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Submitted 15 January 2021

ICI Global[1] Response to the HK SFC's Consultation on Proposed Requirements on Fund Managers' Management and Disclosure of Climate-related Risks

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.

Although we agree that climate risk is of growing importance, for investments in certain sectors or companies, other sustainability factors may be more relevant than climate risk. We therefore urge the SFC to maintain flexibility for asset managers to more broadly integrate consideration of material sustainability factors into the investment and risk management process. Flexibility is also key for the SFC's framework to be able to evolve to keep pace globally and avoid conflict with other international developments.

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?

We appreciate the SFC's clarification that the proposed disclosure requirements would apply only where the fund manager is responsible for overall operation of a fund (ROOF).

We generally agree with SFC's proposal of applying the requirements to the management of CISs but not discretionary accounts.

In Paragraph 32, the SFC proposes not to apply the requirements to discretionary accounts, but then states that the manager of a discretionary account that incorporates a client's climate-related investment preferences would need "to ensure that it acts accordingly" when managing the account.[2] We ask the SFC to confirm that the SFC's requirements would not apply in this case and that a fund manager would address climate-related risk in accordance with the client's preferences. If the SFC does intend fund managers to apply the SFC requirements for discretionary accounts with climate-related investment preferences, we then would ask for further clarification on what types of discretionary accounts would be in scope (e.g., only if climate-related preferences apply to the main strategy?), and whether the FMCC requirements would apply (e.g., would the ROOF test apply?).

[1] ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US$36.0 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

[2] *See* SFC Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers (October 2020), at Paragraph 32, *available at* https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=20CP5 (Consultation Paper).

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In Paragraph 35, the SFC proposes to require a fund manager that is a sub-investment manager of a fund with full discretion over the investment management function "to observe the proposed requirements applicable to its role."[3] We ask the SFC to confirm that this provides the sub-investment manager with flexibility to apply the requirements in a manner that is proportional and appropriate to the circumstances.

We also request clarification (e.g., through FAQs) that the proposed requirements would not apply in the following circumstances:

- A fund that is not SFC authorized; and
- A fund whose investment management is delegated to an HK fund manager but where the fund is not distributed in HK.

We further request clarification on whether and how the proposed requirements would apply in the following circumstances:

- A fund where the manager has control over some of the investment/risk management process, but not full discretion; and
- A fund where the manager's risk management function is not in HK.

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?

We agree with the SFC's proposed approach of aligning its disclosure requirements with the TCFD recommendations. The TCFD framework appropriately focuses on material climate-related disclosures with a principles-based framework that allows for broad application. Alignment with the TCFD recommendations also will facilitate international consistency. Many financial services regulators have expressed support for the TCFD and are adopting disclosure requirements aligned with the TCFD recommendations.

We caution the SFC, however, against incorporating the TCFD recommendations in a manner that would automatically incorporate any future iterations of the TCFD into the proposed requirements. Although we support the 2017 TCFD recommendations, we would want the SFC to maintain the ability to scrutinize any updates or changes to the framework before adopting them into the requirements.

[3] *See* Consultation Paper, at Paragraph 35.

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

In calculating assets for purposes of determining the threshold, we request further clarity on whether an asset manager would include AUM of assets under Investment Management Agreements contracted with the asset manager, where the portfolio management function has been delegated to an overseas affiliate.

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

We strongly support the SFC's proposal to permit global fund managers to use group-wide policies and disclosures, where relevant, to address the SFC's requirements. Integration of material climate-related risk should not be a separate process, but rather part of a manager's existing processes and related governance/oversight structures used to manage investment risks more broadly.

We note, however, that the SFC has stated this approach only in the text of the consultation paper. We strongly urge the SFC to make this clear in the revised FMCC and/or the circular, to explicitly recognise that, for global fund managers, climate risk related issues may be subject to oversight at the group/parent entity level rather than at the level of the Board or senior management of the local manager entity.

Proposed Requirements – Governance

We have some concerns about the proposed requirement for the board to "[o]versee progress against goals for addressing climate-related issues."[4] We ask the SFC to clarify that the board is responsible for oversight of prudent risk management of climate factors as opposed to requiring the board to set goals on climate issues more broadly.

We further ask for clarification on whether the board will be able to delegate to senior portfolio managers who are better equipped to monitor climate risks in the investment and risk management processes.

Given that the SFC aims to align these requirements with the TCFD Recommendations, we suggest making the following changes to the proposed circular language for better alignment with the wording of the TCFD Recommendations:

> Proposed Circular – Governance – Baseline requirements – Board's and management's roles and responsibilities, 3rd bullet:
>
> "determine how the board or the board committee executes this role, including the process and frequency by which the board or the board committee is informed ~~of the status of incorporating~~

[4] *See* Consultation Paper, at Paragraph 45 and Appendix 2, p. 36.

~~climate-related considerations into the investment and risk management processes through appropriate reporting and escalation~~ about climate-related issues;"

Proposed Requirements – Investment Management

We support the SFC's inclusion of the term "material," which appropriately recognizes the importance of materiality in identifying and managing climate-related risks to investments. We would welcome further clarification, however, on the processes that the SFC expects firms to adopt to identify the relevance and materiality of climate related risks, and the difference between relevance and materiality standards. The use of both terms creates confusion, and a simple materiality standard would provide more clarity.

As another suggestion, we would welcome language that includes the principle of proportionality and provides asset managers with flexibility to implement the SFC requirements in a manner that is commensurate with the size and nature of their activities.

If climate-related risks are considered to be material to a strategy or a fund, the SFC proposes that fund managers should take them into consideration in the portfolio construction process. The SFC notes that "[f]und managers can adopt different methods and strategies including exclusionary screening, best-in-class screening, norms-based screening and impact investing," but then states that "[f]und managers can adopt an approach which they consider the most appropriate for their circumstances, taking into account their expertise and resources." We would like to clarify that the methods and strategies that the SFC lists are types of ESG investing strategies, rather than approaches to managing climate risk as an investment risk. We recommend removing this list as it may suggest that all funds should use ESG investing strategies regardless of investor preference or fund objective, or that management of climate risk is relevant only for ESG funds.

We appreciate the SFC's clarification that index funds that adopt a full replication methodology may be able to justify a carve-out from the proposed requirements. We urge the SFC, however, to remove the reference to PRI's suggestion for funds that use a partial replication methodology or enhanced passive strategy—namely, that the manager 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.[5] We are concerned that this would require a manager to change a fund's investment strategy in contravention of the investment objective as disclosed in the fund's offering documents.

Although we agree that passive funds should not be carved out from the requirements unless the manager has assessed that climate-related risks are irrelevant, we are concerned that the prescriptive nature of the SFC's requirements, particularly related to investment management and risk management,

[5] *See* Consultation Paper, at Paragraph 54, *referencing* A Practical Guide to ESG Integration for Equity Investing, UN PRI (2016).

make it difficult for passive managers to demonstrate compliance. We therefore suggest that the SFC include language in the circular similar to the following:

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

<u>Proposed Requirements – Risk Management</u>

We recommend amending proposed new Paragraph E(2)[6] under Appendix 2 of the FMCC as follows: "A Fund Manager should establish and maintain effective systems, policies and procedures to: (i) identify relevant and material climate-related risks…" This would better align with wording of Paragraph 3.11.1 of the FMCC, which refers to risks that are both relevant and material.

The SFC proposes to require Large Fund Managers to acquire or estimate the Weighted Average Carbon Intensity (WACI) of Scope 1 and 2 GHG emissions for funds under management for risk management purposes if climate-related risks are assessed to be material.[7] We note there is a wide range of different ways for fund managers to assess climate risks of the underlying investments. For example, apart from WACI, the TCFD provides other metrics that asset managers can report (including portfolio carbon footprint, total carbon emissions, and carbon intensity). We therefore ask the SFC to adopt an approach to risk management that provides an asset manager with flexibility to use other metrics as appropriate to the circumstances.

With respect to the SFC's proposed approach to scenario analysis, we caution that scenario analysis is still nascent and available data are limited. We highlight that scenario analysis may not be meaningful in all circumstances and mandating that Large Fund Managers use scenario analysis in a particular manner would be counterproductive at this juncture. We instead recommend including a high-level reference in the circular stating that Large Fund Managers should incorporate scenario analysis where appropriate. This would allow flexibility for assessing physical risks and scenario analysis, recognizing the developing nature of this discipline and that the data available in the market remains incomplete as well as a lack of adequate disclosure from investee companies. This type of approach also would allow for the continuing

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[6] *See* Consultation Paper, at Appendix 2, p. 34.
[7] *See* Consultation Paper, at Paragraph 66.

work in this space to develop, including efforts by the Network of Central Banks and Supervisors for Greening the Financial System (NGFS), Financial Stability Board (FSB), and TCFD.

As further background, service providers use a variety of methodologies in estimating the level of climate risk associated with specific climate change pathways. Most of these analyses seek to provide insights on the purported exposure to physical risks, transitional risks, and opportunities associated with climate change. In general, the methodologies behind these analyses are highly sensitive to inputs that are subjective and can, in fact, vary extensively. Therefore, the range of potential outcomes of the analyses will also vary widely, depending on the methodology used and the assumptions made.

For instance, transitional risk is dependent on many inputs, including the probability, timing, magnitude, and scope of governmental regulation. It is impossible to gauge many of these inputs with any precision (e.g., estimates of a carbon tax that have over a 5x range from low to high). Scenario analysis for specific 1.5 or 2.0 degree (or other) pathways also assumes some probability of governmental response (e.g., imposing a carbon tax); this is often based on a subjective view of risk. The methodologies also may not account for timing of potential government action. In addition, some providers choose not to provide details on the proprietary methodology used to calculate their results. Further, most of these methodologies do not account for differences both between and within sectors in how climate risks may impact profitability/long-term viability based on differences in industry structure, geographic mix, and other factors. Although service providers are focused on developing scalability of scenario analysis methodologies, we note that scale cannot come at the expense of security-level accuracy.

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?

We do not agree with this approach as it would require the manager to call out one specific type of risk that is irrelevant to the strategy of the fund. Managers are not required to provide this type of negative disclosure for other risks that are considered to be irrelevant for a particular strategy (e.g., credit risk for an equity strategy). This type of disclosure is likely to confuse investors. We instead suggest that the SFC emphasize that any fund- or strategy-level disclosure of climate-related risk should be made to the extent it is relevant to a particular strategy or fund.

If the SFC determines to require this disclosure, however, we support providing fund managers with the flexibility to make this disclosure at an entity or fund level.

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?

We generally agree with this approach.

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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?

Yes, we have significant concerns about disclosures of quantitative climate-related data and therefore agree that these disclosures should not be part of the baseline requirements.

We do not find that entity-level disclosures of quantitative climate-related data are useful or meaningful to end investors, and we therefore agree that the disclosure is better made at the fund level instead of the entity level, and not only at the initial stage. We recommend focusing this disclosure requirement on funds with a climate-related strategy (i.e., "climate funds" referred to in the SFC's draft revised circular on ESG funds) where this disclosure would be most meaningful to investors.

Also, as mentioned in Paragraphs 76-78, it may be difficult for a fund manager to disclose quantitative climate-related data such as WACI for all funds generally due to the limited availability of data. To address concerns about the quality and availability of data, we suggest providing Large Fund Managers with the flexibility to choose which metric they disclose, rather than prescribing disclosure of WACI. For example, apart from WACI, the TCFD provides other metrics which asset managers can report (including portfolio carbon footprint, total carbon emissions, and carbon intensity).

9. Do you think the following transition periods are appropriate? (1) a nine-month and a 12-month transition period for Large Fund Managers to comply with the baseline requirements and enhanced standards respectively; and (2) a 12-month transition period for other fund managers to comply with the baseline requirements. If not, what do you think would be an appropriate transition period? Please set out your reasons.

We strongly recommend that the SFC provide asset managers with a 18-month transition period to ensure meaningful implementation. In particular, Large Fund Managers will need time to establish the complex new processes, or make changes to existing funds, investment management, risk management and corporate governance processes to fulfill the scenario analysis and WACI disclosure requirements. We do not see the merit of a staggered implementation timeline for Large Fund Managers and other managers, as this will be confusing to investors and would not facilitate comparison.

Global managers typically address ESG-related implementation projects on a global basis, and asset managers are currently dealing with an unprecedented implementation schedule of new ESG-related regulatory requirements in other jurisdictions, such as the Monetary Authority of Singapore (MAS) environmental risk framework and a host of extensive new obligations on EU financial market participants and financial products. We also urge the SFC to ensure that the requirements under the Guidelines do not conflict with those introduced in other jurisdictions, in particular in the EU, or allow firms that have complied with relevant EU requirements to be deemed to have satisfied some or all of the SFC's requirements. This is particularly important for firms with global footprints that will need to comply with multiple requirements.