THE SFC'S NEW REGIME FOR CLIMATE-RELATED RISK MANAGEMENT AND DISCLOSURE UNDER THE FMCC - A STEP-BY-STEP GUIDE

Introduction

On 20 August 2021, the Securities and Futures Commission ("SFC") issued a Circular to licensed corporations – Management and Disclosure of Climate-related Risks by Fund Managers which sets out the expected standards for complying with the amended Fund Manager Code of Conduct ("FMCC"). On the same day, the SFC released a set of Frequently Asked Questions to provide further guidance on how fund managers can comply with the amended FMCC. The Consultation Conclusions on the Management and Disclosure of Climate-related Risks by Fund Managers was also released to summarise the feedback from fund managers and the SFC's corresponding responses regarding the proposed regulatory requirements for managing climate-related risks.

In this article, we undertake a review of the climate-related risks regulatory framework[1] and set out a step-by-step guide for fund managers who have less than HK$8 billion assets under management ("AUM") on

This issue:

(A)

How to assess the applicability of the relevant regulatory requirements

(B)

What they should do to ensure compliance

(C)

Any potential legal disclosure considerations

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1.Please note that this article only aims to provide guidance to Fund Managers with less than HK$8 billion AUM in their collective investment scheme ("CIS"). Fund Managers with AUM in their CIS which equal or exceed HK$8 billion must also comply with additional enhanced standards.

Step 1: Consider if you are "in-scope"?

In a nutshell, the new disclosure requirements only apply to managers in Hong Kong who hold a Type 9 (Asset Management) Regulated Activity licence under the SFO and are responsible for the management of "funds".

Table 1

In-scope :	Fund managers who manage CIS[2] with investment discretion ("Fund Managers"), irrespective of whether the funds in question are distributed in Hong Kong.
Out-scope :	Licensed corporations which act as investment advisors or distributors without any investment management discretion.[3]

Step 2: Determine which requirements are applicable if you are "in-scope"

Assuming a Fund Manager is "in scope" – the next step is to consider which of the requirements set out by the SFC are applicable to it. The fundamental requirements (also known as the "Four Pillars") may be summarised as follows:

Table2

Area	Requirements
Governance	**Board's roles and responsibilities** • Define the role of the board or the board committee • Oversee progress against goals for addressing climate-related issues • Determine how the board or the board committee executes their role **Management's roles and responsibilities** • 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 • Determine how the management will monitor the progress in managing climate-related risks and establish a management reporting process • Devote sufficient human and technical resources for climate-related risks management and establish internal controls and written procedures to ensure compliance • Set goals for addressing climate-related issues and develop action plans
Investment management	• Identify relevant material, physical and transition climate-related risks for each investment strategy and fund managed • Where relevant, factor the material climate-related risks into the investment management process. • Take reasonable steps to assess the impact of these risks on the performance of underlying investments
Risk management	• Take climate-related risks into consideration in risk management procedures and ensure appropriate steps have been taken to identify, assess, manage and monitor the relevant and material climate-related risks for each investment strategy and fund managed • Apply appropriate tools and metrics to assess and quantify climate-related risks
Disclosure	**Entity level** • Describe the (i) governance structure, (ii) the board's roles and oversight and (iii) management's roles and responsibilities • Disclose steps taken to incorporate relevant and material climate-related risks into the investment management process • Describe the processes used for identifying, assessing, managing and monitoring climate-related risks, including the key tools and metrics used **Entity level/ fund level** • If climate-related risks have been assessed to be irrelevant to certain types of investment strategies or funds managed, disclose details of such exceptions at the entity or fund level

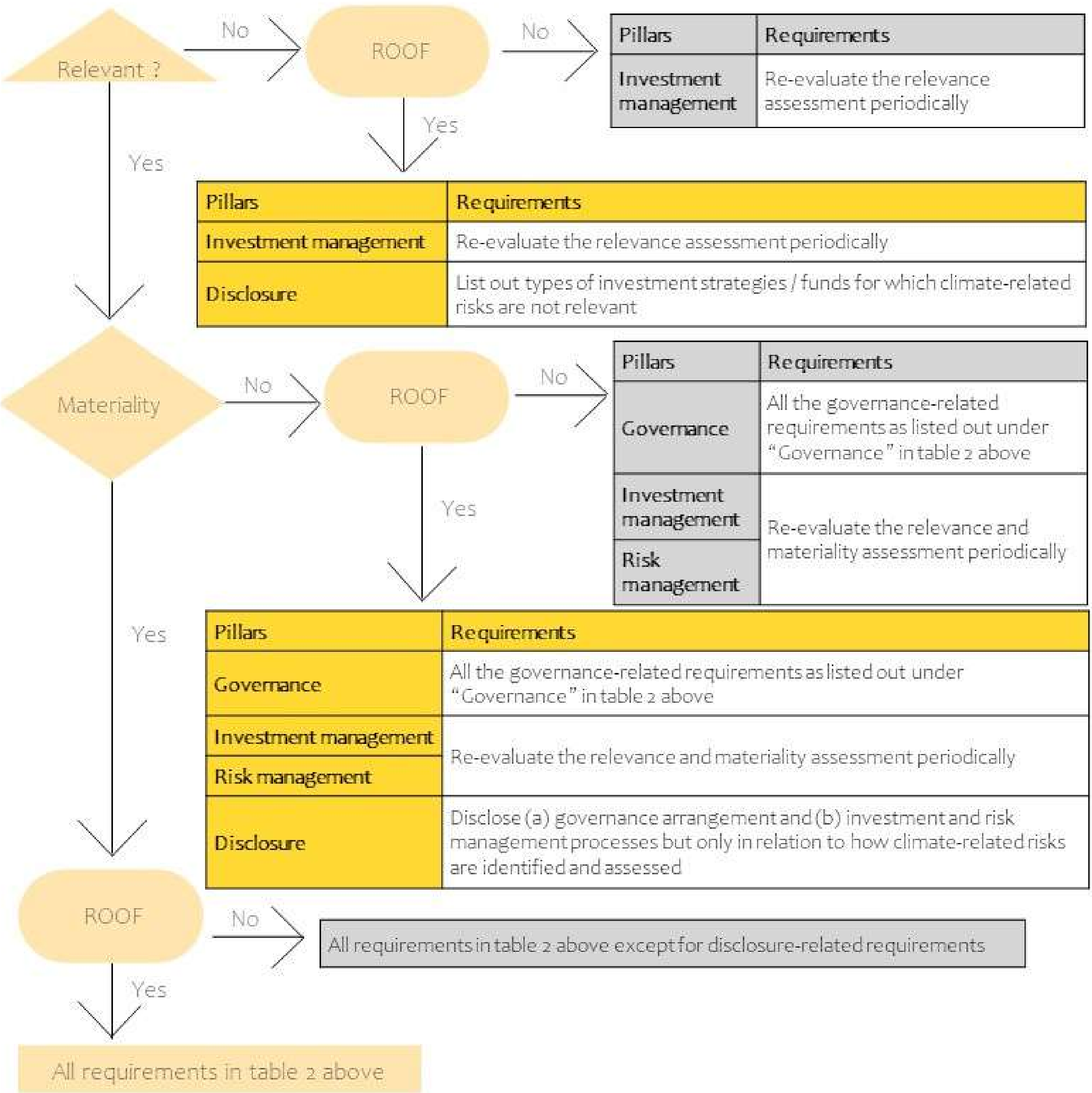
2. Including SFC-authorised or non-SFC authorised CIS.
3. However, Fund Managers should note that, where they have the overall investment management discretion, they would still be in-scope despite delegating the investment management function to sub-managers.

And, depending on the three determinants of:

1. Relevance
2. Materiality
3. ROOF status

the following flowchart will help guide Fund Managers on which of the Four Pillars are applicable to them:

Flowchart 1



Step 3: How to determine "Relevance" of climate-related risks?

All in-scope Fund Managers should then identify the following types of climate-related risks and determine whether they are relevant to their funds and investment strategies:

Table3

Type of climate-related risks	Definition	Examples
Physical risks	Risks which arise from the physical effects of climate change, environmental degradation and climate-related hazards	• Extreme weather events • Long-term climate change • Indirect effects of climate change
Transition risks	Risks which are associated with societal and economic transition to a low-carbon and more climate-friendly economy	• New laws and regulations • New environmental technology • Change in market pattern

In determining relevance, Fund Managers may adopt any, or a combination, of the following approaches:

(A) Investment Strategies Approach

Although the SFC has expressed the view that it will be rare that climate-related risks are not relevant, it accepts that there may be circumstances that such risks are not relevant to certain funds and investment strategies. In that case, Fund Managers must, after exercising professional judgement, provide justification. Below are some examples of investment strategies for which climate- related risks are likely to be not relevant:

- Day trading strategies
- Forex strategies
- Index tracking strategies/managed futures strategies
- Interest rate strategies
- Macro strategies
- Quantitative strategies

(B) Asset Classes

If a Fund Manager chooses to assess the relevance of climate-related risks by reference to the asset classes in which it invests, the following types of asset classes are likely to be relevant:

- Agricultural assets
- Commodities
- Government securities
- Digital assets (e.g., cryptocurrencies)
- Infrastructure
- Real estate
- Single-name issuers' equity or bonds

Step 4: How to determine "materiality" of climate-related risks

If climate-related risks have been assessed to be not relevant, there is no need to analyse their materiality. However, if the risks are relevant, Fund Managers then need to assess the materiality of climate-related risks by adopting an approach which is appropriate and proportionate to their circumstances. When assessing materiality, Fund Managers may adopt an approach that is (a) qualitative, (b) quantitative or (c) some combination of both.[4] The table below sets out steps suggested for each approach:

Table 4

Approach	Suggested Steps
Qualitative approach	• Identify sectors[5] and/or geographical locations which carry high physical and transition risks • Evaluate whether the fund has material exposure to these sectors and/or geographical locations • Consider the second level effects of these sectors and/or geographical locations on companies within the value chain
Quantitative approach	• Utilise data tools to analyse the climate-related risks to which the fund has material exposure • Assess the likely impact of climate-related risks on the portfolio (e.g. financial impact of carbon prices, impact of changes in hazard frequency and water scarcity)

Fund Managers may also set their own percentage thresholds which are deemed appropriate and proportionate to their investment strategies or funds. Nevertheless, such percentage thresholds should be (i) justified to be objectively sensible and (ii) applied on a consistent basis.

In conducting materiality assessment, Fund Managers should, depending on whether they have similar assets and/or strategies, decide whether the analysis of climate-related risks is required at (a) an investment strategy level, (b) a specific portfolio level, (c) an individual investment level, (d) an overall portfolio level or (e) some or all of the aforementioned levels.

Step 5: Disclosure Requirements

If disclosure is required,[6] Fund Managers should follow the guidelines given by the SFC on disclosure below.

Table 5

Disclosure requirements	Guidelines on disclosure
Applicability	• Disclosure requirements only apply to ROOF Managers
Channel of Disclosure	• Required information may be disclosed in a way which ROOF Managers deem appropriate • For the majority of Fund Managers, the Fund's disclosure documents (namely, the Private Placement Memorandum ("PPM")) would be the obvious medium for disclosure (including by way of supplements/updates). However, the SFC has also stipulated that disclosures may be made across various channels (e.g. websites, newsletters or reports) to bring fund investors' attention to changes determined to be material to them insofar as investors' attention is drawn to the information. If climate-related risks are deemed to be material, Fund Managers may consider making a separate disclosure

4. However, we suggest our clients to start with qualitative approach first and progress to quantitative approach at a later stage if feasible.
5. Examples of sectors that are likely to have material climate-related risks include utility and power, mining, healthcare, real estate and consumer services.
6. Please refer to Flowchart 1 above to see when disclosure is required.

Table 5 (Cont.)

Disclosure requirements	Guidelines on disclosure
Local or Group Disclosure	• Group disclosure may be adopted if: (i) the ROOF Manager confirmed that group-wide policies and procedures are applied consistently in its operations in Hong Kong (ii) such policies meet or exceed the SFC's requirements (iii) such group disclosure is provided to the investors • However, group disclosures should be supplemented with additional disclosures at the local level if local adoption deviates from the group policies, procedures or disclosures
Level of Disclosure	• Disclosures may be made at the entity level if the same policies and processes apply consistently across different strategies and funds • Disclosures may also be made at the fund level if ROOF Managers deem appropriate
Scope of Disclosure	• ROOF Managers should observe the following when making disclosures: (i) adopt a proportionate approach (ii) make adequate disclosures in writing and communicate to fund investors (iii) review disclosures at least annually, update disclosures as appropriate and inform fund investors of any material changes as soon as practicable

Step 6: Maintain records and periodically review the assessments

Regardless of the approach that the Fund Manager chooses to adopt (and the conclusions that are drawn therefrom), reasons and justifications for methodologies used and any conclusion determined should be properly documented in writing. Internal records of such assessments should also be duly maintained. In addition, such assessments should be reviewed regularly (at least annually) and whenever any major changes occur (e.g. change to a fund's investment strategy). To reflect the latest assessments, disclosure should also be updated.

Special consideration for fund of funds ("FOF")

For FOFs, it is unlikely that ROOF Managers can take no action at all and completely rely on the risk management measures of the manager of the underlying invested funds. Depending on the circumstances, ROOF Managers should take appropriate and proportionate actions and cooperate with the underlying managers to analyse the materiality and relevance of the climate-related risks.

Step 7: Deadline and other practical considerations

Fund Managers who have less than HK$8 billion AUM must comply with the requirements above by 20 November 2022. Last but not least, Fund Managers should take the following into consideration when assessing and implementing a risk management framework for climate-related risks:

- Detailed records of all documents involved in the assessment of climate-related risks should be duly maintained for compliance review purposes.
- Assessment of climate-related risks and relevant risk management procedures and policies and their disclosures should be reviewed periodically and be updated as appropriate.
- Risk management procedures and policies should be complied with and applied consistently.
- Good corporate stewardship should be built to influence investee companies to implement climate-related risk mitigation measures.
- Management of climate-related risks should involve the board, portfolio managers, investment management team and risk management team, and not only the legal and compliance team.
- The risk management framework for assessing and managing climate-related risks should be proportionate to the circumstances of each Fund Manager.

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The materials contained in this publication were assembled in December 2021 and were based on information available at that time.

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