Japanese Financial Services Agency's Supervisory Guidelines for Publicly Offered ESG Investment Trusts

Finance Law Newsletter May 26, 2023

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1. Introduction

On March 31, 2023, the Japanese Financial Services Agency ("**JFSA**") revised supervisory guidelines[1] regarding Environmental, Social, and Governance ("**ESG**") investment trusts and related green washing issues (the "**Revised Guidelines**") were issued and came into effect. In Japan, investment trusts (*toushi shintaku* in Japanese) are a popular structure for mutual funds. Accordingly, the number of questions raised during the Revised Guidelines "public comment" process exceeded 200, indicating a high level of interest and need for clarification among market participants. In part, this interest arrives from the fact that, while Europe and the United States have taken various approaches to ESG fund regulation, such as the enactment and amendment of laws and regulations, and enforcement by authorities, until now, the corresponding elements of Japan's approach have remained unclear.[2]

In this newsletter, we will explore this trend by examining the content of the Revised Guidelines and JFSA's responses to questions from the public comment process (the "**JFSA Responses**").

2. Descriptions of the Revised Guidelines and the JFSA Responses

(1) Purpose of the Revised Guidelines and the Scope of ESG Investment Trusts

The purpose of the Revised Guidelines is described below.

> The number of investment products which incorporate Environmental Social and Governance (ESG) factors in their names and investment strategies has been increasing both in Japan and overseas, and at the same time, concerns over "greenwashing" that their actual investments may not be commensurate with their ESG claims are attracting attention globally. Given this background, regarding publicly offered investment trusts in Japan with ESG factors included in their names and investment strategies, it is necessary to ensure their credibility in the market and to promote ESG investment, which will help build sustainable society. In order to help retail investors make informed investment decisions, supervisors will check if the disclosures of publicly offered investment trusts and organizational resources and due diligence of investment trust management companies regarding ESG are appropriate by paying attention to the following points.

[1] The JFSA mentions in its supervisory guidelines as follows: "[i]n order to conduct daily supervisory processes under these circumstances, we decided to systematically sort out the contents of sector-by-sector guidelines for supervision and administrative processes, and work out concepts concerning supervision, supervisory viewpoints and methods of supervision in a comprehensive manner on a cross sectoral basis."

[2] Response to the FSA's Consulation on the Proposed Amendment of the Comprehensive Supervisory Guidelines for Financial Instruments Business Operators, etc. regarding ESG Investment Trusts

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The Revised Guidelines only are applicable to investment trust management business within the scope of the investment management business.

The definition of "ESG Investment Trust" is a publicly offered investment trust which:
(1) considers ESG as a key factor in the selection of investment assets, and
(2) describes the content of (1) in the "Objective and Characteristics of the Fund" section of its delivery prospectus.

Therefore, privately offered investment trusts and foreign investment trusts are not subject to the Revised Guidelines (No. 55-60 of the JFSA Responses).

On the other hand, there is no clear definition of "ESG" itself. However, as will be seen later, the Revised Guidelines have been stated in a way that also encompasses so-called "impact investing." In addition, the JFSA stated that "it is difficult to define ESG in a uniform manner" (No. 10 of the JFSA Responses).

Regarding the determination of the relevance of ESG Investment Trusts, the meaning and scope of the "key factor" described in (1) has become particularly important. In fact, many questions have been asked about it and the responses imply that whether something is a "critically important factor" is the threshold (No. 12-13 of the JFSA Responses). According to the JFSA Response, for instance, the following situations include such critically important factors: (i) investments are not conducted if pre-determined ESG criteria are not satisfied, or (ii) investment ratios are determined based on the pre-determined ESG criteria.

However, No. 11 of the JFSA Responses states that "the JFSA does not have clear numerical standards. Asset management companies need to consider the ratios and targets which reasonably demonstrate that ESG is the key factor in the selection of investment targets." Therefore each asset management company needs to decide "key factors" on their own.

On the other hand, business engaging in the following are not considered to be ESG Investment Trusts: "considering multiple factors such as financial indicators and ESG comprehensively" (No. 20 of the JFSA Responses) or making investment decisions by equally considering the three factors of "financial information scores (fundamentals)", "stock price information scores (charts)," and "ESG scores" (No. 25 of the JFSA Responses).

In addition, with regard to delegation of investment management (including funds of funds ("**FOF**")), investment trust management companies are required to make appropriate judgments regarding the suitability of ESG Investment Trusts based on their investment strategies and portfolio composition. Nevertheless, even in the case of delegation of investment management, the JFSA stated that the assessment of the appropriateness of the "key factor" is important (No. 48-52 of the JFSA Responses).

(2) Points of Attention Regarding Disclosure

The Revised Guidelines do not prohibit the establishment of ESG Investment Trusts.

Rather, from the viewpoint of dealing with green washing, they are distinctive in their approach to summarizing the points of concern for disclosure. Specifically, there are six categories: i) prevention of investor misperceptions; ii) investment strategy; iii) portfolio composition; iv) reference index; v) periodic disclosure; and vi) outsourcing. Contents for each of these items is described in the table below.

Viewpoint	Contents
i. Prevention of Customer Misunderstanding	Where an investment trust does not fall under the category of ESG investment trust, supervisors will check the following. ・ The name or nickname of the investment trust excludes ESG-related terms such as ESG, SDGs (Sustainable Development Goals), green, decarbonization, impact, sustainable, etc. in order to avoid misleading investors.

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Viewpoint	Contents
	▪ Where an ESG factor is considered along with other factors such as financial indicators in the selection of investment assets, ESG-related initiatives described in the "Objective and Characteristics of the Fund" of its delivery prospectus, sales materials, advertisement, etc. would not mislead customers into thinking that ESG is a key factor in its selection of investment assets. ▪ Where an investment trust which has been set up before the end of March, 2023 includes ESG-related terms in its name or nickname although it is not categorized as ESG investment trusts, that its delivery prospectus clearly states that it is not an ESG investment trust.

From the perspective of "i. Prevention of Customer Misunderstanding", there are strong JFSA's concerns about the use of ESG related terms for publicly offered investment trusts that do not fall under the category of ESG Investment Trusts. Furthermore, the JFSA stated that "we believe it is desirable to establish industry-wide standards for further prevention of misunderstanding among investors." (No. 77 of the JFSA Responses)

Regarding new investment trusts to be established after April 2023, "even if the delivery prospectus states that ESG is not a key factor in the selection of investment targets, it is not appropriate to use the relevant terminology such as "ESG" in the name, etc." (No. 91 of the JFSA Responses).

In addition, for existing publicly offered investment trusts established before the end of March 2023, from the perspective of preventing investors from being misled, the places to indicate the fact that they are not ESG Investment Trusts are considered to include the "Objective and Characteristics of the Fund" section of the prospectus and other appropriate places, such as the front page (No.98 of the JFSA Responses).

Viewpoint	Contents
ii. Investment Strategy	Supervisors will check the following items are described in the "Objective and Characteristics of the Fund" section of the delivery prospectus of an ESG investment trust. It is also accepted for point c below to be described in the "Investment Risk" section. a. details of key ESG factors (e.g. comprehensive ESG rating or specific environmental or social issues) in the selection of investment assets b. how key ESG factors are considered in the investment process (e.g. explanation of relevant criteria and indicators, evaluation methods, etc.) c. risk and limitation in consideration of key ESG factors in the investment process d. regarding an ESG investment trust that aims to create environmental or/and social impact in order to build a sustainable society, description of its purpose, details of the impact and how to measure and achieve it including target indicators and numbers, and methodologies e. the content of the stewardship policy, where the investment trust management company has one related to key ESG factors in the selection of investment assets that is company-wide or specifically dedicated to the investment strategy f. the references, where an ESG investment trust discloses further details of the above items from a through e on the website of the investment trust management company, etc.

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From an “ii. Investment Strategy” perspective, the points to be included in the delivery prospectuses of ESG Investment Trusts are identified. The range of “ESG Investment Trusts” is highly meaningful and includes references to impact investing. As to ESG investment processes, there are well-known investment methods, such as negative screening, positive screening, ESG integration, and ESG engagement. The extent to which the content of such well-known investment methods can be described in the delivery prospectus, which is required to be simple and easy to understand, is likely to be a practical issue, and involve simultaneous consideration of the “key factor” for assessment of ESG Investment Trusts.

Notable JFSA Responses on this item are as follows.

- In cases of funds that seek to track specific ESG indices (i.e., passive funds), descriptions concerning how to consider ESG and index methodologies in the specific ESG indices are required (No. 109-110 of the JFSA Responses).
- If the objective is to create impact, disclosure of the method for evaluating and achieving such impact is required even if the target figures cannot be disclosed (No. 120-121 of the JFSA Responses).
- If there is a company-wide stewardship policy related to ESG Investment Trusts, it is subject to disclosure even if such policy is not specific to ESG Investment Trusts, (No. 123 of the JFSA Responses).

Viewpoint	Contents
iii. Portfolio Construction	・ An ESG investment trust has a target or guideline ratio of its investment asset (on a market value basis) that are selected by the use of key ESG factors out of its net asset value ・ An ESG investment trust has other target or guideline indicators for evaluation of achievement of the whole portfolio regarding key ESG factors in the selection of investment asset Where either or both of the above is true, supervisors will check the ratio or figures are disclosed in the “Objective and Characteristics of the Fund” section of its delivery prospectus. Where it does not set such target or guideline ratio, supervisors will check the reason behind is explained.

With regard to disclosures related to “iii. Portfolio Construction”, disclosure of numerical values in cases where certain targets and indicators are established is required, especially with respect to the ratio of investment related to ESG and achievement of evaluation factors of the whole portfolio. On the other hand, in the absence of numerical targets and indicators, the JFSA indicates that explanations such as “we do not set targets and indicators related to ESG” are inadequate (please refer to No. 137 of the JFSA Responses).

Viewpoint	Contents
iv. Reference Index	Where an investment trust seeks to track a specific ESG index, supervisors will check that it explains how ESG factors are incorporated in the index in the “Objective and Characteristics of the Fund” section of its delivery prospectus and the reason why the investment management trust company has chosen the index.

With regard to “iv. Reference Index”, passive/index funds seeking to track ESG indices are required to explain how to account for and why to select ESG in the reference index. In the case of passive funds, etc., multiple questions were raised about whether it would be sufficient to include item iv only (with the above descriptions in items i to iii being optional). No. 147 to 149 of the JFSA Responses mention that “when the contents of the descriptions are substantially the same, there is no problem in avoiding duplication, but it is necessary to disclose the contents in consideration of the purpose of each item.”

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Viewpoint	Contents
v. Periodic Disclosure	Supervisors will check the following items are disclosed periodically in the delivery investment reports (periodic disclosure documents for Exchange-Traded Funds; the same applies hereinafter) and the "Investment Performance" section of the delivery prospectus of an ESG investment trust. a. the actual proportion, where it has a target or guideline ratio of investment assets selected with the use of key ESG factors (on a market value basis) out of its net asset value b. the status of achievement, where it has target or guideline indicators for evaluation of the whole portfolio regarding key ESG factors considered in the selection of investment assets c. regarding an ESG investment trust that aims to create environmental or/and social impact in order to build a sustainable society, the extent of the impact achieved d. the actions taken in accordance with the stewardship policy where an investment trust management company has one related to key ESG factors considered in the selection of investment assets that is company-wide or specifically dedicated to the investment strategy e. the references, where the further details of the above items from a through d are disclosed on a website, etc.

Item "v. Periodic Disclosure" is similar to items "ii. Investment Strategy" and " iii. Portfolio Construction", but it can be understood that explanation for the circumstances of achievements and compliance regarding the matters disclosed and explained to investors in the delivery prospectus are required to be provided to investors through the delivery of investment reports.

In addition, No. 156 of the JFSA Responses states that it is appropriate that the information in the delivery investment reports should be included in the investment reports (overall version). Based on the rules of the Investment Trusts Association, Japan, a self-regulatory organization, the asset management company would be expected to make its creativity and ingenuity so that it would be "easy for investors to understand the information."

Viewpoint	Contents
vi. Outsourcing	Where investment management of an ESG investment trust is outsourced to a third party, supervisors will check the investment management trust company conducts appropriate due diligence on the third party and review the status of investment management, and that it discloses the actual status of (2) to (5) of its invested funds in its delivery prospectus and delivery investment reports. Supervisors will check the reason behind is explained in case of difficulty in the disclosure above.

Item "vi. Outsourcing" is a matter of due diligence of delegated third parties who manage ESG Investment Trusts and disclosures about the due diligence. Outsourcing here also includes FoF as described above.

No. 195 of the JFSA Responses mentions that "in the case of outsourced to a third party, if the investment strategies, etc., of the delegated third party are examined and information corresponding to items ii to v is disclosed, it will satisfy the disclosures requirements in the Revised Guidelines".

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(3) Resources and Due Diligence

In addition to governance, the Revised Guidelines mention points to be considered when using third party providers for ESG rating and data. With regard to using third party providers, there is no prohibition on using such providers, however, the Revised Guidelines refer to appropriate due diligence.

i. Organizational Resources
- Supervisors will check that an investment management trust company has adequate resources to implement operations in line with an investment strategy considering ESG factors and to monitor its implementation status on an ongoing basis. These resources include development of data, IT infrastructure and human resources regarding ESG factors.
- Where investment management of a publicly-offered investment trust is delegated to a third party, supervisors will check that the investment trust management company has appropriate resources in place to conduct due diligence on the organizational resources of the third party and to confirm the status of (2) ii to v of the invested funds.
- Where these disclosure are difficult to be made, supervisors will check the reason behind is stated.

ii. Use of ESG Rating and Data Providers
- When an ESG rating provided by a third party is used in the investment process of publicly offered investment trusts, or when data provided by a third party is used in own ESG assessment by an investment trust management company, supervisors will check it conducts appropriate due diligence which could include an understanding of the organizational resources of the third party, what is being rated or assessed by its product, how it is being rated or assessed, and limitations and purposes for which its product is being used.

3. Conclusion

Regardless of whether a publicly offered investment trust falls under the category of Sustainable Finance Disclosure Regulation Article 8 and 9 funds in the EU, the Revised Guidelines explicitly mention that whether such investment trusts fall under ESG Investment Trusts for the purpose of this Japanese regulation is dependent on the requirements under the Revised Guidelines (No. 35 of the JFSA Responses). On the other hand, the Revised Guidelines also refer to international harmonization of similar foreign regulations (refer to the U.S. SEC in No. 16 of the JFSA Responses).

Financial regulations are independent in each country and region, and the JFSA Responses have just pointed out the obvious in this regard. On the other hand, the JFSA mentions that it will regularly review the Revised Guidelines in light of future responses by asset management companies based on the Revised Guidelines, as well as global trends surrounding ESG (No. 6 of the JFSA Responses). Through their responses, we can see the JFSA’s thoughts about harmonization and regulatory equivalence of global ESG investing and green washing issues.

In any event, since the Revised Guidelines are not negligible for investment trust management companies that set up publicly offered investment trusts related to ESG, we hope that this newsletter will help in the structuring and examination of investment trust products.

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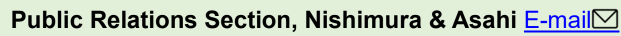

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