Principles for Responsible Investment

PRI RESPONSE

JAPAN FSA INVITATION FOR PUBLIC COMMENTS REGARDING "DRAFT BASIC GUIDELINES ON IMPACT INVESTMENT"

10 October 2023

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To inform this briefing, the following investor group has been consulted: PRI Regional Policy Reference Group for Japan. This consultation is not an endorsement or acknowledgement of the views expressed in this briefing.

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INTRODUCTION

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

The PRI develops policy analysis and recommendations based on signatory views and evidence-based policy research. The PRI welcomes the opportunity to respond to the Japanese Financial Services Agency (JFSA) call for public comments on its Draft Basic Guidelines on Impact Investment.

ABOUT THIS CONSULTATION

On 30 June 2023, JFSA's Strategy Development Division, Strategy Development and Management Bureau published its Draft Basic Guidelines on Impact Investment (available in English and in Japanese). The Draft Basic Guidelines on Impact Investment were developed by the Working Group on Impact Investment, established under the Expert Panel on Sustainable Finance. They aim to grow the impact investment market in Japan by providing a set of principles-based expectations that foster a common understanding among market stakeholders on what impact investing is and how it can help them achieve relevant objectives. The Working Group will continue to pursue measures to promote impact investment by establishing a consortium and cooperating with stakeholders on identifying and executing further initiatives.

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PRI POSITION AND KEY RECOMMENDATIONS

Around the world, investors are recognizing that both economic growth and financial returns depend on a healthy environment and a stable society. At the same time, many governments want to help investors put their capital to work addressing crises like climate change and poverty.

Japan has assumed strong leadership in this area, with strong support for sustainable finance coming from across the private sector as well as from policy makers and regulators. We recognize the initiative taken by the FSA to promote discussions and knowledge-sharing on impact investment, namely through the Impact Investing Roundtable and the Working Group on Impact Investment. The Draft Basic Guidelines on Impact Investment marks another important step in this direction by the Japanese government to support investors as they aim to intentionally pursue sustainability impacts.

In order to ensure that investors receive the necessary support to invest for sustainability impact, we encourage the FSA to:

- **Consider clarifying the broad landscape of approaches investors can take to invest for sustainability impact.** The Draft Basic Guidelines on Impact Investment refers to PRI's A Legal Framework for Impact (LFI), which explores the degree to which investors are legally required or permitted to invest for sustainability impact, as well as policy options to better enable investors to pursue such impacts. In doing so, we developed a framework that provides three categories depending on the level and nature of intention to pursue sustainability impacts. The FSA should consider and message where "impact investing" fits into these categories. This would help investors to understand the various approaches they can take to invest for sustainability impact and encourage more to engage in the practice.
- **Consider broader financial policy reform to promote investing for sustainability impact.** Our Japan-specific LFI recommendations cover policy options that support investors to consider sustainability impacts and outcomes across their entire portfolio and at the fund level. These include policy options that would clarify how investors should consider sustainability outcomes within their investor duties, nurture and enhance an impact-focused market infrastructure (such as through stewardship guidance and corporate disclosure), as well as strengthen mechanisms for transparency and market discipline to enable impact-focused decision making across the investment chain. Considering these policy options can further enhance the market ecosystem for investing for sustainability impact and expand uptake of the FSA's Draft Basic Guidelines on Impact Investment.
- **Consider progressing discussion on how investors can understand their contribution, especially in terms of credibility and causation.** The Draft Basic Guidelines on Impact Investment are important in that they do not limit the scope, opening it to a wide range of investees, investors, and asset classes. The FSA has played an important role in considering various approaches to understanding or assessing the difference an investor's activities make in changing the impact of business enterprises such as through its Impact Investing Roundtable. Seeing that "additionality" and "support for novelty and/or advantages" have been established as principles, we believe it will be key, especially for listed equity investors, to receive support on how to establish a credible narrative on their contribution.

DETAILED RESPONSE

CONSIDER CLARIFYING THE BROAD LANDSCAPE OF APPROACHES INVESTORS CAN TAKE TO INVEST FOR SUSTAINABILITY IMPACT

'Impact investing' as proposed by the FSA is an important approach where investors can allocate their assets into projects and companies that bring about specific social and environmental impacts. There are, however, other levers that investors can utilize to influence their investees and other third parties and bring about sustainability impacts aligned with sustainability outcome goals such as the Paris Agreement and the UN Sustainable Development Goals (SDGs). We think that there is an important distinction between the more specific kind of impacts that 'impact investing' pursues and the outcomes-aligned (such as net-zero aligned) impacts that broader approaches can enable. By clarifying the broad landscape of approaches investors can take to invest for sustainability impact, investors and policymakers alike will be able to better harness the power of the Japanese financial market to bring about necessary sustainability impacts.

The A Legal Framework for Impact (LFI) is a joint flagship project of PRI, the UN Environment Programme Finance Initiative (UNEP FI), and the Generation Foundation, which seeks to identify and overcome barriers to a financial system that is consistent with sustainability outcome goals. The project can provide an important frame of thinking on the broad approaches investors can take to invest for sustainability impact and identify where 'impact investing' sits, so that investors and policymakers alike are aware of its possibilities and limitations.

The project's bedrock output, commissioned by the project group and authored by Freshfields Bruckhaus Deringer, is a 2021 paper (the LFI Report) which provides a legal analysis of the degree to which investors are currently permitted or required to pursue positive sustainability outcomes, and explores potential policy-level barriers and solutions. The LFI Report's high-level legal findings are as follows:

- Financial return is generally regarded as the primary purpose for investors;
- Investors are likely to have a legal obligation to consider pursuing sustainability impact goals where that can help achieve their financial objectives;
- Some investors can pursue sustainability impact goals for reasons other than achieving a financial return;
- Investors are legally required to pursue sustainability impact goals if the objective of the financial product commits them to do so.

The LFI Report also introduced the concept of investing for sustainability impact (IFSI). This is not a legally defined expression. Instead, it is used in the LFI Report's legal analysis as a concept to catch, broadly, any activities that involve an investor intentionally attempting (through investment decisions, stewardship or policy engagement) to bring about assessable behaviour changes among investee companies, policy makers or other third parties to achieve positive sustainability outcomes. The LFI

Report distinguishes between two types of investing for sustainability impact based on the investor's objectives:

- instrumental IFSI, where achieving the relevant sustainability impact goal is 'instrumental' in realising the investor's financial return objectives;
- ultimate ends IFSI, where achieving the relevant sustainability impact goal, and the associated overarching sustainability outcome, is a distinct goal, pursued alongside the investor's financial return objectives, but not wholly as a means to achieving them.

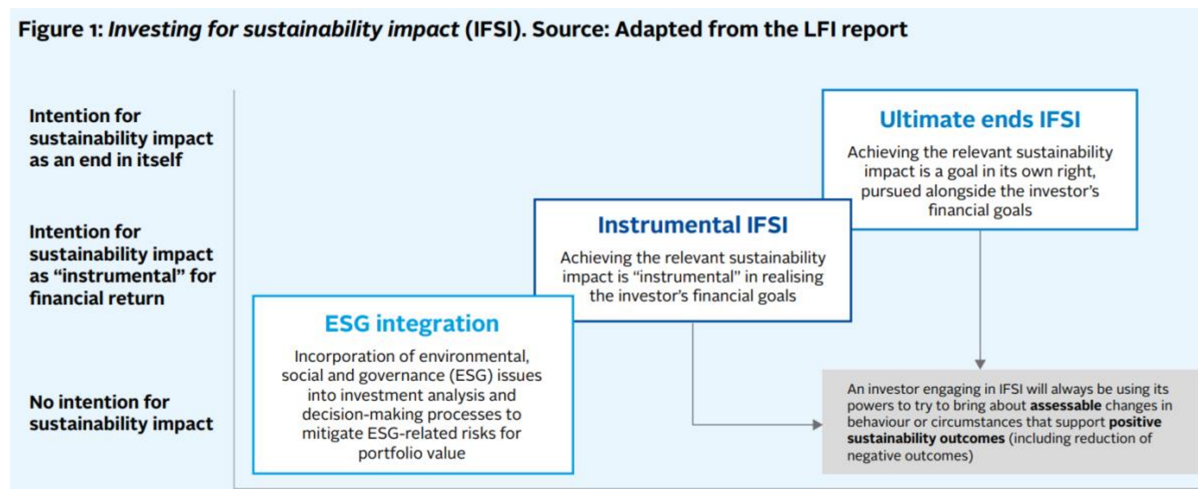

Figure 1: *Investing for sustainability impact* (IFSI). Source: Adapted from the LFI report

The classification of instrumental IFSI and ultimate-ends IFSI aligns with the findings of the Report by the Working Group on Impact Investment and was referred to in the report as well. However, while the Report by the Working Group on Impact Investment highlights that 'impact investing' can help to improve sustainability outcomes and reduce potential system-level risks from an instrumental IFSI perspective, in practice, 'impact investing' appears to focus on an ultimate-ends IFSI approach, as the intention is to pursue sustainability impact in and of itself, alongside financial return.

The LFI Report explores this question on the relationship between what is commonly referred to as 'impact investing' and the kind of activities that fall within the scope of IFSI. Essentially, the concept of IFSI is broad enough to cover impact investing. Indeed, there appears to be a strong correlation between the two at a broad conceptual level. However, they are distinguishable, in particular, because of the sort of investors and investments involved, and this difference is still present between the 'impact investing' being proposed by the FSA and IFSI. This was also a topic explored across the Japan LFI Report launch events.

Interest in various forms of 'impact investing' has grown in the last decade. Various international initiatives have emerged that seek to define what it is and develop effective approaches for managing and measuring impact outcomes. They have led the way in generating valuable know-how and investment tools. They include the Global Impact Investing Network,[1] the Impact Management

[1] https://thegiin.org

Project,[2] the Operating Principles for Impact Management[3] (promulgated by the International Finance Corporation), the 'Future of Investing' platform of the World Economic Forum,[4] the OECD Social Impact Investment Initiative,[5] the Global Social Impact Investment Steering Group[6] and the (wider in scope) United Nations Environment Programme Finance Initiative Positive Impact Initiative.[7] There is joint working between many of these groups.

As noted, there is a basic consistency between the features of IFSI and the key elements of impact investing, as described by the groups and initiatives mentioned above.[8] With differences of emphasis, the way they define impact investing involves three recurring themes:

- the key distinguishing feature is its purpose, which is to secure identified positive outcomes of some sort;[9]
- there is generally an expectation that the investor's purpose also includes earning a financial return; and[10]
- the importance of being able to assess progress in achieving the relevant impact goal.

The main area of difference with IFSI concerns the way impact investing functions in practice, especially (i) the types of investors involved and (ii) the sort of enterprises in which they invest and the associated methodologies applied. This may result, in part, from its origins at the interface between investment and philanthropy. Some of the initiatives mentioned above seek to draw on and apply more widely experience and techniques developed in this context.

- **Investor types:** In terms of investor types, impact investing has tended to be the preserve of development finance institutions, private investors and specialist investment funds more than major institutional investors and investment firms. That has begun to change in recent years with attempts to 'mainstream' impact but, at least in the context of capital allocation, it remains largely the case. Even where more 'mainstream' investors use their investment powers to engage in impact investing, they can tend to do so through specialist impact investing units

[2] https://impactmanagementproject.com

[3] https://www.impactprinciples.org

[4] https://www.weforum.org/platforms/shaping-the-future-of-investing

[5] https://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/social-impact-investment-initiative.htm

[6] https://thegiin.org

[7] https://www.unepfi.org/positive-impact/positive-impact/

[8] A high-level review was undertaken for the purposes of the LFI Report.

[9] Impact investors may be more likely to pursue ultimate ends IFSI than other categories of investor, but their activities could include both instrumental and ultimate ends IFSI.

[10] Alternatively, some impact investors may treat not losing the capital invested as a base line. That would not be usual for the type of asset owners covered by this project.

more than their core investment activity.[11] IFSI on the other hand involves the integration of sustainability impacts across core investment activity at the portfolio level, rather than a specialized portion of the portfolio.

- **Investment targets:** As to what these investors invest in, while it is not easy to generalise, the targets have often been discrete, early-stage, private enterprises that tend to be concerned with addressing a specific social or environmental issue; enterprises that have sometimes been described as 'impact-driven organisations'.[12] They fall along a spectrum from those intended to generate market levels of investment return through to others which prioritise a social or environmental goal. Some impact investors think of 'impact' in terms of the positive impact their capital provision can have for these early-stage enterprises that may not be able to access other capital sources. Impact investing has historically been less concerned with securing sustainability impacts in larger, more mature and diversified businesses, including major multinationals whose securities are traded on the world's investment exchanges. The concept of IFSI is intended to catch impact-driven investment activities whatever sort of business enterprise is involved.[13]

'Impact investing' as proposed by the FSA differs from traditional impact investing in that it is intended to capture all investments, without defining or restricting the investors, investees, or asset classes involved. This represents an important step toward mainstreaming sustainability impact considerations in investments. However, the framework is similar in nature to traditional impact investing in that it is based on investments in individual projects and companies, and in that it involves the intention to pursue and measure the individual positive impact of its funding. These characteristics are distinctly different from the general characteristics of IFSI, which is premised on setting portfolio- and fund-level sustainability impact targets and encompasses a wider range of investor activities beyond asset allocation. The Draft Guidelines are also unique in that they appear to assume an above-market-rate financial return target to align with the fiduciary duty of a wider range of investors – although this will preclude cohorts of traditional impact investors that prioritize social and environmental impact above financial returns. This may be seen as a point that resembles strong alignment with IFSI, which is a framework suited toward large-scale asset owners rather than impact

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[11] See, for example, From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors, A Report by the World Economic Forum Investors Industries, World Economic Forum, 2013, particularly sections 1 and 3; Social Impact Investment: Building the Evidence Base, OECD, 2015, 26 et seq. See also the profile of those participating in the GIIN Annual Impact Survey, 2020: Annual Impact Investor Survey 2020, Global Impact Investing Network, 2020, 1, 25 and 69 et seq.

[12] Social Impact Investment: Building the Evidence Base, OECD, 2015, 16. See also the discussion of the impact investing 'demand-side' at 24 et seq. which talks variously of 'social enterprises' and 'social ventures', but does not consider the relationship between investing in this sort of enterprise and capital allocation to companies meeting social needs more widely, such as utilities companies.

[13] See, for example, World Economic Forum, From the Margins to the Mainstream, 9, 15 et seq.; Social Impact Investment: Building the Evidence Base, OECD, 2015, 46 et seq.; Creating Impact: The Promise of Impact Investing, IFC, 2019, 2; and examples of impact investments given in Social Impact Investment 2019: The Impact Imperative for Sustainable Development, OECD, 2019. A desire to look beyond this traditional focus lies behind the PRI's Impact Investing Market Map, PRI, 2018. The GIIN Annual Impact Investor Survey 2020, 38 et seq. indicates that the largest share of the AuM of those surveyed (65 per cent) was invested in mature public or private companies. That was out of an aggregate amount of $400bn (objectively large, but modest by reference to global AuM, see Part A.3), and the nature of the enterprises to which the capital was allocated (as opposed to the company from which the enterprise was being run) is unclear. However, GIIN's figures nonetheless suggest that allocation to more mature companies by impact investors has been growing since 2015.

investors with more specialized mandates, but may be a point that needs clarification for more traditional impact investors.

All in all, 'impact investing' proposed by the FSA in The Report by the Working Group on Impact Investment is a marked departure from traditional and narrow forms of the practice. We importantly acknowledge that this aligns with Japanese Prime Minister Fumio Kishida's statement at PRI in Person 2023, where he highlighted that "strengthening the functioning of finance that encourages sustainability outcomes" is a policy priority, and noted that "addressing social challenges through investment would encourage companies to drive change, enhance sustainability of our economies and societies, as well as harness growth potential of our world. This would, in turn, provide long-term financial opportunities to both investors and the beneficiaries who entrust their funds to the investors. This approach of responsible investment is something that would precisely embody elements of what is generally called "fiduciary duty."" [14]

'Impact investing', while an important piece of the landscape, will not be enough to drive portfolio and entity-level changes required to mainstream sustainability impacts at the fiduciary duty level and embed it across responsible investment practices. The FSA should consider examining how 'impact investing' fits into the broader spectrum of investing for sustainability impact in order to clarify what kinds of objectives and approaches to pursuing impacts 'impact investing' can support, as well as clarify other approaches investors can take to pursue sustainability impacts, beyond 'impact investing'. It can also clarify areas where the FSA can consider policies that complement the practice.

CONSIDER BROADER FINANCIAL POLICY REFORM TO PROMOTE INVESTING FOR SUSTAINABILITY IMPACT

The Report by the Working Group on Impact Investment will be an important step toward the mainstreaming of impact investing – a key trend that we observe in the high-level analysis above. However, this alone will not sufficiently explore the practical levers investors have at their disposal to instrumentally invest for sustainability impact, and importantly will not take into account measures more closely aligned with instrumental IFSI, such as stewardship and policy engagement.

We therefore encourage the FSA to also focus its efforts to establish a regulatory and market environment that supports instrumental IFSI, an approach that is already conducive to the legal duties of investors in Japan. This topic has an especially important implication for the inclusion of key asset owners, namely pension funds, to mobilize their capital toward pursuing sustainability impacts. We recommend that this more fundamental discussion on incorporating sustainability impacts and outcomes across investor duties be pursued alongside practical impact investment support, to ensure that investors acknowledge the legal and practical implications of investing for sustainability impact specifically as an approach, alongside the various levers at their disposal to incorporate economic externalities.

[14] Prime Minister's Office of Japan (2023) Statement by Prime Minister Kishida at PRI in Person 2023

In doing so, we once again encourage the FSA to consider our Japan-specific LFI recommendations, compiled in the report, [Japan: Integrating sustainability goals across the investment industry] (the LFI Japan Report), which explores what local legal and market conditions currently prohibit further action to invest for sustainability impact. Japan's policymakers and private sector are particularly interested in incorporating the SDGs and the Paris Agreement into their respective objectives. The LFI legal analysis supports this trend, finding that generally investors in Japan already have the legal freedom, and in certain cases the duty, to consider and pursue sustainability goals whenever doing so is consistent with their fundamental duties to pursue financial return. However, many investors remain unaware of the extent to which they are permitted or required to invest for sustainability impact; although Japanese authorities have made it clear that investors are permitted to consider ESG factors when these are relevant to financial returns, they have not treated investment for sustainability impact with the same clarity. The report therefore features five policy recommendations for Japanese regulators and policymakers, urging them to clarify the legal conditions and enhance the market conditions for practitioners to enable investors to pursue positive sustainability outcomes:

- Clarify the extent to which investors' duties permit or require them to consider pursuing sustainability impact goals;
- Ensure better investor access to corporate sustainability-related information by updating existing rules, standards and guidance;
- Clarify when and how investors can use stewardship activities to pursue sustainability impacts, by updating the stewardship code, and through relevant implementation support programmes;
- Enhance transparency and market discipline on responsible investment claims by introducing rules and guidance on disclosures, labelling and classification;
- Ensure better communication between investment managers and their clients and beneficiaries on sustainability objectives and preferences by introducing relevant guidance.

CONSIDER PROGRESSING DISCUSSION ON HOW INVESTORS CAN UNDERSTAND THEIR CONTRIBUTION, ESPECIALLY IN TERMS OF CREDIBILITY AND CAUSATION

A key characteristic of impact investing is to intend on specific sustainability impacts and understand or assess the investment's contribution, or "additionality" in this case, toward achieving that target. We understand that the focus here is on establishing a reasonable level of confidence that steps the investor is planning, or has taken, are likely to lead in some way to a change of third-party behaviour that is material in moving towards the investor's sustainability impact goal.

Demonstrating the precise extent to which an investor's intervention has resulted in a change of outcome is not always straightforward. Much may turn on the sort of activities the investor is engaging in and with whom, and what sustainability impacts it is targeting. In some cases, the means of influence necessarily involve reasonably clear measures of an investor's influence, either individually or as part of a group, for example, where a company agrees to change its practices following

PRI Principles for Responsible Investment

engagement with the investor community or where resolutions are passed or legislation is changed – although these do not appear to be considered within the impact investing framework of The Report by the Working Group on Impact Investment.

In relative terms, understanding the difference an investor has made is, perhaps, most straightforward where an influential investor has a substantial funding role in a privately held enterprise pursuing a goal which is aligned with realising positive sustainability impacts. Here, it should be possible to apply a form of 'but for' test, which is essentially what the concept of 'additionality' does. Even so, outcomes are rarely the result of a single causal factor and understanding the extent of the investor's contribution may therefore still be challenging.[15] In public markets, where the bulk of institutional investment is focused, there is also likely to be more of a need to look at the level of collective sustainability impact initiatives in which the relevant investor is involved.[16]

The question of how investors can provide credible narratives on the causation that their investments have brought about "additionality", or a change resulting from an allocation of capital or the provision of non-financial inputs by an investor to a given enterprise which would not otherwise have happened, will have different implications for different types of investees, investors, and asset classes. For example, although not explored as an option in the Report by the Working Group on Impact Investment, investors are in the midst of considering how to measure and manage the impacts they contribute to within collaborative action initiatives. A similar point can be made with investments into listed equity, where the individual contribution of an investor, whether it be through asset allocation, stewardship, or policy engagement, is difficult to assess with the market infrastructure provided today. The same concerns can apply to the principle of support for "novelty and/or advantage."

We acknowledge and welcome the FSA's initiatives thus far to promote discussions and knowledge-sharing in this area, namely through the Impact Investing Roundtable and the Working Group on Impact Investment. We also look forward to discussions within the proposed Consortium to address these questions so that the Draft Basic Guidelines are able to sufficiently support and be inclusive of all types of investees, investors, and asset classes.

The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of the JFSA further to create policies addressing sustainability impacts.

Please send any questions or comments to policy@unpri.org.

More information on www.unpri.org

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[15] From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors, A report by the World Economic Forum Investors Industries, September 2013, 26.

[16] See, for example, Wendy Abt, 'Almost Everything You Know About Impact Investing is Wrong', Stanford Social Review, 18 December 2018.