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Unpacking the SFC's requirements on the management and disclosure of climate-related risks for fund managers

Joyce Li

Hong Kong's Securities and Futures Commission (**SFC**) held two virtual briefing sessions in October 2021 and provided useful guidance on its newest climate-related risk management requirements for fund managers, as detailed in the [Consultation Conclusions](#) on the Management and Disclosure of Climate-related Risks by Fund Managers (with amendments to the Fund Manager Code of Conduct (**FMCC**)) and the [Circular](#) issued on 20 August 2021.

Familiarisation with SFC's requirements

Fund managers should familiarise themselves with the SFC's requirements detailed in the Circular, and the Consultation Conclusions as supplemented by [FAQs](#) on the application of the climate-related risk requirements under the FMCC.

The FMCC sets out the high-level principles. The expected standards for compliance with the FMCC are more particularly described in the Circular. Given the evolving nature of local and international standards in this area, we expect the SFC to refine its requirements and provide further guidance from time to time. Fund managers should keep an eye out for any updates to the Circular, the FAQs and any other additional guidance issued by the SFC.

Determining applicability

Type 9 licenced corporations (**LCs**) with investment management discretion in respect of collective investment schemes (**funds**) are required to comply with the climate-related risks requirements. The SFC adopted a two-tier approach, where all in-scope LCs are required to comply with the baseline requirements. In-scope LCs that qualify as large fund managers (i.e. LCs with funds under discretionary management equal to or in excess of HK\$8 billion) are required to comply with enhanced standards in addition to the baseline requirements. For details, please refer to our previous [bulletin](#).

Four key questions to ask in determining applicability:

- (i) Is the LC managing funds (whether private or authorised) with investment discretion?
- (ii) Are climate-related risks relevant and material to the fund?
- (iii) If the responses to (i) and (ii) are affirmative, is the LC a large fund manager?
- (iv) Is the LC responsible for overall operation of the fund (**ROOF**)?

Question (i) above determines whether or not an LC is in-scope and questions (ii) to (iv) will determine the extent to which the new requirements apply. At this stage, LCs will be out-of-scope under the following scenarios:

- (a) It is not exercising investment discretion in relation to the management of funds; or
- (b) It is only managing discretionary accounts

What's next for in-scope LCs

In-scope LCs should begin preparing for compliance as early as possible.

The SFC has stressed that climate-related risk is regarded as one type of investment risk which funds may be exposed to, similar to market risks, liquidity risks, counterparty risks and so on. As such, LCs should adopt the same approach and standard as when addressing other investment risks and existing FMCC requirements.

Proper record keeping will be crucial as LCs navigate and develop their policies around the new and fast-changing territory of managing climate-related risks.

Suggested questions to consider:

Governance: Where you are currently and where do you need to be?

The involvement of the LC's board and management is crucial in ensuring effective integration of climate-related risks across an organisation. The requirement for having adequate and proper internal controls and governance structures is consistent with existing provisions of the FMCC.

LCs may begin with reviewing their current policies, procedures and control frameworks and enhance the same as required to define the roles and responsibilities of their board or board committees as well as those for management-level functions to cover the requirements under the Circular.

An LC belonging to a fund management group may also wish to consider whether to leverage on group policies, procedures or resources to satisfy the SFC's requirements.

Investment Management: Do you recognise the climate-related risks? How do you measure and assess the risks? What are your assessment results?

An LC will need to identify and understand the climate-related risks that may be relevant to its strategies or funds. Flexibility is given to LCs to determine whether it is more appropriate to make an assessment at umbrella fund-level or sub-fund level. When making such determination, LCs should consider whether or not the sub-funds under the umbrella fund are similar in nature.

The SFC noted that, to assess relevance and materiality of climate-related risks, LCs should start by reviewing how climate-related risks impact each individual investment of a fund or strategy and then aggregate the impact of all investments to determine the overall level of relevance and materiality. The SFC has stressed that climate-related risk could have an impact on all types of funds and is not dependent on the investment style that is being adopted. Thus, LCs should not limit their assessment to funds that have an ESG focus or strategy. That said, the SFC recognises that climate-related risks may not be relevant to certain funds due to their 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). Nonetheless, if an LC determines that climate-related risks are not relevant, it must ensure its conclusions are justifiable and maintain proper records of its assessment and basis of determination.

As next steps, LCs should develop an appropriate framework to assess and determine the relevance and materiality of climate-related risks. Such framework should take into account the physical and transitional climate-related risks over a longer time horizon than a fund's usual investment horizon as the impact of physical and transitional risks may be immaterial in a short term but may become material in the medium or long term, especially if fund assets are reinvested in similar sectors or asset classes.

LCs should also review their existing investment philosophy and investment strategies and incorporate climate-related data into the research and analysis process.

Risk Management: *How do you identify, assess and manage climate-related risks and how should you manage such risks?*

Once the relevance and materiality of climate-related risks have been identified, LCs should review its existing risk management process, making sure that such process takes climate-related risks into consideration. Where necessary, enhancements should be made so that the risk management process incorporates additional steps to ensure that climate-related risks can be identified, assessed, monitored and managed on an ongoing basis. LCs should also start identifying the appropriate tools and metrics to assess and quantify climate-related risks.

LCs may adopt different approaches in managing climate-related risks, for example, reallocation of assets, exercising stewardship and active engagement as well as through proxy voting. The SFC recognises that it could be difficult for LCs to manage climate-related risks by re-allocating assets or avoiding high climate risks investments due to return considerations or strategy constraints (e.g. passive strategies). In such cases, the SFC believes engagement becomes a more important tool in risk management.

Disclosures: *What are your disclosure obligations? How will you disclose the information to investors?*

LCs which are ROOFs could begin preparing disclosures that are required under the Circular and develop procedures and policies for reviewing, updating and disseminating such disclosures.

Group-wide disclosures are acceptable if an LC confirms, after internal assessments, that group-wide policies and procedures are applied consistently in its operations in Hong Kong and that they meet the SFC's requirements. Group-wide disclosures will need to be adapted or supplemented to the extent local adoption deviates from group-wide policies and procedures and/or to reflect Hong Kong's regulatory requirements.

LCs may also wish to determine whether it is more appropriate to make disclosures at entity level or at fund level as well as the preferred means of disclosure, which can be various channels such as websites, newsletters or reports to investors so long as the investors' attention is drawn to the information and it is made in writing.

Enhanced standards: *Are you a large fund manager?*

Large fund managers subject to enhanced standards will need to take into account additional requirements when formulating their internal policies, procedures, processes and disclosure requirements.

Delegation and its impact on the scope and applicability of the climate-related risks requirements

Where an LC is being delegated full investment discretion for managing a fund, the relevant climate-related risks requirements will apply regardless of whether the fund is distributed in Hong Kong. The full amount of asset under management (**AUM**) of the fund should be taken into account when calculating whether the LC qualifies as a large fund manager.

The principle of proportionality will apply when an LC is being delegated investment discretion for a portion of a fund, and the applicability of the SFC's requirements will be limited to the portion of assets under its management and the role assigned to it. In calculating whether the LC qualifies as a large fund manager, the AUM of that portion of the fund for which it has discretion over the investment management process should be taken into account.

In the reverse scenario where an LC has overall investment management discretion of a fund but has subsequently delegated its investment management functions to another entity, pursuant to paragraph 1.10 of the FMCC, the LC remains responsible for ongoing monitoring of the competence of its delegate to ensure that the principles of the climate-related risks requirements are followed. In response to a question raised at a briefing session, the SFC stated that the AUM of such fund should also be taken into account when calculating whether the LC qualifies as a large fund manager.

Data availability and quality of data are not barriers to compliance

The SFC recognises that the data availability and quality may be limited and inconsistent across different asset classes and jurisdictions, however, this should not be a barrier to compliance.

The SFC reiterated that LCs have the flexibility to adopt different types of tools and metrics they consider appropriate to assess climate-related risks and may use a qualitative or quantitative approach or a combination of both. References to the standards and approaches of various international organisations can also be made. Where data is not readily available or cannot be reasonably estimated, LCs may also consider engaging investee companies directly.

Compliance deadlines

Large fund managers have until 20 August 2022 to comply with the baseline requirements and 20 November 2022 to comply with the enhanced standards. Other in-scope LCs must comply with the baseline requirements by 20 November 2022.

Conclusion

Climate-related risks management is an area that is evolving and developing quickly both locally and internationally and is one of the top regulatory agenda items globally. LCs are encouraged to act sooner rather than later and be robust yet flexible in its approach in managing climate-related risks.

Launch of Hong Kong re-domiciliation mechanism for foreign investment funds

Fiona Fong

On 30 September 2021, the Government passed into law the Securities and Futures (Amendment) Ordinance 2021 and the Limited Partnership Fund and Business Registration Legislation (Amendment) Ordinance 2021 (the **Ordinances**). These new laws will enable foreign investment funds to be re-domiciled and registered in Hong Kong as open-ended fund companies (**OFCs**) or limited partnership funds (**LPFs**). The Ordinances will come into effect on 1 November 2021.

The Ordinances do not only set out the re-domiciliation procedure, but more importantly provide certainty on the continuity of non-Hong Kong investment funds upon registering in Hong Kong. The re-domiciliation does not operate to (a) create a new legal entity; (b) prejudice or affect the identity or continuity of the non-Hong Kong fund in its place of incorporation or establishment; (c) affect any contract made, resolution passed or any other thing done by or in relation to the non-Hong Kong fund; (d) affect any function, property, right, privilege, obligation or liability acquired, accrued or incurred by or to the non-Hong Kong fund; or (e) render defective any legal proceedings commenced or continued by or against the non-Hong Kong fund.

From overseas corporate funds to OFCs

An application should be made to the Securities and Futures Commission (**SFC**) to register a non-Hong Kong fund corporation as an OFC. As soon as reasonably practicable after such registration, the SFC will notify the Companies Registry (**CR**) which will issue a certificate of re-domiciliation, certifying that the entity has become an OFC.

Don't forget that the new grant scheme for OFCs is also open to a non-Hong Kong fund corporation which successfully re-domiciles to Hong Kong as an OFC before 9 May 2024. The grant will cover eligible expenses paid to Hong Kong-based service providers in relation to the re-domiciliation, subject to a cap of HK\$1 million per OFC and a maximum of three OFCs per investment manager. For further details, please refer to our publication "[Time to apply for subsidies for open-ended fund companies and REITS](#)".

From overseas limited partnerships to LPFs

An application should be made to the CR by the general partner to register a non-Hong Kong limited partnership fund as an LPF. Such application must be submitted on behalf of the general partner by a Hong Kong firm or a solicitor. On registration, the CR will issue a certificate to that effect.

For both OFCs and LPFs, the non-Hong Kong investment fund must be deregistered in its original place of incorporation or establishment within 60 days after re-domiciling to Hong Kong. The SFC or CR (as the case may be) may extend this 60-day period on application if it considers appropriate.

We have seen strong interest from Hong Kong investment managers in adopting Hong Kong-domiciled fund structures since the introduction of the OFC and LPF regimes. This trend is expected to continue as the Hong Kong Government pushes out more initiatives to benefit the asset management industry and develop Hong Kong as the preferred fund domicile.

Mainland China briefing: China expands the investment scope for QFIs

Taylor Hui and Iris Shan

On 13 October 2021, the China Securities Regulatory Commission (**CSRC**) issued an *Announcement on the Participation of Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors in Financial Derivatives Transactions* (**Announcement**, available [here](#) in Chinese).

According to the Announcement, with effect from 1 November 2021, Qualified Foreign Investors (**QFI**) will be eligible to trade commodity futures, commodity options and stock index options listed and traded on futures trading venues approved by the State Council or CSRC. Trades of stock index options are limited to transactions with hedging purposes.

The Announcement was made in accordance with the *Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors* (**QFI rules**) issued in September 2020 (for more information, you may refer to our previous article [here](#) which addresses the key points of the QFI rules), which merged the Qualified Foreign Institutional Investors (**QFII**) and RMB Qualified Foreign Institutional Investors (**RQFII**) regimes. QFII and RQFII have been the major channels for foreign investors to access China securities markets.

Expanding the investment scope for QFI is in line with China's aims to open up securities and futures markets and attract more foreign investments. Going forward, mainland regulators will continue to evaluate and deepen the opening of capital markets as stated by the CSRC.

Hong Kong SFC licensing and compliance hints

Lilian Lai

Remote working: operational resilience and risk management

On 4 October 2021, the SFC issued a [Circular](#) setting out the expected standards and required implementation measures for intermediaries to ensure ongoing operational resilience and risk management within the industry having regard to current market conditions as well as remote working. A [Report](#) has also been published to supplement case examples drawn from the SFC's review of some licensed corporations' measures in coping with COVID-19 related disruptions.

Whilst alternative measures can be adopted to achieve the objectives, intermediaries are encouraged to adopt the techniques and procedures highlighted by the SFC where applicable. Below are some tips for intermediaries to consider.

Oversight and ongoing supervision

- Put in place senior management oversight to identify possible disruptive scenarios, ascertain the intermediary's risk tolerance and develop effective systems and controls to maintain business activities.
- Enhance frequency of reviews and monitoring measures, e.g. trade surveillance tools to make up for the reduced in-person supervision and face-to-face interaction.

Sufficient and adequate resources

- Provide suitable equipment and IT infrastructure with good capacity and connectivity to prevent delays or disruptions, in particular for time-sensitive business activities, e.g. market making of listed products.

- Digitalise workflow and records if possible, but if certain functions are not fit to be performed remotely, e.g. processing cheques for trade settlement services, ensure appropriate minimum staff are present in the office to carry out functions.

Outsourcing and third-party arrangements

- When engaging vendors, assess their business continuity plans, financial status, cybersecurity policies and their sub-contractors to mitigate any risk of service failure due to disruptive events.
- Appoint or identify back-up service providers to mitigate vendor concentration risk.

Information security and cybersecurity

- Implement measures to prevent unauthorised access to systems and data, e.g. requiring multi-factor authentication or performing regular antivirus checks for every remote log-in.
- Ensure confidential information has been handled properly, e.g. sample checking virtual conferences made through its devices or blocking transmission of documents classified as secret.
- Set up multiple back-up systems to mitigate the risk of data inaccessibility or loss due to system failure or cyberattacks.

Record keeping and audit trail

- For off-premises trading, deploy suitable recording systems to ensure orders received or placed by remote-working staff are recorded.
- Only allow temporary keeping of requisite records at premises other than those approved by the SFC when effective controls have been put in place for such records to be delivered back to the approved premises as soon as practicable.

Notification obligation

- If significant changes occur in the business plans covering internal controls, organisational structures, contingency plans and related matters, notify the SFC and where applicable, the HKMA of such changes, even if the remote working arrangement is only deployed for a short period of time.

Regular training

- Promote staff's awareness of their obligations through training and attestation of understanding of and compliance with related internal controls on a regular basis, or when the relevant policies/procedures have been reviewed and updated.

Business contingency plans (BCP)

- Review BCPs at least annually and test regularly. Implement incident management process to cover the escalation procedures, follow-up actions, analysis of root cause and remedial actions to mitigate the impact of similar disruptive events in the future.

Recent publications

Can a tenant get away with its payment obligations in view of COVID-19 and Government Closure Orders?

Capacity of the applicant and the duty of full and frank disclosure in applications for enforcement of arbitral awards

Court of Appeal limits application of “fraud exception” in Order 14 summary judgment applications, while such exception is set to be abolished before the end of 2021

Watch out for that “doxxing” post – what businesses need to know

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