PRI RESPONSE

JAPAN FSA INVITATION FOR PUBLIC COMMENTS REGARDING PROPOSED PARTIAL AMENDMENTS TO THE COMPREHENSIVE SUPERVISORY GUIDELINES FOR FINANCIAL INSTRUMENTS BUSINESS OPERATORS, ETC. REGARDING ESG INVESTMENT TRUSTS

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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.

PRI Association
Registered office: 25 Camperdown Street
London, UK, E1 8DZ Company no. 7207947
T: +44 (0) 20 3714 3220 W: www.unpri.org E:info@unpri.org

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 proposed partial amendments to the comprehensive supervisory guidelines for financial instruments business operators, etc. regarding ESG investment trust funds (draft supervisory guidelines).

ABOUT THIS CONSULTATION

On 19 December 2022, JFSA's Asset Management Business Monitoring Office published its draft revisions to the comprehensive supervisory guidelines for financial instruments business operators, etc. The draft revisions build upon the *Progress Report on Enhancing Asset Management Business 2022* published in May 2022, where the JFSA presented findings from a review of 225 publicly offered ESG-related investment trust funds and proposed a set of voluntary expectations for asset managers to better their practices based on the findings.

For more information, contact:

Daniel Wiseman	Kazuma Osaki
Head of APAC Policy	Senior Policy Analyst
daniel.wiseman@unpri.org	kazuma.osaki@unpri.org

PRI POSITION AND KEY RECOMMENDATIONS

The PRI supports the JFSA's efforts to address concerns of "greenwashing" among publicly offered investment trust funds with express ESG claims. This will contribute toward market discipline necessary in providing investors with appropriate information on the attributes and strategies of relevant investment funds. Ultimately this can be a crucial step toward enabling a transition to a more sustainable economic model by ensuring credibility and confidence in the responsible investment market of Japan. The PRI's key recommendations to ensure that the draft supervisory guidelines better address greenwashing concerns are as follows:

- The JFSA should consider clarifying key concepts such as "greenwashing" and "ESG investment trust funds" to ensure that investment trust management companies and other market participants are able to clearly understand the applicability of the supervisory guidelines and how they should be responding.
- The JFSA should take note of global trends regarding investor ESG disclosure and anti-greenwashing policies and seek alignment and interoperability where appropriate.
- The JFSA should consider strengthening the disclosure requirements of the draft supervisory guidelines by introducing independent disclosure items covering the sustainability objectives, key definitions and information sources
- The JFSA should consider referring to Japan's Stewardship Code and The Code of Conduct for ESG Evaluation and Data Providers as a framework that investment trust management companies can leverage in their efforts to meet the draft supervisor guideline's requirements.
- The JFSA should consider committing to a periodic review of the supervisory guidelines to ensure proportionality to a quickly evolving market.
- The JFSA should consider ensuring that the policy considerations relevant to ESG investment trust funds are consistently applied to other policy developments relating to retail investment

Beyond these key recommendations relating to the draft supervisory guidelines, more generally the PRI recommends that the JFSA considers future opportunities for broader reforms to support the development of responsible investment and sustainable finance in Japan. This should include:

- The JFSA should work together with other relevant regulators and ministries to clarify the duties of different categories of investors to take into account ESG-related risks and impacts in their decision-making, as per the examples proposed in the *Legal Framework for Impact* report.
- The JFSA should work with other relevant regulators and ministries to require investors to disclose if and how they take into account ESG-related risks and impacts in their governance, risk management and investment processes. This requirement should apply at both the entity and the fund level.
- To help investors better incorporate the consideration of sustainability risks and impacts in to their decision-making, and to align with global market and policy developments, the JFSA should consider developing a robust and science-based sustainable finance taxonomy. If

properly implemented and linked to corporate and investor disclosure requirements, such a taxonomy could help investors to substantiate their sustainability-related claims and help to build trust in the market in the credibility of responsible investment practices.

DETAILED RESPONSE

RECOMMENDATION 1. THE JFSA SHOULD CONSIDER CLARIFYING KEY CONCEPTS SUCH AS “GREENWASHING” AND “ESG INVESTMENT TRUST FUNDS” TO ENSURE THAT INVESTMENT TRUST MANAGEMENT COMPANIES AND OTHER MARKET PARTICIPANTS ARE ABLE TO CLEARLY UNDERSTAND THE APPLICABILITY OF THE SUPERVISORY GUIDELINES AND HOW THEY SHOULD BE RESPONDING

The PRI supports the underlying principle of the draft supervisory guidelines to provide regulatory guidance on the disclosures and conduct of publicly offered ESG-related investment trust funds. This policy would be beneficial in providing investors and market participants with clearer and more consistent information about if and how a particular investment product considers ESG-related risks and impacts. If implemented appropriately this can help both retail and institutional investors to better identify products that align with their ESG-related objectives and convictions, reducing the risks of greenwashing.

However, we consider that in their current form, the draft supervisory guidelines do not provide adequate context about the concept of greenwashing or adequately define the scope of investment trust funds that will be categorised as ESG investment trust funds. This could cause confusion for market participants and undermine the objectives of the amendments.

Although we acknowledge that the *Progress Report on Enhancing Asset Management Business 2022* provides context to a certain extent, overall we consider that further clarification would be beneficial to achieve the JFSA’s objectives. As such, the PRI recommends that further explanation be provided to clarify the JFSA’s understanding of two key concepts: greenwashing and ESG investment trust funds. Noting that these concepts are yet to be clearly defined at an international level, this could potentially be achieved through the publication of an interpretive guidance or a subsequent iteration of the Progress Report.

GREENWASHING

We acknowledge that the (1) Background section of the draft supervisory guidelines addresses “greenwashing” as the primary concern that this amendment aims to address. However, greenwashing is a complex issue where market-wide agreement on what constitutes such misleading claims is yet to be reached. It would be beneficial for all stakeholders if the JFSA provided guidance on the recognized types of practices that could be interpreted as greenwashing either by elaborating more on this within the (1) Background section of the draft supervisory guidelines or within an additional interpretive guidance.

In their report *Recommendations on Sustainability Related Practices, Policies, Procedures and Disclosure in Asset Management*, the International Organisation of Securities Commissions (IOSCO) defines the term “greenwashing” as “the practice of misrepresenting sustainability-related practices or the sustainability-related features of investment products.” For marketing purposes and in order to promote their “green” credentials, some investment trust managers may label products as sustainable in a deceptive manner, without making necessary changes in the underlying investment objectives and strategies. IOSCO also issued a Call for Action[1], which aims to build a solid global baseline in tackling greenwashing.

We would furthermore encourage the JFSA to consider how other regulatory bodies (notably IOSCO) are conceptualising this phenomenon and how the JFSA's intended definition aligns with these – noting that the JFSA is yet to fully attempt defining greenwashing. The recent guidance published by the Australian Securities and Investments Commission *How to avoid greenwashing when offering or promoting sustainability-related products*[2] can also be referred to as a leading example where the regulator has provided a guidance on possible ways that funds could misrepresent the fund's investments and objectives, which may, in turn, mislead investors into purchasing funds that appear to be focused on ESG factors or sustainability.

As IOSCO importantly notes in their Call for Action, "greenwashing can occur throughout the investment value chain and any market participant (issuers, asset managers, financial advisers, ESG rating agencies and data providers, etc.) can engage in this behaviour." We note that the draft supervisory guidelines subject to this consultation response is applicable primarily to publicly offered investment trust funds. However, it would also be beneficial for the JFSA to acknowledge in the Background section that greenwashing, or any form of sustainability-related misrepresentation related to financial products, is an issue that can occur across the investment value chain and that the expectations noted here are applicable to practices or actors involved throughout the investment value chain.

DEFINING ESG INVESTMENT TRUST FUNDS

The JFSA's approach as seen in the draft supervisory guidelines is to differentiate between ESG investment trust funds and those that are not and providing principles-based requirements applicable to each. The draft supervisory guidelines define ESG investment trust funds as those that consider ESG as a key factor in the selection of investment assets and refers to ESG in the "Objective and Characteristics of the Fund" section of the delivery prospectus. While this relatively vague definition can provide room for practitioners to make more nuanced decisions in a market where practices are yet to standardize, it also may be prone to ambiguity and confusion among practitioners. It is also worth noting that "ESG factors" is left undefined but would benefit from greater clarity as well.

The variety of responsible investment strategies is complex and continuously evolving, but the JFSA may find it useful to refer to the categories of responsible investment such as those provided by PRI[3] and the Global Sustainable Investment Alliance[4] to be cognizant of the various types of ESG claims and the permutations relevant to each category. For example, while ESG investment trust funds that positively screen assets based on ESG factors aligns closely with the nuance of the JFSA's scope of

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[1] The International Organisation of Securities Commissions (November 2022), IOSCO Good Sustainable Finance Practices for Financial Markets Voluntary Standard Setting Bodies and Industry Associations: Call for Action

[2] The Australian Securities Commission (June 2022), How to avoid greenwashing when offering or promoting sustainability-related products | ASIC - Australian Securities and Investments Commission.

[3] PRI, Reporting Framework Glossary

[4] Global Sustainable Investment Alliance (2020) Global Sustainable Investment Review 2020

ESG investment trust funds, funds employing an ESG integration strategy may belong to a grey zone where the degree to which ESG is "key" to the fund may be hard to discern; perhaps funds that negatively screen assets based on ESG factors may be encouraged to consider ESG a non-key factor as it does not positively influence the selection of assets. In the UK, this approach of listing recognized ESG investment approaches to ensure better understanding by practitioners is exhibited in the FCA's Sustainability Disclosure Requirements (SDR) and investment labels consultation paper.

A key step to better defining the scope of ESG investment trust funds will be defining the concepts it refers to in the existing definition. For example, the concept of names and nicknames of investment trust funds is not addressed in the existing definition but is referred to in the (3) Disclosure requirement section under the requirements for non-ESG investment trust funds. This leaves ambiguities for instances such as where ESG is considered as a key factor but is not referred to in the name of the name of the investment trust fund. As noted above, "ESG as a key factor" is also not a concept clearly defined yet, which would heavily influence decisions on applicability.

RECOMMENDATION 2. THE JFSA SHOULD TAKE NOTE OF GLOBAL TRENDS REGARDING INVESTOR ESG DISCLOSURE AND ANTI-GREENWASHING POLICIES AND SEEK ALIGNMENT AND INTEROPERABILITY WHERE APPROPRIATE

Global developments surrounding ESG-related disclosure are evolving rapidly, and numerous regulatory efforts have emerged to address market fragmentation in the use of ESG names and standards in various jurisdictions and regions.

In the Institute of International Finance (IIF) - European Banking Federation Global Climate Finance Survey of 70 financial institutions,[5] 65% of institutions reported that "green" regulatory market fragmentation was a major obstacle and would have a material impact on the market for sustainable finance. We encourage the JFSA to make additional efforts toward international harmonization; there is a growing number of jurisdiction-specific rules governing ESG disclosures that create a complex and fragmented environment for registrants to navigate. This would help reconcile information from various sources and align related requirements across different jurisdictions while moving towards a sustainable financial system and engaging in the coordination efforts led by global regulators and initiatives, such as:

- The Chartered Financial Analyst (CFA) Institute Global ESG Disclosures Standards for Investment Products whose goal is to provide greater transparency and consistency in ESG-related disclosures, to enhance clarity with respect to the ESG-related features of investment products.[6]

[5] The Institute of International Finance (IIF) and European Banking Federation (January 28, 2020), Global Climate Finance Survey: A Look At How Financial Firms Are Approaching Climate Risk Analysis, Measurement, and Disclosure.

[6] The Chartered Financial Analyst Institute (May 2021), Global ESG Disclosures Standards for Investment Products

- The IIF Sustainable Finance Working Group (SFWG) Report, which highlights sources of confusion in sustainable investment terminologies that may prevent the development of sustainability-related investment products.[7]
- The International Platform on Sustainable Finance (IPSF) recommendations whose objective is to scale up the mobilization of private capital towards environmentally sustainable investment.[8]
- The International Organisation of Securities Commissions (IOSCO) called upon all voluntary standard setting bodies and industry associations operating in financial markets to promote good practices among their members to counter the risk of greenwashing.[9]

It would also be beneficial for the JFSA to note approaches taken by regulators in other jurisdictions. This is because firstly, the JFSA may identify better regulatory messaging on matters such as defining key concepts as explored above. The JFSA may also be able to identify better approaches to ensure compliance and adherence to the intentions of the draft supervisory guidelines. While we understand that the JFSA is prioritizing proportionality to the market's maturity by ensuring that practitioners and the JFSA alike can make nuanced decisions regarding the supervision of ESG investment trust funds, we also acknowledge the benefit of approaches taken in other jurisdictions that are rules-based, setting clear boundaries especially where fund labels and names are involved.

Secondly, the interoperability of investment product related rules would benefit an ever globalizing market. Especially to contribute to consistency across domestic frameworks, the JFSA should pay particular attention to potential alignment in the terminologies and definitions it employs. As such, we would like to bring to the JFSA's attention the following policy initiatives being implemented in other jurisdictions:

- The European Securities and Markets Authority (ESMA) published a supervisory briefing on sustainability risks and disclosures that, alongside the Sustainable Finance Disclosure Regulation (SFDR), aim to better regulate and supervise investment products with sustainability-related claims.[10]
- The UK's Financial Conduct Authority (FCA) is currently holding a consultation on proposed policies addressing exaggerated or misleading sustainability-related claims about investment products.[11]

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[7] The IIF Sustainable Finance Working Group (October 2019), The Case for Simplifying Sustainable Investment Terminology

[8] The International Platform on Sustainable Finance (August 2022), International Platform on Sustainable Finance | European Commission (europa.eu).

[9] The International Organisation of Securities Commissions (November 2022), IOSCO Good Sustainable Finance Practices for Financial Markets Voluntary Standard Setting Bodies and Industry Associations: Call for Action

[10] European Securities and Markets Authority (May 2022), Supervisory briefing – Sustainability risks and disclosures in the area of investment management

[11] The Financial Conduct Authority (October 2022), Sustainability Disclosure Requirements (SDR) and investment labels – Consultation Paper

- The US Securities and Exchange Commission (SEC) held a public consultation regarding a new proposed rule on fund names that are likely to mislead investors, which includes a dedicated component on ESG terminology.[12]

RECOMMENDATION 3. THE JFSA SHOULD CONSIDER STRENGTHENING THE DISCLOSURE REQUIREMENTS OF THE DRAFT SUPERVISORY GUIDELINES BY INTRODUCING INDEPENDENT DISCLOSURE ITEMS COVERING THE SUSTAINABILITY OBJECTIVES, KEY DEFINITIONS AND INFORMATION SOURCES

INVESTMENT STRATEGY

We acknowledge that the JFSA's proposed disclosure requirements for investment strategies is comprehensive, covering most items addressed in similar frameworks and policies. We, however, note that the draft requirements may be insufficient to ensure that practitioners provide enough explanation of the purpose and objective of their ESG approach.

For example, the requirement to disclose the "details of key ESG factors in the selection of investment assets" and "how key ESG factors are taken into account in the investment process" appear to address "what" ESG factors are considered and "how", but not necessarily "why" this is the case. The requirement for ESG investment trust funds that aim to create sustainability impacts to describe the purpose of their impacts covers this question on intentionality but is limited to a subset of applicable ESG investment trust funds.

The good practices provided in IOSCO's Call for Action address this notion of intentionality in section GP2, where "investment objectives disclosure" and "investment strategies disclosure" are independent items of disclosure. IOSCO indicates that investment objectives should be clear, especially regarding the fundamental nature or features of the product as it relates to the product's unique sustainability-related investment objective. The JFSA may similarly seek to introduce a section that comes before "investment strategy" that addresses the intentionality of sustainability-related investment objectives.

Such a requirement may also benefit from introducing the various recognized categories of sustainability-related investment strategies. For example, the seven categories proposed by PRI and the GSIA can serve as an effective reference point. The JFSA may also find it helpful to refer to the UK FCA's proposed three categories of sustainability-related investment product labels that classify products according to different natures of intentionality.

KEY DEFINITIONS

The draft supervisory guidelines do not endeavour to define and differentiate between key concepts and terms such as "sustainable", "transition", and "impact". While we assume that the JFSA's expectation is that investment trust fund managers provide clear explanations for what they mean when complying with the disclosure requirements under the Investment Strategy section, we

[12] The US Securities and Exchange Commission (May 2022), [File No. S7-16-22]

recommend that the JFSA explicitly note their expectation that when claiming responsible investment related propositions investment trust fund managers must provide explanations for key ESG-related terminologies that they use.

INFORMATION SOURCES

We acknowledge that the JFSA aims to encompass a wide range of disclosure items under the “investment strategy” section, especially where it pertains to “how key ESG factors are taken into account in the investment process”. We, however, note that the JFSA does not address the information sources utilized to consider ESG factors in an independent requirement.

The IOSCO Call for Action, for example, explicitly notes that where fund managers are expected to disclose information on methodologies regarding ESG ratings, the sources of information should be addressed. The IOSCO goes into further detail, advocating for granular information the timeliness of the information used, whether the information is filled using estimates, and if so, the methods to derive such estimates.

The CFA Institute’s Global ESG Disclosure Standards for Investment Products similarly introduces an independent recommendation for investment products to note the “sources and types of ESG information” used in the investment process or stewardship activities. The CFA Institute provides three relevant categories of disclosure items: the elements of the investment process or stewardship activities that use ESG information and how the information is used; the type of ESG information used and the sources rom which that information is obtained; the risks and limitations of the ESG information used and how those risks and limitations are managed.

While the Code of Conduct for ESG evaluations and data providers[13] addresses similar concerns pertaining to ESG evaluations and data providers, the same attention should be given to this issue for investment trust fund managers, as proprietary ratings by investment managers also exist.

RECOMMENDATION 4. THE JFSA SHOULD CONSIDER REFERRING TO JAPAN’S STEWARDSHIP CODE AND THE CODE OF CONDUCT FOR ESG EVALUATION AND DATA PROVIDERS AS A FRAMEWORK THAT INVESTMENT TRUST MANAGEMENT COMPANIES CAN LEVERAGE IN ITS THEIR RELATIONSHIP WITH ESG RATING AND DATA PROVIDERS IN THEIR EFFORTS TO MEET THE DRAFT SUPERVISOR GUIDELINE’S REQUIREMENTS

Two key policy instruments by the JFSA are greatly relevant to practitioners responding to the draft supervisory guidelines: the Principles for Responsible Institutional Investors (Japan’s Stewardship Code)[14] and the Code of Conduct for ESG Evaluation and Data Providers. Given that sustainability is a concept embedded in Japan’s Stewardship Code as of the 2020 revision, it would be a relevant framework for all investment managers disclosing a stewardship policy in response to the draft

[13] The Japan Financial Services Agency (December 2022) The Code of Conduct for ESG Evaluation and Data Providers

[14] The Japan Financial Services Agency (March 2020) Principles for Responsible Institutional Investors

supervisory guidelines. For investment managers disclosing information on resources and due diligence where the use of ESG rating and data providers is involved, they should be seeking to utilize such service providers already supporting the Code of Conduct, or seeking for their partners to uphold the Code of Conduct or equivalent standards of disclosure and practice.

Although we acknowledge that the JFSA may not wish to be restrictive in their approach to investment managers as a wide range of practices can meet the spirit of the draft supervisory guidelines, we also see benefit in the JFSA encouraging practitioners to view the JFSA's policy instruments as frameworks that convey the minimum expectations. Practitioners new to this field may find it more efficient and easier to understand if the JFSA messages the alignment and connectivity of its various policy instruments within the contents of each document.

RECOMMENDATION 5. THE JFSA SHOULD COMMIT TO A PERIODIC REVIEW OF THE SUPERVISORY GUIDELINES

The draft revisions to the supervisory guidelines are currently retained to high-level principles, leaving ample room for investment trust fund managers to interpret how best to follow these expectations. The JFSA should commit to comprehensively reviewing fund-level disclosures in compliance with the supervisory guidelines – i.e. a periodic follow-up to the Progress Report on Enhancing Asset Management Business 2022. This would allow the JFSA to better understand where clearer signalling and additional requirements may be beneficial to ensure market discipline and enable an evidence-based approach that is appropriate given the quick pace of development of market practice in this area.

RECOMMENDATION 6. THE JFSA SHOULD CONSIDER ENSURING THAT THE POLICY CONSIDERATIONS RELEVANT TO ESG INVESTMENT TRUST FUNDS ARE CONSISTENTLY APPLIED TO OTHER POLICY DEVELOPMENTS RELATING TO RETAIL INVESTMENT

The draft revisions to the supervisory guidelines note in the Background section that their aim is to ensure market discipline that allows retail investors to make informed investment decisions. Meanwhile, as a pillar of the Japanese government's policy on doubling asset-based incomes, which is led by a sub-committee of the cabinet secretariat, the JFSA's Customer-Oriented Business Conduct Task Force[15] has been discussing topics relevant to beneficiary best interest and the customer-facing transparency and governance of financial products. We understand that the task force is considering revisions to the Principles for Customer-Oriented Business Conduct and recommend that the task

[15] The Japan Financial Services Agency (December 2022) The Customer-Oriented Business Conduct Task Force Interim Report

force set greenwashing and fund-related sustainability requirements as a key agenda when considering revisions to the Principles.

To inform this briefing, the PRI consulted the Japan Sustainable Investment Forum (JSIF).

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 greenwashing and market discipline regarding sustainability claims in investment products.

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

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