SFC Circular on management and disclosure of climate-related risks by fund managers

On 20 August 2021, the Securities and Futures Commission ("**SFC**") issued a circular in relation to management and disclosure of climate-related risks by fund managers. This circular is accompanied by Frequently Asked Questions to provide guidance to the industry on the implementation of the requirements.

The Fund Manager Code of Conduct ("**FMCC**") will be amended to require a fund manager managing collective investment schemes (whether authorized or unauthorized by the SFC)[1] to take climate-related risks into consideration in its investment and risk management processes and make appropriate disclosures.

Scope and applicability

Given the broad spectrum of climate-related risks and the wide range of financial assets and investment strategies in the market, the SFC considers that it is more appropriate to take a pragmatic approach based on a fund manager's business model and investment strategies. The scope and applicability of the circular hinges on the following factors.

Discretion over the investment management processes

If a licensed corporation solely provides investment advice to a separate team of an affiliate or acts as a distributor of funds with no investment management discretion, the licensed corporation will not be expected to comply with the SFC's requirements.

Relevance assessment of climate-related risks

In limited circumstances, a fund manager may assess that climate-related risks are not relevant to its investment and risk management processes owing to the nature of a fund's investments or strategy (e.g., a quantitative fund, macro strategy fund, index tracking fund, forex fund or managed futures fund), or the time horizon of the investments (e.g., day trading). The fund manager should exercise its professional judgement by referring to the publications and standards of other organizations. The fund manager should maintain appropriate records explaining why climate-related risks are irrelevant.

Materiality assessments of climate-related risks

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 a combination of both. Fund managers may make reference to the publications and standards of international organizations which focus on climate change or sustainability in assessing the materiality of climate-related risks and developing their policies and procedures. Fund managers should maintain appropriate internal records to demonstrate that they have assessed the materiality of the risks.

[1] The SFC considers it appropriate to apply the requirements to managers of all funds despite some investors do not view ESG risks as an important consideration and some funds are not green or ESG-themed fund.

Regulatory requirements

The regulatory requirements cover four key elements, namely (1) governance, (2) investment management, (3) risk management and (4) disclosure. The following table summarizes the flowchart provided by the SFC.

Scenario	Regulatory Requirements
If the licensed corporation has no discretion over investment management process	None. The licensed corporation will not be expected to comply with the SFC's requirements.
If climate risk is considered irrelevant	**1. Investment** • Maintain appropriate records which explain why climate-related risks are irrelevant; and • Reevaluate the relevance of climate-related risks at least annually and update the disclosures where necessary. **2. Disclosure (only applicable for ROOF[2])** • At entity/fund level, list out types of investment strategies/funds not relevant.
If climate risk considered relevant but not material	**1. Governance** • Board's roles and responsibilities: (i) define the board's or the board committee's role in overseeing the incorporation of climate-related considerations into the investment and risk management processes; (ii) oversee progress against goals for addressing climate-related issues; and (iii) determine how the board or the board committee executes this role, including the process and frequency by which the board or the board committee is informed about climate-related issues. • Management's roles and responsibilities:

[2] For the meaning of a fund manager which is responsible for the overall operation ("**ROOF**") of a fund, please see answer to Question 1 of FAQs on the FMCC.

	(i) assign roles and responsibilities for managing climate-related risks to management-level positions or management committees which report to the board or the board committee, and determine the appropriate management structure; (ii) determine how the management (through specific positions or management committees) will monitor the status and progress of efforts to manage climate-related risks; (iii) establish a process for management to be regularly informed about the status and progress of efforts to manage climate-related risks; (iv) devote sufficient human and technical resources for the proper performance of the duty to manage climate-related risks (eg, provide training to staff, engage subject experts and acquire climate-related data from external sources); (v) establish satisfactory internal controls and written procedures to ensure compliance with internal policies and procedures as well as regulatory requirements related to the management of climate-related risks; and (vi) set goals for addressing climate-related issues and develop action plans for managing climate-related risks. **2. Investment management and risk management** • Reevaluate the relevance and materiality of climate-related risks at least annually and update the disclosures where necessary. **3. Disclosure (only applicable for ROOF)** • Describe (i) governance structure; (ii) describe the board's roles and oversight; and (iii) management's roles and responsibilities; and • At entity level, describe the processes for identifying, assessing, managing and monitoring climate-related risks.
If climate risk is considered <u>relevant</u> and <u>material</u>	**<u>Baseline requirements (for all fund managers)</u>** **1. Governance** • Board's roles and responsibilities:

	(i) define the board's or the board committee's role in overseeing the incorporation of climate-related considerations into the investment and risk management processes; (ii) oversee progress against goals for addressing climate-related issues; and (iii) determine how the board or the board committee executes this role, including the process and frequency by which the board or the board committee is informed about climate-related issues. • Management's roles and responsibilities: (i) assign roles and responsibilities for managing climate-related risks to management-level positions or management committees which report to the board or the board committee, and determine the appropriate management structure; (ii) determine how the management (through specific positions or management committees) will monitor the status and progress of efforts to manage climate-related risks; (iii) establish a process for the management to be regularly informed about the status and progress of efforts to manage climate-related risks; (iv) devote sufficient human and technical resources for the proper performance of the duty to manage climate-related risks (eg, provide training to staff, engage subject experts and acquire climate-related data from external sources); (v) establish satisfactory internal controls and written procedures to ensure compliance with internal policies and procedures as well as regulatory requirements related to the management of climate-related risks; and (vi) set goals for addressing climate-related issues and develop action plans for managing climate-related risks. **2. Investment management**

	• Identify relevant and material physical[3] and transition[4] climate-related risks for each investment strategy and fund it manages; • Where relevant, factor the material climate-related risks into the investment management process. For example, include climate-related risks in the investment philosophy and investment strategies and incorporate climate-related data into the research and analysis process; and • Take reasonable steps to assess the impact of these risks on the performance of underlying investments. **3. 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; and • Apply appropriate tools and metrics to assess and quantify climate-related risks (either a qualitative or quantitative approach, or a combination of both). **4. Disclosure (only applicable for ROOF)** • Describe (i) governance structure; (ii) describe the board's roles and oversight; and (iii) management's roles and responsibilities; • 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. **Enhanced standards (additional requirements for Large Fund Manager[5])** **3. Risk management**

[3] Physical risk stems from the direct impact of extreme weather events and progressive, longer-term shifts in the climate patterns.

[4] Transition risk is arising from the transition from high-carbon economy to a low-carbon economy.

[5] "Large Fund Manager" is defined as fund managers with asset under management (excluding discretionary account management) equals or exceeds $8 billion in fund assets for any three months in the previous reporting year.

	• Assess the relevance and utility of scenario analysis in evaluating the resilience of investment strategies to climate-related risks under different pathways; and • Take reasonable steps to identify the portfolio carbon footprints of the Scope 1 and Scope 2 greenhouse gas (GHG) emissions associated with the funds' underlying investments, where data is available or can be reasonably estimated, and define the calculation methodology and underlying assumptions. **4. Disclosure (only applicable for ROOF)** • Describe the engagement policy at the entity level and preferably provide examples to illustrate how material climate-related risks are managed in practice, including how the engagement policy is implemented; and • At a minimum, provide the portfolio carbon footprints[6] of the Scope 1 and Scope 2 GHG emissions associated with the funds' underlying investments at the fund level, where data is available or can be reasonably estimated, and indicate the calculation methodology, underlying assumptions and limitations, and the proportion of investments (e.g., in terms of the net asset value of funds) which are assessed or covered.

Notes on disclosure requirements

Where applicable, fund managers should make appropriate disclosures to investors via various channels such as websites, newsletters or reports and ensure investors' attention is drawn to the information.

The requirement to make disclosures at the entity level is designed to reduce the compliance burden of fund managers to disclose information if the same policies and processes apply consistently across different strategies and funds. If different governance structures, investment and risk management approaches are adopted across different strategies or funds, fund managers may elaborate on the strategy at the fund level as appropriate.

[6] Portfolio carbon footprint is a representation of carbon emissions normalised by the portfolio's market value and expressed in tons of carbon dioxide equivalent emissions per million dollars invested. Refer to paragraph 19 of the Circular for the formula for the calculation of portfolio carbon footprint.

Implementation timeline

The regulatory requirements for climate-related risks will become effective after the following transition periods:

- All fund managers (except Large Fund Manager): a 15-month transition period (i.e., until 20 November 2022).

- Large Fund Manager: 12-month transition period to comply with the baseline requirements (i.e., until 20 August 2022) and a 15-month transition period to comply with the enhanced standards (i.e., until 20 November 2022).

How can Optima Partners help?

- Give you guidance on the relevance and materiality assessment of climate-related risks and assist with such documentation;
- Revisit the duties and responsibilities of board of directors and management;
- Provide you with practical guidance on updating your investment and risk management process; and
- Update relevant documentations, including Compliance Manual and Compliance Monitoring Programme.

Contacts

To have a deeper discussion about how this topic might impact your business, please contact Optima Partners.

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