

MEMO# 34248

August 10, 2022

Asia ESG: Japan Consults on Code of Conduct for ESG Data Providers

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TO: ICI Global Members

ESG Task Force

Global Regulated Funds Committee

Global Regulated Funds Committee - Asia SUBJECTS: ESG

International/Global RE: Asia ESG: Japan Consults on Code of Conduct for ESG Data Providers

On 12 July 2022, Japan's Financial Services Agency (JFSA) published for public consultation a Code of Conduct for ESG Evaluation and Data Providers^[1] ("Draft Code of Conduct"),^[2] based on the recommendations^[3] of its technical committee on ESG evaluation and data providers ("Technical Committee").^[4] The Draft Code of Conduct is open for public comments until 5 September 2022.

The Draft Code of Conduct largely tracks the high-level recommendations IOSCO published in November 2021,^[5] but acknowledges the differences between a "subscriber pays" model and a "issuer pays" model^[6] in its recommended practices. Once finalized, the JFSA will call for ESG evaluation and data providers to endorse the Code of Conduct. If a provider endorses the Code of Conduct, it should publish the endorsement on its website and notify the JFSA of it. The JFSA will also publish a list of endorsements for the Code of Conduct.

Similar to the IOSCO Report, the Technical Committee also sets out principle-based recommendations for investors using ESG evaluation and data (including asset managers)^[7] and companies subject to assessment by ESG evaluation and data providers.^[8] While not being part of the Draft Code of Conduct, the JFSA is expected to communicate these recommendations with market participants via industry dialogue.

ICI Global is pleased to see that the Draft Code of Conduct adopts a principles-based approach and recognizes the diverse range of ESG evaluation and data providers. This memorandum compares the recommended practices in the Draft Code of Conduct with the recommendations for ESG rating and data product providers in the IOSCO Report, and briefly summarises the Technical Committee's recommendations for investors using ESG evaluation and data.

Scope of the Draft Code of Conduct

The Draft Code of Conduct will be applicable to ESG evaluation and data providers that (i) participate in Japanese financial markets, or (ii) provide services to the participants of the Japanese financial markets.

While the recommendations in the IOSCO Report apply to products marketed as providing an ESG focus or an opinion on an entity's ESG profile,[\[9\]](#) the JFSA limits the scope of the Draft Code of Conduct to ESG evaluation and data services that contribute to the investment decisions of the financial market participants in Japan, and are repeatedly and continuously offered as part of the providers' business operations. The provision of ESG data that involves adding estimates, calculations, and other information to the publicly disclosed data by corporates will also be covered by the Draft Code of Conduct. A provider's endorsement will only be applicable to its services that fall under the scope of the Draft Code of Conduct.[\[10\]](#)

Recommended Practices for ESG Evaluation and Data Providers

The JFSA recognizes the importance of allowing for innovation in the ESG evaluation and data space. It further highlights that the diversity of ESG ratings is not necessarily a problem, provided there is sufficient transparency about objectives, approach, and basic methodology of the evaluation. Similar to the recommendations in the IOSCO Report, the Draft Code of Conduct focuses on: (i) the quality of ESG evaluation and data, (ii) management and mitigation of conflicts of interests, (iii) transparency of objectives and basic methodologies, (iv) handling of confidential information, and (v) communication with assessed entities.[\[11\]](#)

Compared to the IOSCO's recommendations, the JFSA provides more detailed guidance on the levels of transparency expected. The JFSA urges the providers to make transparency a priority for their ESG evaluation and data services, giving necessary consideration to the intellectual property related to methodologies. The JFSA suggests that providers make public disclosures on the general information, including purposes, approach, and general methodology of ESG evaluations. More specific information, such as details of data used for evaluation, may be disclosed only to users and assessed entities in order to help them understand the basic framework and rationales for the evaluation results. Further, where evaluation and data services involve a higher degree of qualitative judgment, the providers should explain the general process and methodology more carefully.

The Draft Code of Conduct provides separate guidance on managing conflicts of interest for "subscriber pays" and "issuer pays" models. Under an "issuer pays" model, providers receive compensation from the assessed entities. This gives rise to a higher risk of conflicts of interest compared to a "subscriber pays" model. Thus, the JFSA expects providers using an "issuer pays" model to implement more detailed procedures to avoid conflicts of interest, for instance, establishing a firewall between sales and ESG evaluation activities.

Technical Committee's Recommendations for Investors Using ESG Evaluation and Data

The Technical Committee sets out recommendations for investors (including asset managers) using ESG evaluation and data services. Notably, these recommendations are not part of the Draft Code of Conduct, which directs at the ESG evaluation and data providers only. The Technical Committee recommends the JFSA engage with financial market participants via industry dialogue and promote the adoption of these recommended practices.

Similar to IOSCO's recommendation to users of ESG ratings and data products,^[12] the Technical Committee suggests investors carefully review the purpose, methodologies, and limitations of the ESG evaluation and data services they use in their investment decisions. In case of an unreasonable gap between the evaluation's policies and the results, investors are encouraged to engage in dialogues with the ESG evaluation and data providers and the assessed entities.

One notable difference between the IOSCO Report and the Technical Committee recommendations is that the Technical Committee recommends investors explain how ESG evaluation and data are used in making investment decisions. A similar explanation should be provided if an investor uses its in-house ESG evaluation, along with a description of the purpose and criteria of the in-house evaluation.

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endnotes

[1] The JFSA defines ESG evaluation and data providers as "collect, provide, and evaluate information on companies' ESG initiatives, the eligibility of green bonds and other ESG-related, or ESG-labelled, bonds and ESG-related loans." In our view, the term "ESG evaluation" generally aligns with the more commonly used term "ESG rating".

[2] See The Code of Conduct for ESG Evaluation and Data Providers (Draft), July 2022, available at https://www.JFSA.go.jp/news/r4/singi/20220712/20220712_6.pdf.

[3] See Report of the Technical Committee for ESG Evaluation and Data Providers - Towards market development through further improvement of ESG evaluation and data quality, July 2022, available at https://www.JFSA.go.jp/news/r4/singi/20220712/20220712_2.pdf. ("Committee Report")

[4] In February 2022, the JFSA established the Technical Committee on ESG Evaluation and Data Providers, etc. to develop a code of conduct for ESG evaluation and data providers.

[5] See FR09/21 Final Report - Environmental, Social and Governance (ESG) Ratings and Data Products Providers, November 2021, available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD690.pdf>. ("IOSCO Report") Also See ICI Memorandum [33922], dated 24 November 2021, available at <https://www.ici.org/memo33922>.

[6] The JFSA identifies two types of business models in the ESG evaluation and data space - "subscriber pays" model and "issuer pays" model. Under the "subscriber pays" model, ESG evaluation is conducted and provided on an equity or company-by-company basis, and

investors and other users of the evaluation and data bear the cost. Under the "issuer pays" model, ESG evaluation is conducted for an ESG-related bond or project, and the issuing companies bear the cost. See Draft Code of Conduct, *supra* note 1, at 3(vi), p.14-15.

[7] The recommendations of the Committee Report are primarily aimed at institutional investors such as asset owners and asset managers. See Committee Report, *supra* note 2, at footnote 5, p.3.

[8] See Committee Report, *supra* note 2, at Sections 4 and 5, p. 37-42.

[9] IOSCO provides the definitions of "ESG ratings" and "ESG data products". ESG ratings refer to the broad spectrum of ratings products that are marketed as providing an opinion regarding an entity, a financial instrument or a product, a company's ESG profile, or characteristics or exposure to ESG, climatic, or environmental risks or impact on society and the environment that are issued using a defined ranking system of rating categories, whether or not these are explicitly labeled as "ESG ratings." ESG data products refer to the broad spectrum of data products that are marketed as providing either a specific E, S, or G focus or a holistic ESG focus on an entity, financial instrument, product, or company's ESG profile or characteristics or exposure to ESG, climatic or environmental risks or impact on society and the environment, whether or not they are explicitly labeled as "ESG data products." See IOSCO Report, *supra* note 4, at Annex 1.

[10] The JFSA sets out the basic concepts regarding the services of ESG evaluation and data providers that are covered by the Draft Code of Conduct. See Draft Code of Conduct, *supra* note 1, at Section 3(iv), p.9-13.

[11] See IOSCO Report, *supra* note 4, Recommendations 2-6, 8 and 9 at Annex 2.

[12] See IOSCO Report, *supra* note 4, Recommendation 7 at Annex 2.