HKVCA
Hong Kong Venture Capital and Private Equity Association
香港創業及私募投資協會
The Association for Private Capital in Asia

15th January 2021

The Securities and Futures Commission
54/F One Island East, 18 Westlands Rd
Quarry Bay, Hong Kong

By email to: 2020_Climate_Consultation@sfc.hk

Dear Sir/Madam

Consultation on 'Management and Disclosure of Climate-related Risks by Fund Managers'

Many thanks for providing this opportunity to comment on the detailed proposals laid out in the Consultation Paper on the Management and Disclosure of Climate-related Risks by Fund Managers dated October 2020. HKVCA is pleased to contribute to the debate on this important topic.

By way of introduction, we would note that HKVCA has been promoting the importance of Environmental, Social and Governance ("ESG") enhancements to both our own members' businesses and those of their investee companies whilst those businesses are under our members' stewardship. Private Equity/Venture Capital ("PE/VC") involves medium to long-term holding of investments – and this provides a good platform from which we can improve the businesses in which we invest.

HKVCA is supportive of Climate Change risk assessment and reduction measures – and encourages its members to adopt best practices in this area.

The comments we would like to submit to the SFC are:

1. ESG is a very high priority issue for the PE/VC community and whilst firms attach different levels of weighting, nearly all PE/VC firms have processes in place to apply ESG principles in the businesses into which they invest. Whilst Climate Change may be an extremely important element of ESG, regulation of Climate Change risks should be implemented in such a way that it enhances the overall ESG response – and should not diminish other ESG processes within businesses.

2. The vast majority of HK-based PE/VC firms have investment mandates which are cross border in nature. Further, the large majority of the capital these firms deploy is sourced from international fund investors. Thus the capital is both sourced and deployed across many jurisdictions.

   It is critical that Climate Change measures promoted by governments, regulators and Climate Change action groups are co-ordinated, uniform, non-conflicting and non-overlapping. Any regulation in this area should be in line with international best practice – and adapt if, in time, best practice changes.

3. HKVCA supports encouraging detailed but voluntary ESG improvement and Climate Change reduction measures. Requiring and encouraging Fund Managers to make disclosures of Climate Change measures, Climate Change strategies and targets (or the intention not to have targets) is an effective way to drive improvement by generating internal and external buy-in for a firm's response.

HKVCA has a preference for regulation that provides a baseline requirement – and allows individual firms to set and articulate how far they wish to go beyond the baseline response.

4. The proposed differentiation between rules applicable to Large Fund Managers and small firms is much appreciated. Smaller firms are less able to afford the resources to report on and measure the Climate Change risks in their portfolio companies.

   By way of reference: HKVCA has 234 fund managing members of whom 121 (48%) have assets under management of less than HK$4bn. Comments from our LP investor members suggest that they would not consider a PE fund manager with AUM of HK$4bn (split over, say, 2-3 funds) as a 'large manager'. SFC could consider a slightly higher hurdle (say HK$5bn). The HK$4bn dividing line is reasonable, but might better at HK$5bn.

5. The measures that would apply to smaller firms – establishing and reporting on the processes for monitoring Climate Change risk, without having to calculate the WACI at a fund or firm level, are a reasonable proposal.

6. At a portfolio company level, there are some considerations:

   The climate change risks vary enormously across different industry sectors – and the concept of proportionality should be respected. Many PE/VC firms focus on certain investment sectors which have a relatively low Climate Change impact (online services, healthcare, education, fintech) whilst a greater Climate Change emphasis may be desirable on investments in manufacturing, transportation, energy and infrastructure sectors.

   Over 70% of Asian PE/VC investments are minority shareholdings and 73% of all Asian PE investments in the last three years have been smaller than US$10m. Smaller PE/VC firms tend to invest in minority shareholdings in smaller businesses. Investments are typically held for four and half years.

   The implication of these numbers is that most of the existing portfolios of HK-based PE/VC firms are non-control shareholdings in Small Medium Enterprises ('SMEs'), where rights to obtain detailed Climate Change analysis has not been negotiated in a shareholders agreement at the time of investment. The SMEs are unlikely to report Climate Change information and may see no benefit for the SME to do so – and it will take time and cost to the PE/VC firm to obtain this data.

   We suggest that existing investments can be grandfathered in from the new requirements that relate to implementation of metrics and/or collection of data relating to specific investments given when such investments were entered into, the contracts, accessibility and rights were not negotiated with such new requirements in mind, thus their implementation at this point (even with the implement period) may be commercially burdensome for the fund manager.

7. To a greater or lesser extent, many of HKVCA's members have already adopted ESG principles and measurement as set out by Sustainability Accounting Standards Board, United Nations Principles of Responsible Investment, UN Global Compact, the IFC Sustainability Framework and the United Nations 17 Sustainable Development Goals. These ESG frameworks are premised on addressing a wide range of ESG KPIs rather than just focusing on Climate Change factors. HKVCA will continue to

stress the importance of these types of framework for its Members.

It is noted that there is widespread support for Task Force on Climate-related Financial Disclosures ('TCFD') standards.

8. There is a concern that the Climate Change reporting is a detailed and technical regulatory approach of one element of ESG – and that this approach will later be joined by different technical rules with respect to other elements of ESG.

9. Large Fund Managers will be required to annually publish WACI statistics 'at the Fund level' where the WACI is a representation of the tons of carbon dioxide equivalent emissions per million dollar revenue of investee companies. Some businesses, by their nature, will have low WACI ratios – and whilst there may be relevant strategies to encourage those businesses towards carbon neutrality – the calculation of the WACI for these businesses may not be cost effective. Low carbon emission companies have little incentive to comply with WACI reporting. At least at the outset of this regulation, it might be helpful to establish a WACI baseline below which low-WACI businesses will not have to calculate the WACI ratio – and where 'Fund level' reporting will apply only to high WACI investments. This will add a measure of proportionality to the reporting requirements.

10. Once the Climate Change regulation is finalised, PE/VC firms will have 9-12 months to implement the disclosure requirements. It is possible that some PE/VC firms will require opt-out clauses for some historic investments where access to WACI data may not be available – or where it may take some time to negotiate information rights. Again a degree of proportionality should be applied to this opt-out.

11. SFC should undertake to work with other regulators and the principal ESG standard setters to maintain uniformity of ESG and Climate Change standards across jurisdictions.

12. The SFC is proposing here to legislate by circular. While this is not an unusual step for the SFC, the extent and technicality of the rules that will be propagated by circular is unusually great.

13. Paragraph 46 (appropriate management structure) appears to require quite a lot of board resources to comply with.

14. How will the inclusion of climate-related risks in 3.11.1(b) of the FMCC apply? There is currently nothing in the suggested amendments that limits this requirement to where climate-related risks are relevant. And the flow chart does not make it clear whether this needs to be applied if they are immaterial. This is confusing and the SFC should add clarity to ensure that the regulatory requirements are clear enough to managers.

15. We believe that particular emphasis should be put on combatting "greenwashing" which is an issue raised in the consultation paper and is material misleading to investors. If an asset manager markets themselves as "green" or "sustainable", we suggest that perhaps they should be held to the same higher standards and requirements as proposed hereunder for Large Fund Managers to ensure that their investment management process is in line with how they market themselves to the investors.

16. A number of regulated firms employ an investment strategy of being PE Fund Investors or Fund of PE Funds. Whilst they may make some direct investments or direct co-investments in operating businesses (for which they may incur reporting requirements), the majority of their investments are

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in PE or VC Funds.

An LP in a Fund will probably be unable to report on Climate Change factors of the underlying portfolio companies of the fund in which it has invested. The LPs may be able to request Fund Managers to supply Fund level data – but in existing Fund investments this may not be available. In addition, potential Fund Managers in some jurisdictions may not wish to comply with the request for Climate Change data.

LPs in PE Funds should be able to report on the Fund level data of the Funds in which they invest – and be able to provide explanations as to why they are unable to provide data on some Funds.

Yours sincerely

Jie Gong
Chair, HKVCA ESG Committee

John Levack
Chair, HKVCA Technical Committee

About HKVCA

HKVCA is a member-based trade association which was established in Hong Kong in 1987 currently with 460 members of whom 290 are Hong Kong based private equity managers across the full spectrum of the industry from venture capital, through growth capital and growth buyouts to institutional fund investors, fund of funds and secondary investors. HKVCA represents small teams investing in start-ups as well as all of the 10 largest global private equity firms.

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CONSULTATION PAPER ON THE MANAGEMENT AND DISCLOSURE OF CLIMATE-RELATED RISKS BY FUND MANAGERS

January 2021

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.

Response: It is appropriate to focus on climate change. Whilst many member firms are strongly committed to enhancing a range of ESG goals, it is understood that Climate Change is one of the most important. SFC is not alone in setting up its efforts to regulate climate risk management and disclosure specifically. Hence singling out this specific type of risks is consistent with global regulatory trends and should help accelerate adoption and compliance.

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?

Response: See response to Q5 below

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?

Response: Agree. SFC should, as far as possible, align with the TCFD Recommendations to minimise managers' compliance workload and costs to comply with different reporting standards. Other frequently mentioned standards are UN PRI, UN Global Compact.

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

Response: No specific comment. The proposed threshold appears to be set referencing other jurisdictions which have adopted similar climate change related management and disclosure requirements.

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

Response: SFC may consider defining more specifically the conditions under which Discretionary Account Managers are required to make baseline disclosure, e.g. upon client request, or where the Managers has specifically included ESG or impact investment, etc. into the investment mandate of that discretionary accounts.

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?

Response: Yes, if a fund manager considers climate-related risks to be irrelevant, they should ensure their assessment is well supported by facts and analysis. And they should be required to make disclosures of this assessment together with relevant facts and analysis to their (prospective) investors and periodically (e.g. at least once a year) disclose update their assessments. SFC may include this as part of its regular audit on licensed corporations to ensure compliance.

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?

Response: Agree that the starting point would be to apply the disclosures requirement at the entity level. That said, the real impact would necessarily come from disclosure at the fund level. It would make sense to extend the reporting requirements at the fund level to all fund managers at some stage once the industry has established a more consistent set of disclosure requirements.

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?

Response: Agree that the quantitative disclosures such as WACI should be applicable to Large Fund Managers due to their access to resources. Also mandatory disclosures by Large Fund Managers would have a more visible impact in the industry as a whole.

9. Do you think the following transition periods are appropriate?

- **a nine-month and a 12-month transition period for Large Fund Managers to comply with the baseline requirements and enhanced standards respectively; and**
- **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.

Response: The transition period is generally appropriate for the baseline requirements, but can consider exemptions for existing investments and a longer transition period (such as 18 months) for Large Fund Managers to comply with the enhanced standards due to time requirement to collect relevant information at the fund level from underlying issuers.