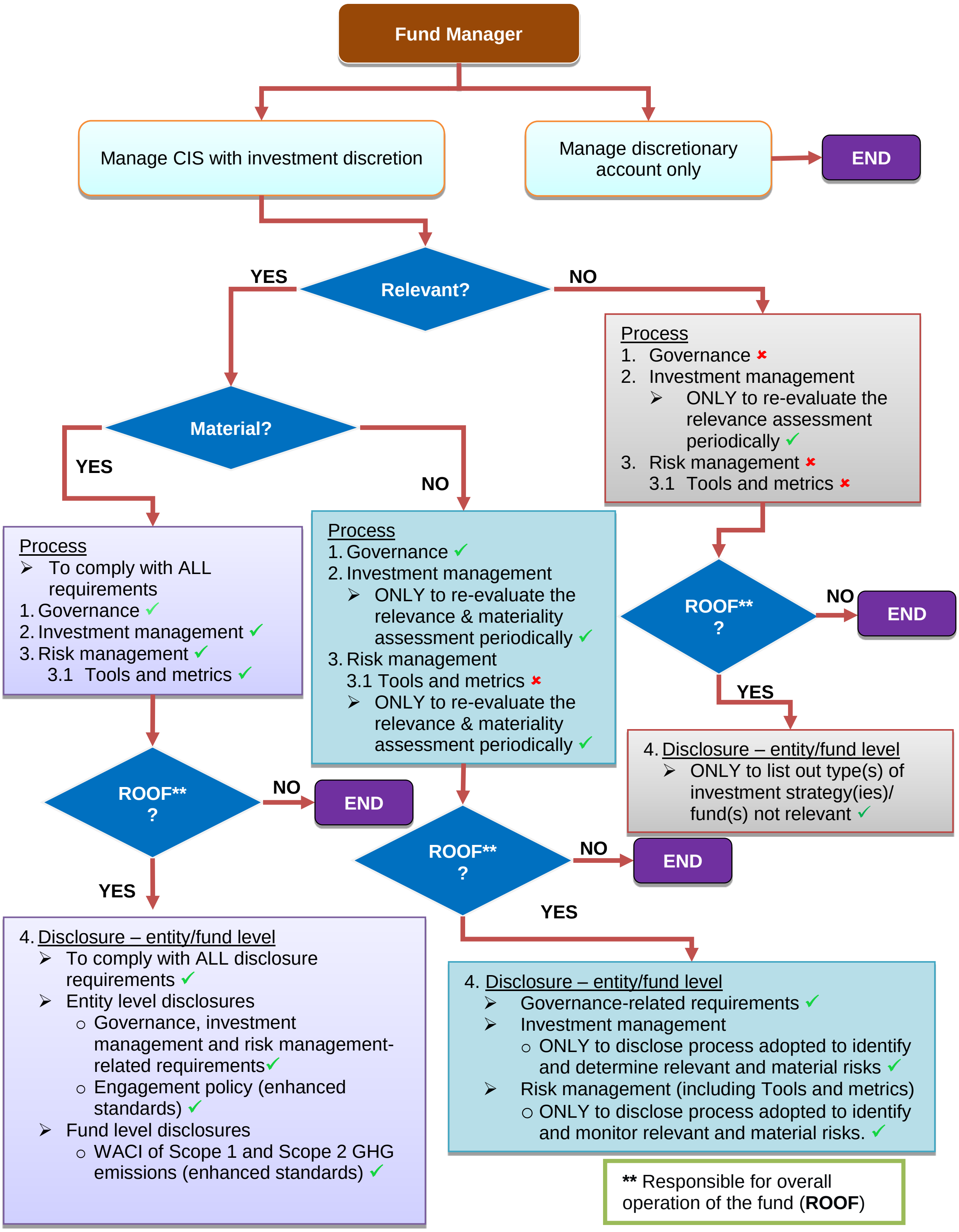
Investment Management	
Proposed baseline requirements	▪ Identify relevant and material physical and transition climate-related risks for each investment strategy and fund it manages; ▪ factor the material climate-related risks into the investment management process. For example, include climate-related risks in the investment philosophy and investment strategies and incorporate climate-related data into the research and analysis process; and ▪ take reasonable steps to assess the impact of these risks on the performance of underlying investments. Note: 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 makes disclosures of 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.

Risk Management	
Proposed baseline requirements	**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. **Tools and metrics** ▪ Apply appropriate tools and metrics to assess and quantify climate-related risks.
Proposed enhanced standards	**Tools and metrics** Large Fund Managers are also required to follow the standards below: ▪ 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 ▪ if climate-related risks are assessed to be material, take reasonable steps to identify the weighted average carbon intensity of Scope 1 and Scope 2 GHG emissions associated with the funds' underlying investments, where data is available or can be reasonably estimated, and define its calculation methodology and underlying assumptions.

Disclosure	
Proposed baseline requirements	<u>Entity level disclosures</u> *<u>Governance</u>* ▪ Describe the governance structure; ▪ describe the board's roles and oversight, including: ➢ whether the board or the board committee will review the risk management framework covering climate-related risks; and ➢ 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; and ▪ describe the management's roles and responsibilities, including: ➢ how the management will monitor the status and progress of efforts to manage climate-related risks; and ➢ the process for the management to be regularly informed about the status and progress of efforts to manage climate-related risks. *<u>Investment management and risk management</u>* ▪ Disclose the steps taken to incorporate relevant and material climate-related risks into the investment management process; and ▪ describe the processes for identifying, assessing, managing and monitoring climate-related risks, including the key tools and metrics used. <u>Entity level or fund level disclosures</u> ▪ If climate-related risks have been assessed to be irrelevant to certain types of investment strategies or funds under its management, disclose such exceptions at an entity or fund level.
	<u>Manner and frequency of disclosures</u> ▪ Adopt a proportionate approach, ie, the information disclosed should be proportionate to the degree climate-related risks are properly considered in the investment and risk management processes; ▪ make adequate disclosures of information in writing and communicate to fund investors through electronic or other means (eg, on a website rather than individual communications to investors); and ▪ review and update disclosures at least annually and inform fund investors of any material changes made as soon as practicable.
Proposed enhanced standards	Large Fund Managers are also required to follow the standards below: <u>Entity level disclosures</u> ▪ Describe the engagement policy and preferably provide examples to illustrate how material climate-related risks are managed in practice, including how the engagement policy is implemented.

	<u>Fund level disclosures</u> ▪ At a minimum, provide the weighted average carbon intensity of Scope 1 and Scope 2 GHG emissions associated with the funds' underlying investments at a 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.

Appendix 3 - Flowchart on the applicability of the proposed requirements



Appendix 4 - Latest developments in other jurisdictions

Mainland China

The Asset Management Association of China published voluntary Green Investment Guidelines for both public and private securities fund managers in November 2018. Guidance was provided on asset evaluation methods, environmental risk assessments, information disclosures and green investment products and strategies. Fund managers were asked to build systems which can effectively assess the environmental performance of the assets they manage.

Singapore

In June 2020, the Monetary Authority of Singapore (MAS) published a discussion paper on proposed guidelines for asset managers on environmental risk management. It proposed that asset managers which have discretionary authority be required to integrate the consideration of environmental risks into their financing and investment decisions and promote new opportunities for green financing. MAS also encouraged asset managers to make reference to international reporting frameworks such as the TCFD Recommendations.

The EU

In April 2019, the European Securities and Markets Authority (ESMA) published technical advice on the integration into the Markets in Financial Instruments Directive II (MiFID II)[44], Undertakings for Collective Investment in Transferable Securities (UCITS) Directive and AIFMD[45] of sustainability risks and factors relating to ESG considerations with regard to investment firms and investment funds.

In December 2019, the European Parliament and the Council of the European Union issued a regulation[46] to require financial market participants, including fund managers, pension fund managers and insurers, to disclose to investors their sustainability risk integration policies, including impact assessments. The three European supervisory authorities[47] will develop draft technical standards by the end of 2020 to specify detailed information about the environmental-related matters to be disclosed. They issued a joint consultation in April 2020 seeking input on ESG disclosure standards for financial market participants, advisers and products.

France

As part of France's low-carbon strategy, Article 173 of the French Law on Energy Transition and Green Growth, adopted in August 2015, requires major institutional investors and asset management companies to explain how they take ESG criteria into account in their risk management and investment policies.

In March 2020, the Autorité des Marchés Financiers (AMF) issued a policy[48] regarding ESG disclosures of collective investment products marketed to retail investors in France. It prescribed ESG-related information to be provided to investors at the point of sale and in periodic reporting and advertising materials.

[44] ESMA's technical advice to the European Commission on integrating sustainability risks and factors in MiFID II, April 2019.
[45] ESMA's technical advice to the European Commission on integrating sustainability risks and factors in the UCITS Directive and AIFMD, April 2019.
[46] Regulation (EU) 2019/2088 of the European Parliament and of the Council on sustainability-related disclosures in the financial services sector issued on 9 December 2019.
[47] The European Banking Authority, European Insurance and Occupational Pensions Authority and ESMA.
[48] AMF's Information to be provided by collective investment schemes incorporating non-financial approaches, March 2020.

UK

The Financial Conduct Authority (FCA) published a *Climate Change and Green Finance Feedback to Discussion Paper* in October 2019. It emphasised that climate change is the focal point of the proposed new requirements, which cover:

i) climate-related disclosures by securities issuers[49];
ii) the integration of climate-change risks by regulated firms; and
iii) the expectations around green financial products and services.

In addition, the FCA indicated its intention to align its requirements with the TCFD Recommendations.

New Zealand

In October 2019, the New Zealand Government issued a discussion document for Climate-related Financial Disclosures which proposed that financial firms and listed companies be required to report on the impact of climate change on their businesses and investments "in a consistent way" or explain why it is not relevant for them to do so. The Cabinet agreed to introduce a mandatory disclosure regime through an amendment to the Financial Markets Conduct Act (2013) and if approved by the Parliament, financial firms and listed companies could be required to make disclosures in 2023 at the earliest. The New Zealand Government supports the TCFD Recommendations.

[49] The FCA published its Proposals to enhance climate-related disclosures by listed issuers and clarification of existing disclosure obligations on 6 March 2020.

Appendix 5 - Technical glossary

1. Greenhouse gas (GHG) emissions are divided into three categories:
   (a) Scope 1 refers to all direct GHG emissions.
   (b) Scope 2 refers to indirect GHG emissions from the consumption of purchased electricity, heat, or steam.
   (c) Scope 3 refers to other indirect emissions not covered in Scope 2 which occur in the reporting company's value chain, including both upstream and downstream. Scope 3 emissions could include the extraction and production of purchased materials and fuels, transport-related activities in vehicles not owned or controlled by the reporting company, electricity-related activities (eg, transmission and distribution losses), outsourced activities and waste disposal.

2. WACI is a representation of a portfolio's exposure to carbon-intensive companies expressed in tons of carbon dioxide equivalent emissions (CO_2e) per million dollar revenue of investee companies. This metric is recommended by the TCFD.

Weighted average carbon intensity (WACI)	
Formula	$\sum_{n}^{i} \frac{\left(\text{current value of investment}_i \; * \; \frac{\text{issuer's Scope 1 and Scope 2 GHG emissions}_i}{\text{issuer's \$ million revenue}_i} \right)}{\text{current portfolio value}}$
Methodology	Scope 1 and Scope 2 GHG emissions are allocated based on portfolio weights (the current value of the investment relative to the current portfolio value), rather than an equity ownership approach. Gross values should be used.
Key points *+ / -*	+ The metric can be more easily applied across asset classes since it does not rely on an equity ownership approach. + Calculation is fairly simple and easy to communicate to investors. + The metric allows for portfolio decomposition and attribution analysis. - The metric is sensitive to outliers. - Using revenue (instead of physical or other metrics) to normalise the data tends to favour companies with higher pricing levels relative to their peers.

Source: Implementing the Recommendations of the TCFD, TCFD, June 2017

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