ESG REGULATORY DEVELOPMENTS IN THE UK, JAPAN, AND HONG KONG

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UK Asset Management and Investment Funds Alert

By: Yuki Sako, Sook Young Yeu, Joanna Treacy

INTRODUCTION

We've heard a lot over the past year about Environmental, Social and Governance (ESG) regulatory developments affecting asset managers in the European Union, which is regarded as leading the way on ESG regulation. However, regulators in other jurisdictions have also been taking actions in this area. This alert considers those actions, and related developments, in the United Kingdom, Japan and Hong Kong. In particular, we highlight some themes emerging from the global regulatory response in this area including international promotion of the use of the recommendations published in 2017 by the Task Force on Climate-related Financial Disclosures (TCFD).

Regulators in the United Kingdom and Hong Kong are sending a clear message that compliance with ESG disclosure requirements is important, and that greenwashing will not be tolerated. Asset managers have been warned and now need to take action. The Japanese regulator also seems not far behind.

UNITED KINGDOM

FCA Guiding Principles on ESG and Sustainable Funds

On 19 July 2021, the UK Financial Conduct Authority (the FCA) published its Guiding Principles on design, delivery and disclosure of ESG and sustainable investment funds in the form of a Dear Chair letter.[1] These Guiding Principles are a statement of the FCA's expectations for FCA authorised funds which make ESG-related claims. The guiding principles are based on existing rules rather than new ones and the aim of the principles is to avoid greenwashing in the disclosure of authorised funds in the United Kingdom, though the principles may be relevant to other products as an indication of the FCA's views. Whilst the guiding principles are highly relevant for the design of new products, they apply equally to existing ones and should be considered by firms in their next periodic review of a product that makes ESG or sustainability claims.

FCA Policy Statement on Climate-Related Disclosures by Asset Managers, Life Insurers and FCA-Regulated Pension Providers

On 17 December 2021, after a consultation process, the FCA published a policy statement containing the final rules and disclosures on climate related disclosures by asset managers, life insurers and FCA-regulated pension providers (the Policy Statement).[2] The new disclosure obligations are consistent with the TCFD recommendations. The rules are in line with the UK government's roadmap to adopt mandatory TCFD-aligned disclosures across the UK economy by 2025, and will support the transition to net zero by 2050.

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The TCFD was established by the Financial Stability Board to develop recommendations for effective climate-related disclosures to promote informed investment decisions. The TCFD published eleven recommendations on climate-related financial disclosures in June 2017 (the TCFD Recommendations). These TCFD Recommendations span four general themes: governance; strategy; risk management; and metrics and targets.

The consultation process has resulted in some changes to the rules that had been proposed in FCA consultation paper CP21/17.[3] In making these changes the FCA wanted to find an approach that balanced the risk of incomplete or misleading disclosure with the need to 'get started' and thereby encourage industry efforts to improve both data and methodologies.

The FCA has clarified that firms will no longer have to comply with both TCFD and the European Union's Sustainable Finance Disclosure Regulation (SFDR)[4] methodologies: only disclosure of metrics using TCFD methodologies will be required. Some firms may still opt to disclose against TCFD and SFDR methodologies, for example to meet EU regulatory requirements.

The FCA has also clarified that it will not require firms to disclose information if data gaps cannot be addressed through the use of proxies and assumptions, or if to do so would result in disclosures that are misleading. Whilst acknowledging the transitional difficulties, the FCA has included a requirement that firms explain where and why they have been unable to disclose, as well as the steps they will need to take to improve completeness and quality of disclosure.

In the Policy Statement, the FCA has introduced a new ESG Sourcebook (the ESG Sourcebook) in the FCA handbook. It contains rules and guidance for asset managers to make disclosures that are consistent with TCFD Recommendations, (the ESG Rules).

TIMINGS

Implementation of the disclosure requirements will be phased in. For asset managers with more than £50 billion assets under management (AUM) the rules came into effect on 1 January 2022 (the deadline for the first disclosure reports for the 2022 calendar year being on 30 June 2023). For other firms above a £5 billion AUM exemption threshold, the rules will take effect from 1 January 2023 (the deadline for disclosure for the 2023 calendar year being on 30 June 2024).

IN-SCOPE FIRMS AND PRODUCTS

Firms

The ESG Rules apply to in-scope FCA-authorised firms in relation to TCFD in-scope business carried out from an establishment maintained by the firm in the United Kingdom, irrespective of where the clients, products or portfolio are domiciled. The rules do not apply to third-country branches.

The ESG Rules will not apply to foreign asset managers that market their funds to investors in the United Kingdom via the private placement rules. The FCA is exploring how overseas funds marketed into the United Kingdom should be treated as part of its discussion paper regarding the Sustainable Disclosure Requirements (see below for more details).

Asset management firms in-scope of the ESG Rules (asset managers) include:

- Portfolio managers,

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- Full-scope UK Alternative Investment Fund Managers (AIFMs),
- Small authorized UK AIFMs, and
- Undertakings for the Collective Investment in Transferable Securities (UCITS) management companies and self-managed UCITS funds.

The new disclosure obligations will not apply to an asset manager with less than £5 billion in assets under management (calculated as a three-year rolling average). The FCA expects, however, that this will leave around 140 asset management firms covering 98% of the AUM in the UK market in-scope of the ESG Rules. Following feedback received during the consultation process, the FCA have said the £5 billion AUM exemption threshold will be reviewed as part of a post implementation review after three years of disclosures.

In addition to asset managers, the ESG Rules will also apply in parallel to certain categories of life insurer and pension product providers in their capacity as asset owners.

Products

For asset managers, the disclosure obligations will also apply to in-scope financial products and services. The definition of in-scope financial products includes:

- Authorized Funds (UCITS or Alternative Investment Funds (AIFs))
  - Each sub-fund of an umbrella will be treated as a separate product. Feeder funds are excluded.
- Unauthorised AIFs Managed by a UK AIFM
  - The FCA have clarified that investment trusts, a type of listed unauthorised AIF, are included.
- Portfolio Management Services
  - Portfolio management has a specific definition for the purposes of the rules and captures firms managing investments on a discretionary basis, as well as firms engaging in private equity or other private market activities consisting of either advising on investments or managing investments on a recurring or ongoing basis in connection with an arrangement the predominant purpose of which is investment in unlisted securities.

DISCLOSURE REQUIREMENTS

Entity-Level Disclosures

An asset manager will be required publish an entity-level TCFD report on an annual basis, by 30 June in each calendar year, setting out how it takes into account climate-related matters in managing or administering investments on behalf of clients and consumers. Entity level reports will be required to be published on the firm's website in a prominent place. A member of the firm's senior management will be required to sign a compliance statement confirming that the disclosures comply with the requirements of the ESG Sourcebook.

Product- or Portfolio-Level Disclosure

In its TCFD product report disclosure, an asset manager must disclose a baseline set of consistent, comparable disclosures in respect of their products and portfolios, including a core set of climate-related metrics. For asset

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managers, product or portfolio level disclosures would be made annually in a prominent place on the firm's website. Firms will also need to include the product or portfolio disclosures or cross-references to these disclosures in an appropriate form of client communication (e.g., an annual, half-yearly or periodic report) which is published after the annual reporting deadline of 30 June. The FCA has acknowledged that for some client relationships, public disclosures will not be appropriate. This applies to asset managers in respect of discretionary portfolio management mandates for clients with their own climate-related financial disclosure obligations. It also applies to certain reports for investors in unlisted AIFs managed by a UK AIFM. In these cases, there is a procedure for the provision of on-demand product-level reports. These reports will need to be made to relevant requesting clients/investors within a reasonable period of time and the FCA is encouraging the disclosure of such reports even in instances where the client may not be strictly eligible under the rules to request them.

The disclosure requirements for entity level and product level TCFD reports must be consistent with the TCFD Recommendations and recommended disclosures, being the four recommendations and eleven recommended disclosures set out in Figure 4 of Section C of the TCFD Final Report.[5] Firms must also take reasonable steps to ensure that the disclosures reflect the relevant sections of the TCFD Annex, that is Section C; Guidance for All Sectors, which include requirements relating to the disclosure of net zero transition plans, and Part 4, Section D: Asset Managers.

FCA Discussion Paper on Sustainability Disclosure Requirements and Investment Labels

Alongside the FCA's revised ESG strategy,[6] on 3 November 2021 the FCA issued a discussion paper (DP21/4)[7] seeking initial views from the industry on new sustainability disclosure requirements (SDR) for asset managers as well as a classification and labelling system for sustainable investment products. The FCA aims to consult in Q2 2022 on proposed rules to implement SDR and sustainable investment labels within the FCA Handbook.

The SDR builds on the United Kingdom's implementation of the TCFD, however SDR goes further in that it is not just focused on climate change issues but addresses sustainability more broadly. The FCA wants to avoid duplication and conflicts with existing international rules and has stated that reporting standards of the International Financial Reporting Standards Foundation's International Sustainability Board will form a component of the SDR framework. The FCA is also seeking views on how consistent SDR should be with the European Union's SFDR and how funds marketed into the United Kingdom should be treated, including under the Overseas Funds Regime, which will provide a basis for certain non-UK funds, including probably many EU UCITS funds, to be marketed to the retail public in the United Kingdom.

The FCA suggests three levels of disclosure: product labels, consumer-facing disclosures and detailed disclosures at product and entity level for institutional investors.

PRODUCT LABELS

The FCA is proposing a standardized product classification and labelling system to help consumers understand the sustainability characteristics of the product's key sustainability attributes. The FCA has proposed five categories:

- Products not promoted as sustainable

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- Responsible products (which may have some sustainable investments)
- Transitioning (sustainable characteristics, themes or objectives; low allocation to UK taxonomy-aligned sustainable activities)[8]
- Aligned (sustainable characteristics, themes or objectives; high allocation to UK taxonomy-aligned sustainable activities)
- Impact (objective of delivering positive environmental or social impact)

The FCA have set out minimum criteria for each category and have also given indicative mapping of each product against the European Union's SFDR (Article 6, 8 and 9 categories). The FCA is asking for views on their approach on this proposed mapping.

The FCA has created a group called the Disclosures and Labels Advisory Group which includes industry experts, trade bodies and consumer representatives to provide the FCA with feedback, technical advice and constructive challenge as the work develops.

CONSUMER-FACING DISCLOSURES

The FCA is seeking to ensure a baseline level of prescription on retail consumer-facing disclosure to ensure consistency and comparability. The FCA is welcoming views on the level of prescription required including the potential use of templates and an ESG factsheet for providing information. The FCA would like the disclosures to be read alongside the existing Key Investor Information Document, providing color on ESG matters whilst avoiding duplication of information. The proposed disclosure to the retail investor includes the investment product label, the objective of the product (including any specific sustainability objectives), the investment strategy, the proportion of assets allocated to sustainable investment, and the approach to investor stewardship and wider sustainability performance metrics.

PRODUCT- AND ENTITY-LEVEL DISCLOSURES FOR INSTITUTIONAL INVESTORS

More detailed disclosures at the product and entity level are proposed for institutional investors. These disclosures will provide more granular information than the consumer-facing disclosures. The FCA consider information about data sources, limitations and data quality, information about the UK taxonomy alignment and information about benchmarking and performance, to be more suited to this detailed level of product disclosure.

The FCA is envisaging building on the ESG Rules in relation to entity level disclosures and has sought views regarding practical challenges that firms may face in broadening the disclosure to sustainability-related disclosures. The FCA has also sought views on how stewardship and voting records could form part of the disclosures.

JAPAN

As regulators around the globe begin to consider regulations that focus on ESG, the Japanese regulator has also taken steps to develop an ESG-focused regulatory agenda.

Sustainable Finance Committee Report

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In December 2020, the Financial Services Agency of Japan (the FSA) convened an expert panel on sustainable finance. In June 2021, the panel issued a formal report entitled "Building a Financial System that Supports a Sustainable Society" (the Sustainability Report) which identifies certain priorities, including ESG disclosures by asset managers and issuers. The Sustainability Report calls for more disclosures on criteria used to select investment portfolios. In particular, if the fund's name includes "ESG" or "SDGs,"[9] the Sustainability Report recommends more disclosure on how the fund satisfies characteristics of such designation, using specific metrics. Where a fund is characterized as an environmental impact or social impact fund, the Sustainability Report calls for more disclosure on the specifics of the expected impacts including the way they are measured. The panel also directed the FSA to further examine broader ESG practices in the asset management industry, including specific metrics used. The panel further states that asset managers should provide their sustainable investment and engagement policies and other climate-related disclosures at the asset manager level (as opposed to the fund level) in line with the TCFD or another international framework in a manner that enables investors to make comparisons between managers because, in the view of the panel, asset managers, including managers of passive funds, can promote sustainability through their engagement with portfolio companies.

The Sustainability Report also notes the need for improved reliability and quality of data provided by ESG rating and data providers. It encourages the FSA to engage with ESG rating and data providers on this issue and consider views from companies and investors.

Other areas discussed by the Sustainability Report include the role of institutional investors, improvements to ESG-related bond trading platforms, and the role of financial institutions in supporting clients to transition to a de-carbonized economy, and manage climate change-related risks.

ESG Disclosure – Corporate Governance Code Amendments

Meanwhile, Japan's "Corporate Governance Code" as revised in April 2021 (the Code), will apply to corporate governance reports issued following general shareholder meetings that take place after April 2022. The amended Code requires listed companies, on a "comply or explain" basis, to disclose their efforts focused on "sustainability" (which term includes broader ESG factors). This includes providing information on investments in human capital and intellectual properties designed to achieve sustainable growth of the company. In addition, companies listed on the Prime Market of the Tokyo Stock Exchange will be required, on a "comply or explain" basis, to collect and analyse data on the impact of climate change-related risks and earning opportunities on their business activities and profits, and to enhance the quality and quantity of disclosure in accordance with the TCFD Recommendations or an equivalent framework.

FSA 2021 Policy Statement

In August 2021, the FSA issued the 2021 policy statement providing the FSA's policy priorities for July 2021 to June 2022. With respect to ESG-related priorities, the FSA largely incorporated recommendations in the Sustainability Report as the agenda. However, notably, with respect to disclosures provided by asset managers, the FSA only noted that it would further monitor asset managers and brokers in relation to ESG-related funds, and did not elaborate further. In summary, the FSA is currently focusing its efforts mostly on corporate disclosure, but may also turn to asset managers to require more ESG disclosures in the future.

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HONG KONG

HK SFC Consultation Conclusions on the Management and Disclosure of Climate-Related Risks by Fund Managers.

On 20 August 2021, the Securities and Futures Commission of Hong Kong (the SFC) issued Consultation Conclusions on the Management and Disclosure of Climate-Related Risks by Fund Managers (the Conclusions) and imposed requirements on fund managers to take climate-related risks into consideration in their investment and risk management processes, and make related disclosures. The new requirements cover four key elements: governance, investment management, risk management and disclosure. The requirements have been implemented by the SFC through (i) the adoption of amendments to the Fund Manager Code of Conduct that sets high level principles and (ii) the issuance of a related Circular to Licensed Corporations (the Circular) that sets out expected standards for compliance, including illustrative examples of industry practices. The new regime is a significant development in the HK ESG regulatory landscape and creates new obligations for groups with HK-regulated asset management entities.

BACKGROUND

The Conclusions were issued following a consultation that commenced with the issue of a consultation paper on 29 October 2020 and ended on 15 January 2021. In developing the new management and disclosure requirements the SFC made reference to, and such requirements largely reflect, TCFD Recommendations.

The SFC's initial focus has been climate-related risks. This is because metrics are generally more developed in this area currently and the SFC believes that this will help effective implementation. However, the SFC also acknowledges the importance of ESG factors more generally and encourages fund managers to consider integrating a broader spectrum of sustainability risks into their investment management and risk management processes. The SFC has further stated that it will remain abreast of international and market developments and consider an expansion of the regulatory coverage to other aspects of ESG over the longer term.

IN-SCOPE FIRMS AND REGULATORY APPROACH

Firms

Initially, firms in-scope of the SFC regime will be all SFC-regulated asset management entities (Fund Managers) that manage collective investment schemes (CISs) with investment discretion, whether SFC-authorised or not, but not discretionary accounts.

Proportional Approach

The SFC states that Fund Managers should apply the principle of proportionality in determining how to comply with their requirements. Relevant factors in this regard include the relevance and materiality of climate-related risks to the Fund Manager's investment strategy, and the Fund Manager's particular role. For example, if an SFC-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, it will not be expected to comply with the SFC requirements. Similarly, if a Fund Manager is delegated with investment discretion for a CIS but subject to the risk management framework, process and parameters implemented at the delegating entity and is not responsible for the overall operation of the CIS, it would only need to adhere to the SFC's governance and investment management requirements, but not the risk management or disclosure requirements. The SFC also clarified that local Fund

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Managers may leverage group resources in managing climate-related risks as long as the local management retains responsibility to ensure that it is in compliance with the SFC's applicable requirements.

Two-Tier Approach

The SFC is implementing the new requirements using a two-tier approach, with baseline requirements applicable to all Fund Managers and additional enhanced standards applicable to Fund Managers with CIS assets under management that equal or exceed HK$8 billion (US$1.02 billion) for any three months in the previous reporting year (Large Fund Managers). The SFC had initially proposed HK$4 billion as the threshold for Large Fund Managers but increased this to HK$8 billion in response to comments received during the consultation period. It is expected that, with this higher threshold, only about 100 to 200 Large Fund Managers will need to comply with the enhanced standards and the remaining 1,600 to 1,700 smaller Fund Managers will need to comply only with the baseline requirements.

The baseline requirements and the enhanced standards are set out in Appendix C to the Conclusions:

Baseline Requirements

These requirements apply to all Fund Managers and address:

- *Governance* – the Board's and management's roles and responsibilities;
- *Investment Management* – to identify and factor into the investment management process relevant and material physical and transitional climate-related risks for each investment strategy and fund managed, and take reasonable steps to assess the impact of these risks on underlying investments;
- *Risk Management* – to identify, assess, manage and monitor relevant and material climate-related risks for each investment strategy and fund managed, applying appropriate tools and metrics to assess and quantify climate-related risks; and
- *Disclosure* – to make related disclosures.

Enhanced Standards

The additional enhanced standards apply only to Large Fund Managers and address:

- *Risk Management* – to the extent climate-related risks are assessed to be relevant and material to an investment strategy or fund managed, (1) to assess the relevance and utility of scenario analysis and, if deemed relevant and useful, develop a plan to implement scenario analysis within a reasonable timeframe, and (2) to 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 reasonably be estimated, and define the calculation methodology and underlying assumptions; and
- *Disclosure* – to describe, at the entity level, the engagement policy in relation to material climate-related risks and how it is implemented and, at the fund level, the associated portfolio carbon footprint, including the proportion of investments which are assessed or covered.

Disclosure Requirements

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Entity- or Fund-Level Disclosures

The new regime requires Fund Managers who are responsible for the overall operation of funds to make appropriate disclosures to investors via channels such as websites, newsletter or reports. Such disclosures must be reviewed at least annually and updated where appropriate and fund investors must be informed of any material changes as soon as practicable. The information required to be disclosed at the entity level relates to governance, investment management and risk management (including for Large Fund Managers, the related engagement policy and implementation). If climate-related risks have been assessed to be irrelevant to certain types of investment strategies or funds managed, such exceptions must be disclosed at the entity or fund level and appropriate records which explain why such risks are irrelevant must be maintained. The Circular provides illustrative examples of industry practices for managing and disclosing climate-related risks by Fund Managers.

Fund-Level Disclosures

In addition, Large Fund Managers are required, at a minimum, to disclose the portfolio carbon footprints associated with the funds' underlying investments at the fund level, where data is available or can reasonably be estimated, indicating the calculation methodology, underlying assumptions and limitations, and the proportion of investments assessed or covered.

Implementation Timeline

Following the issue of the Conclusions on 20 August 2021, the SFC's requirements will become effective after the following transition periods:

- A 12-month transition period for Large Fund Managers to comply with the baseline requirements (i.e., until 20 August 2022), and a 15-month transition period for them to comply with the enhanced standards (i.e., until 20 November 2022); and
- A 15-month transition period for other Fund Managers to comply with the baseline requirements (i.e., until 20 November 2022).

The disclosures relating to the baseline requirements and the enhanced standards must be made after the above transition periods, except that for funds with a financial year-end date after the effective date of the enhanced standards on 20 November 2022, Large Fund Managers are required to disclose to fund investors the associated portfolio carbon footprints calculated based on the positions as of the financial year end and by not later than the usual due date of the funds' audited accounts or annual reports (usually between three and six months after the financial year end).

FOOTNOTES

[1] https://www.fca.org.uk/publication/correspondence/dear-chair-letter-authorised-esg-sustainable-investment-funds.pdf.

[2] https://www.fca.org.uk/publication/policy/ps21-24.pdf.

[3] https://www.fca.org.uk/publication/consultation/cp21-17.pdf.

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[4] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019.

[5] https://assets.bbhub.io/company/sites/60/2021/10/FINAL-2017-TCFD-Report.pdf.

[6] https://www.fca.org.uk/publications/corporate-documents/strategy-positive-change-our-esg-priorities.

[7] https://www.fca.org.uk/publication/discussion/dp21-4.pdf, which had a comment period that closed on 7 January 2022.

[8] The Green Technical Advisory Group will provide independent advice to the UK government on implementing a UK taxonomy setting the bar for investments that can be defined as sustainable investments. The consultation process will begin in Q1, 2022.

[9] "SDGs" stands for Sustainable Development Goals adopted by the UN Sustainable Development Summit in September 2015.

KEY CONTACTS

YUKI SAKO
COUNSEL

WASHINGTON DC, TOKYO
+1.202.778.9061
YUKI.SAKO@KLGATES.COM

SOOK YOUNG YEU
PARTNER

HONG KONG
+852.2230.3591
SOOK.YEU@KLGATES.COM

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