CONSULTATION RESPONSE

JAPAN FSA INVITATION FOR PUBLIC COMMENTS REGARDING "THE CODE OF CONDUCT FOR ESG EVALUATION AND DATA PROVIDERS"

September 2022

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To inform this response, the following investor groups have been consulted: PRI Global Policy Reference Group. This consultation is not an endorsement or acknowledgement of the views expressed in this response.

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.

Globally, the PRI has over 5,000 asset owner, asset manager and service providers signatories, which combined have over $121 trillion in assets under management. In Japan there are 117 signatories.

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 has previously published a consultation response to the International Organization of Securities Commissions' (IOSCO) Consultation Report on ESG Ratings and Data Products Providers. The PRI has also responded to consultations on ESG ratings and data products providers from global regulators such as the Securities and Exchange Board of India (SEBI), the European Securities Market Authority (ESMA), and the European Commission.

The PRI is generally supportive of effective and proportionate regulatory action to enhance the functioning of the market for ESG ratings and data products, particularly in relation to the transparency of methodologies, rating processes, pricing policies, and the appropriateness of governance arrangements.

The PRI welcomes the opportunity to respond to the Japan Financial Services Agency (JFSA) invitation for public comments regarding the Draft Code of Conduct for ESG Evaluation and Data Providers.

ABOUT THIS CONSULTATION

On 12 July 2022, JFSA's Technical Committee for ESG Evaluation and Data Providers published the Report of the Technical Committee for ESG Evaluation and Data Providers. Based on recommendations made in the report to establish a code of conduct for ESG evaluation and data providers, JFSA also published the Draft Code of Conduct for ESG Evaluation and Data Providers and opened a consultation for public comments. The finalised code is expected to be published at the end of summer 2022, followed by a call for voluntary endorsement of the code from relevant evaluation and data providers.

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KEY RECOMMENDATIONS

The PRI welcomes the intention of JFSA to improve the role that ESG evaluation and data products and the providers of these products play in the financial market. These products and providers play an increasingly important function in investment processes and the market for ESG evaluation and data has experienced considerable growth and consolidation in recent years. Demand for these products and services is only likely to keep growing in the future, given investors' accelerating interest in ESG and sustainable investing and as they increasingly face mandatory ESG disclosure requirements[1].

In light of these developments, the PRI is generally supportive of the JFSA's proposal to establish a Code of Conduct ('the code') for ESG Evaluation and Data Providers. Alongside the Stewardship Code and the Corporate Governance Code, this code can contribute toward enhanced consideration of and engagement on ESG risks and impacts, and in doing so, support a more sustainable financial market. To better ensure that the code plays an effective role in improving the consideration of ESG risks and impacts in the investment chain, the PRI recommends that the JFSA consider the following:

- **Implementing public reporting requirements that make it mandatory for supporters of the code to explain which principles and concepts they comply with and how.** The PRI recognises that the code's principles-based comply-or-explain approach is proportionate to the current maturity of the market and will allow for market innovation. However, this will only be effective if entities that publicly endorse the code are subject to clear disclosure requirements about how they do so. Without such a requirement, the potential for market-based accountability and innovation will be significantly reduced.
- **Implementing a triennial review and revision process that ensures periodic reviews of the effectiveness and relevance of the code in the future and revisions.** Reviewing the code on a three-year cycle would help ensure that the content of the code as well as the mechanisms to ensure compliance to the code are relevant and proportionate to the status of the market. This should include reviews on the state of compliance to the code by reviewing the disclosures and practices of ESG evaluation and data providers publicly supporting the code.
- **Providing better clarity on key concepts used in Principle 4 (Ensuring Transparency), regarding the transparency of methodologies and processes used by ESG evaluation and data providers.** The clarification of key concepts, such as "purpose, approach, and intent" and "sources of information", would help to ensure a greater consistency between different providers and provide investors with the information necessary to understand the products and services better.
- **Providing better clarity in Section 3 (points to be considered of the Code of Conduct) item 4 (scope of services covered by the Code of Conduct) about whether the scope is intended to include ESG evaluation and data providers in relation to private financial markets, as well as public financial markets.** If the scope of the code is intended to cover

[1] According to a position paper by the AFM and AMF, the ESG data and services market could reach a value of over US$5 billion by 2025 (Position Paper: Call for a European Regulation for the provision of ESG data, ratings, and related services).

providers of private market ESG evaluations and data, further consideration should be given to ensuring that the code appropriately reflects the commercial relationships and arrangements involved.

The PRI acknowledges that alongside ESG evaluation and data providers, investors and companies are also critical actors within the ESG investment chain. The PRI especially concerns itself with the responsibility of investors to understand the intended purposes and the methodologies of ESG evaluation and data products and to determine whether these are suitable for the purpose for which they are being used in the investment process. We also recognise the important role companies play in providing material ESG information on its corporate group in a timely and clear manner.

As such, the PRI supports JFSA's inclusion of recommendations for investors and corporates in the appendix. In order to ensure that these recommendations are sufficiently recognised by corporates and investors and that they are implemented appropriately, the PRI recommends that JFSA should additionally consider:

- **The possibility of embedding the recommendations for investors and companies into the Stewardship Code and the Corporate Governance Code, respectively.** Such measures can also provide alignment among the three actors and enable the three codes to complement each other as three pillars supporting the ESG investment chain.

In addition to these points, we recognise the fundamental importance of the increased availability and quality of ESG data. The PRI therefore recommends that the FSA accelerate reform towards mandating corporate reporting and disclosures on ESG issues. We welcome global and regional efforts by regulators to improve the reliability, consistency, and comparability of corporate ESG reporting standards and disclosures. These efforts can by extension contribute to the better quality of ESG evaluation and data products and services for the benefit of investors and their beneficiaries and clients.

More detailed answers and recommendations below are in response to selected sections from the consultation that draw on specific expertise and evidence from the PRI's work.

DETAILED RESPONSE

The PRI supports increased attention by regulators such as JFSA to the market for ESG evaluations and data products and the providers of these products and notes the findings in the IOSCO report[2] on ESG ratings and data products providers. Demand for these products and services is likely to keep growing in the future, given investors' accelerating interest in ESG and sustainable investing and as they increasingly face mandatory ESG disclosure requirements.

Although large investors are increasingly developing in-house metrics to better capture ESG risks and opportunities and sustainability performance within their investment processes, third-party providers of ESG ratings and data will continue to play an important role by providing more tailored services, such as data modelling and analytics, and bespoke data feeds. As intermediaries between corporates and investors, they are an essential component of the ESG investment chain, and the PRI believes their relevance to financial market participants will continue to increase due to the increased use of ESG evaluations by both active and passive investment portfolios.

Investors holding active portfolios are likely to continue to rely on ESG evaluations in the coming years to assess their portfolio selections and make informed decisions regarding their voting and engagement practices in Japan.[3] However, there are also signs pointing toward increasing reliance on ESG evaluations in passive portfolios. Government Pension Investment Fund (GPIF) has been the leading proponent of passive ESG funds, beginning its investments at 1.5 trillion yen in 2017 and growing this to 10.6 trillion yen by 2020.[4] Although the number of passive ESG funds hasn't increased significantly since, in 2021, 22 new passive ESG mutual funds were established domestically, suggesting further uptake by investors.[5] ESG evaluations play a critical role in the methodology of a considerable proportion of these assets, predominantly through their impact on the exclusions and weightings assigned to companies in ESG-themed passive equity, and to a lesser extent fixed income, indices. Given the substantial and growing impact that ESG evaluations have on investment allocations, the integrity of these evaluations is paramount.

For these reasons, the PRI is generally supportive of JFSA's proposal to establish a code to clarify basic principles regarding the governance and transparency of ESG evaluation and data providers. In doing so, any policies should be balanced and proportionate and allow for market innovation when it comes to evaluation methodologies, without being prescriptive about the methodologies themselves.

In order for the code to be fit-for-purpose and influence a higher standard of governance and transparency among ESG evaluation and data providers, the PRI has four recommendations on the code and one recommendation relating to the annex for further consideration. The four recommendations on the code cover issues relating to accountability, periodic revisions, and the clarification of key concepts. The recommendation relating to the annex addresses alignment of the code to the Corporate Governance Code and the Stewardship Code.

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[2] IOSCO 'Environmental, Social and Governance (ESG) Ratings and Data Products Providers' FR09/2021 Environmental, Social and Governance (ESG) Ratings and Data Products Providers (iosco.org)

[3] FSA 'ESG 関連公募投資信託を巡る状況' ESG 関連公募投資信託を巡る状況

[4] GPIF 'ESG Report 2020' ESG Report 2020

[5] FSA 'ESG 関連公募投資信託を巡る状況' ESG 関連公募投資信託を巡る状況

Recommendation 1: Implement public reporting requirements that make it mandatory for supporters of the code to explain which principles and concepts they comply with and how.

The PRI recognises that the code's principles-based comply-or-explain approach is proportionate and will allow for market innovation. However, this approach will only be effective if entities that publicly endorse the code are subject to clear disclosure requirements about how they do so. Without such a requirement, the potential for market-based accountability and innovation will be significantly reduced.

Currently, the draft code does not explicitly provide for any effective accountability mechanisms, either by regulators, or by the market. ESG evaluation and data providers are required to publicly disclose their support for the code but not to disclose if or how they have implemented it. As was with the expectations of the Stewardship Code, this approach can allow for a focus on industry best practices without setting minimum compliance standards. However, the lack of any effective accountability mechanism can undermine market participants confidence that providers are complying with the code and limit its effectiveness. Stronger accountability would not only help to codify terminology and promote greater consistency, it would also create market efficiencies and level the playing field on existing best practices, rewarding first movers and the best performers.

To ensure minimum compliance to the expectations of the code, ESG evaluation and data providers should be held accountable to report publicly on their approach to the six principles and guidelines of the code, much like the existing Corporate Governance Code. This would also provide a clear space for ESG evaluation and data providers to explain which principles they are not in compliance with and why. Introducing a standardised reporting expectation that aligns with the six principles and guidelines would also enable investors and companies to efficiently understand the approach and philosophy of each ESG evaluation and data provider.

Such an approach would align with the sentiments evidenced in the European Commission's targeted consultation on the functioning of the ESG ratings market in the EU and on the consideration of ESG factors in credit ratings, where "almost all respondents (97%) consider that ESG rating providers should be subject to minimum disclosure requirements in relation to their methodologies, and most consider that they should be using standardised templates".[6]

Recommendation 2: Implement a triennial review and revision process that ensures periodic reviews of the effectiveness and relevance of the code in the future and revisions.

Reviewing the code on a three-year cycle would help ensure that the content of the code as well as the mechanisms to ensure compliance to the code are relevant and proportionate to the status of the market. This should include reviews on the state of compliance to the code by reviewing the disclosures and practices of ESG evaluation and data providers publicly supporting the code.

Currently, the draft code does not explicitly note any intentions by JFSA to subject the code to periodic reviews and revisions. Especially in the early stages of implementing the code and given the

[6] European Commission 'Targeted consultation on the functioning of the ESG ratings market in the EU and on the consideration of ESG factors in credit ratings' [Targeted consultation on the functioning of the ESG ratings market in the EU and on the consideration of ESG factors in credit ratings]

voluntary principles-based approach that is being taken, JFSA should commit to measures to ensure that the code is operating effectively and that stakeholder expectations are being met.

The PRI therefore recommends that the code be subject to a formal triennial review to ensure that it remains aligned with up-to-date market practice, as well as with information users' needs and expectations. In light of the rapid developments in this area, ESG evaluation and data providers will continue to work with their stakeholders to improve their governance and transparency practices regarding their services and products. The review should therefore also consider how ESG evaluation and data providers are improving their practices on governance and transparency and consider whether further regulatory action is required.

For example, the review could consider whether the implementation of an accreditation system for different types of ESG evaluation products could be beneficial, potentially distinguishing between those focusing on financial risks posed by ESG factors relevant to a company and those focusing on the environmental and social impacts of companies on their externalities. This is the approach currently being suggested by the Securities and Exchange Board of India (SEBI)[7], discussed further below.

Recommendation 3: Provide more clarity on key concepts used in Principle 4, regarding the transparency of methodologies and processes used by ESG evaluation and data providers.

The clarification of key concepts used in Principle 4, such as "purpose, approach, and intent" and "sources of information", would help to ensure a greater consistency between different providers and provide investors with the information necessary to understand the products and services better.

Investors need to be able to understand an ESG evaluation's or data product's intended purpose and how its outputs are determined, to choose the product that best fits with their investment processes.[8] In this context, transparent and well-communicated methodologies are critical for supporting investors to make these choices – including when changes are made to the underlying data or to the methodologies themselves.[9] In addition, improved transparency would not only help investors, but also make ESG evaluations and data products providers more accountable for how they verify and validate their data sources and metrics, including to regulators. This in turn can help to increase the reliability and quality of ESG evaluations and data products and would also help the market better understand the reasons behind divergent ESG evaluations from different providers.

Enhanced transparency of methodologies would also help to ensure that investors applying ESG evaluations to different asset classes are able to undertake analysis on the appropriateness of the evaluation for use in their particular investment strategy and/or analytical model. ESG-focused data, products and services have historically been tailored to meet the needs of equity investors. PRI

[7] Securities and Exchange Board of India 'Consultation Paper on Environmental, Social and Governance (ESG) Rating Providers for Securities Markets' Consultation Paper on Environmental, Social and Governance (ESG) Rating Providers for Securities Markets

[8] PRI research 'Do ESG information providers meet the needs of fixed income investors?' Do ESG information providers meet the needs of fixed income investors? | Article | PRI (unpri.org)

[9] PRI research 'Do ESG information providers meet the needs of fixed income investors?' Do ESG information providers meet the needs of fixed income investors? | Article | PRI (unpri.org)

research[10] highlighted that fixed income investors utilise ESG evaluations and data differently to equity investors, recommending that further transparency and customisation of methodologies is required to properly accommodate this market. The PRI's ongoing work in this area also notes ongoing confusion by market participants regarding what is measured by ESG evaluations versus credit ratings.[11] Enhancing transparency of methodologies is an important step towards addressing such issues. Furthermore, even for those investors that carry out proprietary ESG assessments, it is important to have transparent methodologies for all ESG evaluations' providers so they can justify to clients why and where assessments may differ from third party providers' evaluations.

The PRI therefore welcomes the JFSA's establishment of an independent principle (Principle 4) dedicated to ensuring transparency regarding the products and services provided by ESG evaluation and data providers. To enable greater transparency that is fit-for-purpose in informing investors of the precise objective of ESG evaluation and data products, the PRI recommends the following:

- **Clarify the concept of "purpose, approach, and intent of formulation of ESG evaluation and data"**

  The PRI recommends that the code be more specific on the items of information that constitute what is broadly referred to as "evaluation objectives". For example, some ESG evaluations try to capture an issuer's exposure to ESG risks and how prepared they are to manage these risks, while others assess the positive and negative impact of companies on the environment and society, irrespective of whether such factors have any impact on the company's enterprise value. ESG evaluation and data providers are currently not always transparent about the objectives of their evaluations, what their methodologies are or what data they use. How they make such assessments should be better explained. This should involve outlining clear expectations on the evaluation's approach to material non-financial information.

  In this respect, the approach proposed by the Securities and Exchange Board of India (SEBI) could be considered.[12] SEBI has proposed the adoption of a classification system with the following categories: 1) ESG risk evaluations that aim to evaluate the impact of environmental and social issues on the company's enterprise value; 2) ESG impact evaluations that aim to evaluate a company's impacts on the environment and society irrespective of whether these issues have an impact on the company's enterprise value; and 3) other evaluations and benchmarks that, for example, evaluate other ESG aspects such as the quality of ESG disclosure or thematic risk exposure (e.g. human rights risk benchmarks or carbon risk ratings).

- **Clarify the concept of "sources of information"**

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[10] PRI research 'Do ESG information providers meet the needs of fixed income investors?' Do ESG information providers meet the needs of fixed income investors? | Article | PRI (unpri.org)

[11] PRI 'Statement on ESG in credit risk and ratings' https://www.unpri.org/credit-risk-and-ratings/statement-on-esg-in-credit-risk-and-ratings-available-in-different-languages/77.articleStatement on ESG in credit risk and ratings (available in different languages) | PRI Web Page | PRI (unpri.org)

[12] Securities and Exchange Board of India, Consultation Paper on Environmental, Social and Governance (ESG) Rating Providers for Securities Markets

As the data coverage of these ESG evaluations and data products continues to expand to meet the needs of investors, companies that are yet to establish robust ESG data collection systems are often assessed based on external evaluations, data sets, and estimations. While it is important for ESG evaluation and data providers to clarify the source of information they use – i.e. whether it is data issued by the company or estimated by the ESG evaluation and data provider – it is equally important for them to clarify the requirements and standards they set when collecting data. For example, whether or not there has been third party assurance provided in relation to the data to ensure reliability.

Another example could be whether the ESG evaluation and data provider supplements company-provided data restricted to entity-level coverage with estimated data to ensure comparability with the standard expectation for group-level coverage. For investors to have access to accurate and standardised data, ESG evaluation and data providers need to ensure that the group-level coverage of ESG data is standardised and where exceptions are made, provide transparency on the rules and procedures of how this impacts the provision of data or the evaluation of a company itself. This should be reflected in both the evaluation and data providers' overall explanation of their approach, as well as flagged in specific instances where corporations deviate from the standard.

Recommendation 4: Providing better clarity in section 3(iv) "Scope of services covered by the Code of Conduct" about whether the scope is intended to include ESG evaluation and data providers in relation to private financial markets, as well as public financial markets.

Under the section on the "scope of services covered by the Code of Conduct", the draft code notes that "the scope of the Code of Conduct are ESG evaluation and data providers that participate in Japanese financial markets or provide services to the participants in Japanese financial markets". The footnotes further note that that 'financial markets' include "stocks, bonds, loans, and others", and that 'services' include those that fall under the category of "financial instruments business". Further context for the intended scope is outlined in the four items included under the heading of "basic concepts to the scope of ESG evaluation and data providers that are to be called for support of the code of conduct".

Currently, however, it is unclear based on this language whether the scope is intended to include ESG evaluation and data providers in relation to private financial markets, as well as public financial markets. In this respect, ESG evaluation and data providers that exclusively cover private markets may be unclear on whether they are included in the scope of ESG evaluation and data providers that are expected to support the Code of Conduct.

If the scope of the code is intended to cover providers of private market ESG evaluations and data, further consideration should be given to ensuring that the code appropriately reflects the commercial relationships and arrangements involved. This may particularly be the case in relation to Limited Partners and General Partners involved in private equity markets and transactions.

Recommendation 5: Consider the possibility of embedding the recommendations for investors and companies into the Stewardship Code and the Corporate Governance Code, respectively.

The PRI acknowledges that alongside ESG evaluation and data providers, investors and companies are also critical actors within the ESG investment chain. The PRI supports the recommendations to investors included in the Appendix to publicly clarify how ESG evaluation and data is used in investment decisions. The PRI also recognises the important role companies play in providing material ESG information on its corporate group in a timely and clear manner and welcomes the recommendations to companies as well.

To ensure that these recommendations are sufficiently recognised by companies and investors and that they are implemented appropriately, these recommendations made for investors and companies should be reflected in the respective policy instruments that support the code – i.e. the Corporate Governance Code and the Stewardship Code. Such measures can also provide alignment among the three actors and enable the three codes to complement each other as three pillars supporting the ESG investment chain.

The PRI has experience of public policy on sustainable finance policies and responsible investment across multiple markets and stands ready to further support the work of JFSA to review the market characteristics for ESG evaluation and data providers in Japan.

Any questions or comments can be sent to policy@unpri.org.