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Practical cross-border insights into ESG law

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1 Setting the Scene – Sources and Overview

1.1 What are the main substantive ESG-related regulations?

In Japan, there is no particular regulation that directly addresses ESG investment/financing, ESG disclosure or ESG business operations. While each of the components of ESG are addressed by some laws and regulations – namely, environmental matters (e.g., the Act on Promotion of Global Warming Countermeasures, and the Act on Special Measures Concerning Promotion of Utilizing Electricity from Renewable Energy Sources by Electricity Utilities), social matters (e.g., the Act on Promotion of Women's Participation and Advancement in the Workplace, and the Act on the Promotion of Ainu Culture and Dissemination and Enlightenment of Knowledge about Ainu Tradition, etc.) and corporate governance matters (e.g., the Companies Act) – the concept of ESG has not been codified in a Japanese law/regulation. Rather, ESG has been developed and become popular through soft-law rulemaking in Japan.

The main Japanese soft-law rules relating to ESG are the Stewardship Code ("SS Code") and Corporate Governance Code ("CG Code"). Acknowledging the growing importance of ESG, the latest SS Code (as amended in March 2020) defines the "Stewardship Responsibilities" thus:

> The responsibility of institutional investors to enhance the medium- to long-term investment return for their clients and beneficiaries … by improving and fostering the investee companies' corporate value and sustainable growth through constructive engagement, or purposeful dialogue, based on in-depth knowledge of the companies and their business environment and *consideration of sustainability (medium- to long-term sustainability including ESG factors)* consistent with their investment management strategies. (*Emphasis added.*)

In addition, Principle 7 of the SS Code provides:

> *To contribute positively to the sustainable growth of investee companies*, institutional investors should develop skills and resources needed to appropriately engage with the companies and to make proper judgments in fulfilling their stewardship activities based on in-depth knowledge of the investee companies and their business environment and *consideration of sustainability* consistent with their investment management strategies. (*Emphasis added.*)

On the other hand, the CG Code, prepared by Tokyo Stock Exchange ("TSE") and amended in June 2021, sets forth the fundamental principles for corporate governance. It has been incorporated into TSE's listing rules in order to promote corporate governance in Japan. Under the TSE listing rules, a TSE 1st or 2nd Section-listed company is required to provide an explanation for non-compliance with any principle of the CG Code. In addition to corporate governance-related matters, the CG Code addresses environmental and social matters in its General Principle 2-3: "Companies should take appropriate measures to address sustainability issues, including social and environmental matters."

In the Supplemental Principle relating to General Principle 2-3, it is further provided that a board of directors should: (i) acknowledge that addressing sustainability issues (e.g., environmental matters including climate change-related issues, human rights-related issues, and issues relating to welfare of employees, fair and proper transactions with counterparties and crisis management in respect of natural disasters) is one of the important business challenges that could lead to profitable business opportunities; and (ii) address such issues properly and carry out studies to actively deal with them.

1.2 What are the main ESG disclosure regulations?

The main regulations in connection with the disclosure of information relating to Japanese corporations are the Financial Instruments and Exchange Act ("FIEA") and the Companies Act. FIEA requires certain corporations and entities (such as listed companies) to prepare and submit a prospectus in order to disclose certain information for the benefit of their investors. The Companies Act requires corporations to disclose their financial information and business performance for the benefit of shareholders and creditors. Further, companies listed on a stock exchange (such as TSE) are required to disclose information in accordance with the listing rules of the stock exchange. Despite the existence of such strict regulations and rules, the subject information is mainly financial information, and no provision directly requires ESG disclosure.

Nevertheless, following the amendment of the enforcement regulation pertaining to FIEA in 2019, more information relating to corporate governance is required to be disclosed in the prospectus. The following non-financial information must be disclosed in accordance with such amendment:

- Policy and strategy for corporate management.
- Explanation of programme for directors' remuneration.
- Explanation of reasonableness of cross-shareholdings (where shares are mutually held not for investment).
- More detailed information regarding corporate governance.

In addition, some of the environmental regulatory laws set forth certain disclosure requirements concerning environmental matters. For example, the Act on Promotion of Global Warming

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Countermeasures requires certain business operators to disclose information about greenhouse gas emissions. Further, the Act on Rational Use of Energy and Conversion into Non-Fossil Fuel, Etc. requires the disclosure of energy use. Unless there is a disclosure regulation such as the foregoing, ESG-related matters are disclosed on a voluntary basis.

Further, it should be noted that a report discussing increased disclosure of non-financial information and improving the efficiency of disclosure by the Working Group on Corporate Disclosure, which is formed by the Financial Services Agency ("FSA"), was published in June 2022. The report proposes, *inter alia*, the creation of a new section in the annual securities report for disclosure of sustainability information.

1.3 What voluntary ESG disclosures, beyond those required by law or regulation, are customary?

General Principle 3 of the CG Code provides:

> Companies should appropriately make information disclosure in compliance with the relevant laws and regulations, but *should also strive to actively provide information beyond that required by law*. This includes both financial information, such as financial standing and operating results, and *non-financial information, such as business strategies and business issues, risk and governance*. The board should recognise that disclosed information will serve as the basis for constructive dialogue with shareholders, and therefore ensure that such information, *particularly non-financial information*, is accurate, clear and useful. (*Emphasis added*.)

Further, Supplemental Principle No. 3 relating to General Principle 3-1 of the CG Code provides, in summary, that: listed companies should properly disclose how they deal with their sustainability issues; and, among them, the companies listed on the Prime Market should collect and analyse the necessary data regarding the effect of climate change risk on their business activities, etc., and develop their disclosure in accordance with the Task Force on Climate-Related Financial Disclosures or equivalent framework.

In accordance with this concept, a number of Japanese corporations voluntarily disclose matters relating to ESG in the form of corporate social responsibility ("CSR") reports or similar. The government encourages corporations to perform such voluntary disclosure – for example, the Ministry of the Environment ("MoE") publishes a guideline for voluntary disclosure of matters related to the environment.

Sompo Holdings, Inc., for example – one of the biggest insurance companies in Japan, which is regularly ranked as a corporation that is highly sensible in its ESG matters – discloses a CSR Communication Report each year. In such report, Sompo Holdings discloses the details of ESG-related matters, such as the amount of greenhouse gas emissions, etc., diversity in human resources, contribution to social welfare, corporate governance system and internal education for compliance. As there is no regulation directly requiring ESG disclosure, the matter of how corporations disclose ESG-related information voluntarily to stakeholders depends on the individual corporation.

1.4 Are there significant laws or regulations currently in the proposal process?

No, there are none. As discussed above, in Japan, the concept of ESG has been developed through soft-law rulemaking and has not been codified. No particular law or regulation is currently in the proposal process.

1.5 What significant private sector initiatives relating to ESG are there?

The landmark action that boosted ESG development in Japan was the Government Pension Investment Fund's ("GPIF") commitment to the Principles for Responsible Investment ("PRI") in 2015. GPIF is Japan's biggest fund and manages more than JPY 193,000 billion. Its commitment to the PRI has significantly affected other investors and was a particularly big moment that hugely promoted ESG. Further, in 2017, GPIF changed its investment principles so that ESG consideration must be taken into account with respect to its investments. It is believed that many other investors have followed such approach of GPIF.

In addition, a number of Japanese corporations are keen to develop ESG (including ESG disclosure and ESG corporate management) and each of them has contributed to the recent development of ESG. There have also been some collective actions by large and well-known corporations to promote ESG. One example is an association named ESG Disclosure Study Group that was established by large Japanese corporations, such as Hitachi Corporation, Nippon Life and Mitsubishi UFJ Financial Group, for the purpose of promoting ESG disclosure. It is expected that such actions by corporations will have a hugely positive impact on ESG development.

Furthermore, the Japanese Bar Association has been conscious of ESG-related matters, and in 2018, it published the "Guide on ESG-related Risk Management", for Japanese companies, investors, and financial institutions to talk about and work together on managing risk related to ESG issues. Such guide was prepared for lawyers providing legal advice to Japanese corporations/investors, as well as for the corporations/investors themselves. Based on the SS Code and the CG Code, the guidance sets out (i) how to disclose non-financial information relating to ESG, (ii) how to prevent and grapple with corporate crisis management, and (iii) model clauses for ESG financing. The guidance is believed to be widely read and used among corporations and investors.

2 Principal Sources of ESG Pressure

2.1 What are the views and perspectives of investors and asset managers toward ESG, and how do they exert influence in support of those views?

Currently, it is widely believed that more and more corporations, investors and asset managers have acknowledged that they will lose market share or profit unless they become more conscious of ESG issues. The current basic approach by Japanese investors/asset managers, however, differs somewhat from those in European countries or the US. According to the Global Sustainable Investment Review ("GSIR") in 2020, in terms of ESG strategy, the percentage of "negative/exclusionary screening" was low (compared to Europe/the US). Rather, Japanese investors/asset managers are inclined to adopt the strategies of "corporate engagement and shareholder action" and "ESG integration".

According to the statistics, though the developed ESG strategies are less diverse in Japan than in Europe/the US, ESG has recently developed quite rapidly in Japan. According to the statistics published by GSIR, the ratio of ESG investment increased from 3.4% in 2016 to 24.3% in 2020 (an overall increase of around 20%). The statistics also show that the amount of ESG investment acutely increased from USD 474 billion in 2016 to USD 2,784 billion in 2020.

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2.2 What are the views of other stakeholders toward ESG, and how do they exert influence in support of those views?

Among ESG stakeholders, non-governmental organisations ("NGOs") and non-profit organisations ("NPOs") play an important role, although, in Japan, NGOs/NPOs are less powerful than they are in Europe/the US. Nevertheless, NGOs/NPOs are active in exerting influence over corporations/investors with respect to ESG.

For example, the exercise by Kiko Network – an NGO acting against global warming – of the shareholders' proposal right under the Companies Act, at the shareholders' meeting of Mizuho Financial Group (one of the biggest financial groups in Japan) in 2020, attracted a lot of attention. It is believed to have been the first case where the shareholders' proposal right was exercised in connection with global warming, and the proposal contained a request to Mizuho Financial Group to disclose a business plan that complied with the Paris Agreement.

Although the proposal was rejected at the shareholders' meeting, it is remarkable that around 35% of shareholders approved the proposal. According to Kiko Network, major advisory companies such as Glass Lewis and Institutional Shareholder Services suggested that the shareholders support the proposal. Subsequently, similar shareholders' proposals were made, such as Market Forces (an Australian NGO acting against global warming) taking similar action against Sumitomo Corporation in 2021. All such proposals have been rejected; however, the rate of support by other shareholders is increasing.

2.3 What are the principal regulators with respect to ESG issues, and what issues are being pressed by those regulators?

As there is no particular regulation that directly addresses ESG, no competent regulator that directly regulates ESG matters exists. Nevertheless: (i) FSA, which forms the committee for the SS Code, has played an important role with respect to ESG; (ii) the Ministry of Economy, Trade and Industry ("METI"), which is the competent authority for investment-related matters, is active in the ESG field and publishes reports relating to ESG; and (iii) MoE is very keen to promote ESG (in terms of "Environment"). In addition, although a quasi-governmental agency, TSE has played a relatively important role, especially by preparing the CG Code.

2.4 Have there been material enforcement actions with respect to ESG issues?

No, there have not. Due to the lack of a hard-law basis, there cannot have been any material enforcement actions.

2.5 What are the principal ESG-related litigation risks, and has there been material litigation with respect to ESG issues, other than enforcement actions?

Litigation relating to global warming poses major ESG-related risks for corporations in Japan. Such risks are eminent especially for energy companies that own coal-fired power plants. There have already been several instances of litigation where local residents brought lawsuits against operating coal-fired power plants or coal-fired power plant construction projects. Local resident plaintiffs led by NGOs/NPOs have brought civil litigation to stop the operation of power plants as well as administrative law litigation alleging illegality in the environmental assessment process.

From the perspective of the Japanese government, which is to publish an updated energy mix target for FY2030 indicating 20% with respect to coal-fired power plants as of FY2030, a certain number of coal-fired power plants (provided that they are efficient and emit fewer greenhouse gases) are necessary to ensure a stable electricity supply (whilst the Japanese government pledges to achieve net-zero carbon in 2050). Such a relatively high rate of coal-fired power plants stems from the particular Japanese circumstance where it is quite difficult to newly construct or even to restart existing nuclear power plants due to the Fukushima Daiichi meltdown disaster in 2011. A reasonable balance between the requirement of divestment from coal-fired power plants and securing a stable energy supply is one of the biggest energy-related issues in Japan.

In addition, litigation risks exist with respect to the working environment, such as in relation to sexual harassment and power harassment. Corporations are keen to hold internal education sessions about harassment issues to prevent such risks. Further, corporations potentially face the risk of litigation over unpaid overtime work. There has been a peculiar Japanese office culture or atmosphere implicitly requiring a certain volume of overtime work without payment. The aggregate unpaid amount equivalent to the salary for such overtime work is believed to be huge.

2.6 What are current key issues of concern for the proponents of ESG?

It is recognised that key issues of concern for the proponents of ESG in Japan are: (i) insufficient information available to determine ESG investment; (ii) no firm confidence on monetary rewards/return for ESG; (iii) a number of uncertainties with respect to the factors (such as politics, scientific technologies and influence of global warming) that are to be considered in connection with ESG; and (iv) a need to construct an internal framework to utilise relevant expertise (e.g., leading scientific technology).

3 Integration of ESG into Business Operations and Planning

3.1 Who has principal responsibility for addressing ESG issues? What is the role of the management body in setting and changing the strategy of the corporate entity with respect to these issues?

In connection with business operations and planning, each director and/or the board of directors of a company has principal responsibility for properly addressing ESG issues. The director's fiduciary duty (*chujitsu gimu*) and the duty of care as a prudent manager (*zenkan chuui gimu*) under the Companies Act can be the basis of such responsibility. Although there has been no court precedent where a director was accused of not addressing ESG issues and directors have broad discretion in making corporate decisions, given the increasing importance of ESG and its impact on business operations and planning, the possibility cannot be entirely ruled out that directors could be regarded as breaching their fiduciary duty or their duty of care as a prudent manager as a result of their failure to properly address ESG issues.

The role of such management body with respect to ESG issues comprises, *inter alia*, the following items:

(a) Environment: (i) establishing the corporation's policy for protecting the environment, energy efficiency and global

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warming, etc.; and (ii) establishing a compliance mechanism with respect to relevant environmental regulations.

(b) Social: (i) ensuring a socially and environmentally sound supply chain; (ii) ensuring a good and healthy working environment (e.g., less overtime, more support for childcare); and (iii) establishing a policy for contribution to social welfare and donation.

(c) Governance: ensuring a legally sound corporate governance system.

3.2 What governance mechanisms are in place to supervise management of ESG issues? What is the role of the board and board committees *vis-à-vis* management?

A number of large corporations have a special committee/group/team to work specifically on ESG-related matters with a mandate from the board of directors. In such cases, corporate actions are to be made in accordance with the detailed policies/strategies set by such internal organisations. They might contain a member from a third-party advisor to ensure that they can create appropriate and reasonable policies/strategies. The board will supervise such internal organisations.

3.3 What compensation or remuneration approaches are used to align incentives with respect to ESG?

An increasing number of Japanese corporations are implementing incentive mechanisms with respect to compensation/remuneration for directors/officers. For example, Omron Corporation, a well-known industrial automation and healthcare equipment company, is one of the front runners in having such a mechanism. According to the disclosed information, it has incorporated a sustainability evaluation into the component corresponding to the mid- and long-term business performance (which constitutes around 40% of the components that are to be considered to determine compensation/remuneration). The evaluation is to be made in accordance with the Dow Jones Sustainability Indices.

3.4 What are some common examples of how companies have integrated ESG into their day-to-day operations?

According to the disclosed information of corporations that are highly ranked in privately published ESG rankings, the following are common examples of how companies integrate ESG into their day-to-day operations:

(i) Diverting energy sources to renewable energy (e.g., joining the RE100 initiative).

(ii) Pursuing greater energy efficiency in offices/factories.

(iii) Providing products and services that contribute to social welfare (e.g., products/services to support areas hit by natural catastrophe).

(iv) More diversity in board members or administrative positions (e.g., appointing more female directors/officers).

(v) Promoting a better working environment (e.g., less overtime work, more remote work and respecting LGBT rights).

3.5 How have boards and management adapted to address the need to oversee and manage ESG issues?

The oversight and management of ESG issues depends on each company's internal policy. An ordinary process consists of: (i) setting internal corporate rules in accordance with relevant internationally or domestically important rules and guidelines relating to ESG (e.g., the United Nations Global Compact, the Universal Declaration of Human Rights, the Organisation for Economic Development ("OECD") Guidelines for Multinational Enterprises, and the G20/OECD Principles of Corporate Governance); and (ii) setting an internal reporting mechanism to ensure that ESG issues are properly overseen and managed in accordance with such internal corporate rules. In such a structure, an internal committee (e.g., sustainability committee) is typically in charge of preparing and updating such internal rules, as well as reporting relevant matters (e.g., how to tackle ESG issues) to the board/management.

4 Finance

4.1 To what extent do providers of debt and equity finance rely on internally or externally developed ESG ratings?

It depends on the policy of each debt provider, but on the whole, providers are becoming more reliant on ESG ratings. For example, according to the disclosed information, one of the Japanese mega banks has developed an ESG financing scheme where a third-party institution, which collaborates with the bank, evaluates ESG-related components of a potential borrower and the bank provides finance based on such evaluation. Another example is a Japanese regional bank that is developing a platform to digitalise ESG-related factors in order to facilitate ESG finance for small or mid-sized business operators in provincial cities. Going forward, there is likely to be more financing that relies on ESG ratings.

4.2 Do green bonds or social bonds play a significant role in the market?

Both Green Bonds and Social Bonds play significant roles in the Japanese market. According to the Japan Securities Dealers Association ("JSDA"), in 2021, the total issued amount of Green Bonds in Japan was approximately JPY 1,100 billion and the number of deals was 84. Such figures are relatively small compared to Europe/the US; however, considering that the total amount in 2016 was merely around JPY 10 billion (only one deal) and around JPY 66 billion in 2017 (six deals), the market for Green Bonds has recently been rapidly expanding. In particular, the number of Green Bonds for renewable energy projects and green buildings is large.

Also, according to JSDA, the market for Social Bonds has recently been rapidly expanding. In 2021, the total issued amount of Social Bonds in Japan was approximately JPY 1,164 billion and the number of deals was 53, while the total amount in 2016 was merely around JPY 35 billion (only two deals) and around JPY 123 billion in 2017 (nine deals). One example of Social Bonds is a bond issued by one of the Japanese mega banks, which is for medical, educational, job-creating and affordable housing matters.

In addition, it is reported that the Japan International Cooperation Agency ("JICA") recently launched Social Bonds such that JICA appropriates the entire proceeds to international cooperation activities overseas, and the Japan Student Services Organization launched Social Bonds to support students. Furthermore, it is notable that FSA issued draft Social Bond Guidelines in July 2021, which provide guidance in relation to the issuance of Social Bonds. It is expected that such guidelines will promote a further increase in Social Bonds in Japan.

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4.3 Do sustainability-linked bonds play a significant role in the market?

Sustainability-linked bonds have not yet played a significant role in Japan. If we follow the definition set by the International Capital Market Association ("ICMA"), which states that "Sustainability Bonds are any type of bond instrument where the proceeds will be exclusively applied to financing or re-financing a combination of Green and Social Projects and which are aligned with the four core components of the GBP and SBP", it seems hard for issuers to meet such requirements. Meanwhile, according to the disclosed information, Tokyo Metro Co., Ltd., which operates the underground network in Tokyo, recently issued sustainability-linked bonds in accordance with ICMA rules. The purpose is to introduce more energy-efficient train carriages (train cars), install safety facilities at stations and install renewable energy facilities.

On the other hand, some Japanese banks have developed sustainability-linked loans whereby the bank provides a loan to a borrower who commits to utilise the loan proceeds for businesses/projects that are good for sustainability. It is reported that a third party has verified the mechanism of such loans.

4.4 What are the major factors impacting the use of these types of financial instruments?

The most important positive factor for both issuers and subscribers is that they can externally and internally publicise their approach of committing to addressing ESG issues by using such financial instruments (hereinafter, collectively referred to as "ESG bonds"). The issuer has the chance to reach out to (new) ESG-friendly investors who would not have subscribed if the financial instrument had not been an ESG bond. Subscribers (investors) can show that their investment portfolio addresses the increasing need for ESG. Despite the relatively higher cost of ESG and their issuance being more time-consuming than for usual bonds, this positive factor is a big driver for involvement by issuers/investors in ESG bonds.

In the case of green project bonds where the financer for an environmentally friendly project (such as renewable energy projects) issues Green Bonds and procures money for its financing, the borrower may enjoy a lower interest rate or more favourable finance conditions as compared to conventional finance schemes (where big banks provide commitment loans).

4.5 What is the assurance and verification process for green bonds? To what extent are these processes regulated?

There is no hard-law regulation directly relating to Green Bonds. Furthermore, the *Green Bonds Guideline* published on the Green Bond Issuance Platform established by MoE does not require a second-party opinion, verification or certification; rather, it only states that such assurance is recommendable. Having said that, under the current practice in Japan, it can be said that it is usual to have a second-party opinion/rating by a private credit rating company when a Green Bond is issued.

Under the laws of Japan, some rating companies are registered with FSA, and others not. Registered rating companies are subject to the regulations under FIEA. On the other hand, with respect to those that are not registered, if a regulated financial service provider under FIEA (e.g., a securities company) retains such a credit rating company, the financial service provider must disclose to its client that the credit rating company has no registration, and the details of the method of rating, etc., used by the rating company, in accordance with Sub-paragraph 3 of Article 38 of FIEA. As such, the rating is regulated and an assurance and verification process is in place.

5 Trends

5.1 What are the material trends related to ESG?

Firstly, one of the biggest recent developments in ESG is that the three Japanese mega banks announced that they will, essentially, refrain from providing further finance to coal-fired power plants (and will also exit from existing finance in the future). New financing for coal-fired power plants has become markedly difficult. The move by these banks is regarded as a significant step to reasonably reduce the number of coal-fired power plants in Japan. This follows METI's announcement back in 2020 of its policy to significantly reduce old, inefficient coal-fired power plants.

Further, investors are placing more importance on ESG disclosure and on how investee companies commit to ESG. Some Japanese investors have recently revised their policy for exercising their shareholders' rights such that action or inaction by investee companies that is problematic from the perspective of ESG shall, when the investors exercise their shareholders' rights, be deemed to be a situation impairing stock value. This kind of policy will place great pressure on investee companies to promote ESG actions.

Lastly, it is notable that, responding to demands from human rights-conscious customers/investors and the legislation of strict human rights-related regulations in Europe, the number of Japanese corporations that have realised the importance of human rights-related due diligence is increasing. It is expected that more corporations will carry out in-depth human rights due diligence when they perform M&A deals, invest in projects/companies and contract with suppliers.

5.2 What will be the longer-term impact of COVID-19 on ESG?

Due to the economic downturn and a number of societal constraints brought in to address the health crisis, small and mid-sized companies are suffering and will suffer huge disadvantages (compared to large companies) in terms of ensuring operating capital. Some argue that it is a good opportunity to develop and promote the issuance of Social Bonds to support such vulnerable small and mid-sized companies. As the amount of such bonds would be relatively small and the issuers are likely to have insufficient leeway to bear the relatively high issuing costs, the development of a certain kind of platform (such as one incorporating the digitalisation of ESG scores), whereby small and mid-sized companies can easily issue the bonds, would be necessary if such a policy were to be implemented.

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