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Japan: Law & Practice

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JAPAN

Law and Practice

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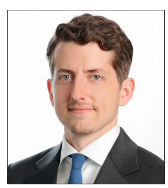

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Introduction

ESG has recently been receiving a lot of attention in Japan. It is now common to see books, as well as articles in newspapers and magazines, referring to both ESG and SDGs (sustainable development goals). Together, ESG and SDGs have become a trending topic. In the professional sphere, an increasing number of corporations, investors and asset managers have acknowledged that they will lose market share or profit unless they become more conscious of ESG issues in their business activities. In Japan, both corporations and the general public appear to have a positive view of ESG and, unlike the situation in the United States, no countermovement by conservative groups has emerged to object to the concept of ESG or ESG investment in Japan.

One landmark action which boosted ESG development and helped facilitate ESG's positive reception in Japan was the Government Pension Investment Fund's (GPIF's) commitment to the Principles for Responsible Investment (PRI) in 2015. The GPIF is Japan's biggest fund and manages around JPY200 trillion (approximately USD1.3 trillion). Its commitment to the PRI has had a significant impact on other investors and has hugely promoted ESG. Moreover, the GPIF changed its investment principles in 2017 to ensure that ESG considerations must be taken into account with respect to investments. It is believed that many other investors have followed the GPIF's approach.

It is noteworthy that current ESG investment trends among Japanese investors/asset managers differ somewhat from those in Europe and the US. According to recent statistics, the percentage of "impact investment", "positive screening" and "negative screening" in Japan is not high in comparison to Europe and the US. Instead, Japanese investors and asset managers are inclined to adopt "corporate engagement and shareholder action" and "ESG integration" strategies, which typically require less commitment regarding ESG development. In addition, statistics show that although the developed ESG strategies are less diverse in Japan as compared to Europe and the US, ESG has recently developed quite rapidly in Japan. From the perspective of further ESG development, however, it would obviously be desirable for investors in Japan to have more diverse ESG investment and development opportunities going forward.

Developments and Trends in Actions by Japanese Corporations

How to implement ESG

The oversight and management of ESG issues depends on the internal policy of the individual corporation, and there are various mechanisms to implement ESG in Japanese corporations. Nevertheless, it is believed that a typical process involves, for example:

- setting internal corporate rules in alignment with relevant international or domestic rules and guidelines relating to ESG (eg, the UN Compact, Universal Declaration of Human Rights, OECD Guidelines and Corporate Governance Code); and
- establishing 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 (eg, a sustainability committee) is typically charged with preparing and updating such internal rules and reporting relevant matters (eg, how to tackle ESG issues) to the board/management.

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

- diverting energy sources to renewable energy (eg, joining the RE100 initiative);
- pursuing greater energy efficiency in offices/factories;
- providing products and services that contribute to social welfare (eg, providing products/services to areas affected by natural disasters);
- aiming for more diversity in board members or administrative positions (eg, appointing more female directors/officers); and
- promoting a better work environment (eg, less overtime work, more remote work and respecting LGBT rights).

Director remuneration

It has recently been reported that an increasing number of Japanese corporations are implementing ESG incentive mechanisms with respect to compensation and remuneration for directors and officers. For example, one Japanese manufacturing company, which is well known for its ESG-related activities, has incorporated a sustainability component into the evaluation of mid- and long-term business performance (which constitutes a certain percentage of the components that are taken into consideration when determining compensation/remuneration). The evaluation is to be made in accordance with global sustainability indexes and other factors.

Collective action and alignment by multiple companies

A number of Japanese corporations are keen to develop ESG (including ESG disclosure and ESG corporate management) and have contributed to the recent development of ESG in Japan. There have also been some collective actions by large and well-known corporations to promote ESG, of which the establishment of the ESG Disclosure Study Group is one example. This association was set up by large Japanese corporations, such as prestigious financial institutions, insurance companies and manufacturing companies, for the purpose of promoting ESG disclosure. It is expected that such actions by corporations will have a significant, positive impact on ESG development.

Recent Trends in Environmental Matters – GX and Climate Change Litigations

Green Transformation (GX)

Probably the most notable movements in Japan concerning the environment part of ESG are the GX League, initiated by private corporations, and the GX Implementation Council, initiated by the Japanese government.

"GX" stands for "Green Transformation", which means a significant transformation in Japanese policy in the industrial and energy sector. Its aim is to transform fossil fuel-centred Japanese industry and social structures into those centred on clean energy. "GX" is therefore an important keyword in Japanese developments concerning the environment.

The GX League

The GX League was established in 2022, as a forum for co-operation among a group of companies, the government, universities, and academic institutions for the purpose of (i) Japan being able to meet its GHG (greenhouse gas) reduction target; and (ii) increasing industrial competitiveness by utilising Japan's goal of carbon neutrality by 2050 as an opportunity for economic growth.

Currently, entities from various industries (more than 600 members as of June 2023) have endorsed the goals of the GX League and are working together to develop a collective vision of a future society, and make rules for market creation. It is also noteworthy that, since April 2023, the GX League has adopted a voluntary carbon credit exchange scheme, which is anticipated to be consolidated into a nationwide carbon credit exchange scheme in 2026.

The GX Implementation Council

While the GX League is managed by private entities, the GX Implementation Council is a government body established by the initiative of Prime Minister Kishida. From July 2022 to September 2023, the Council held seven conferences, and in February 2023 it published a document entitled "Basic Policy Toward Achieving GX – Roadmap for Forthcoming 10 years". This document addresses the importance of, among other things, greater energy efficiency, facilitating the introduction of more renewable energy facilities, utilisation of nuclear power plants, the introduction of CCS (carbon dioxide capture and storage), and more utilisation of rechargeable batteries for grid, hydrogen and ammonia power. The most eye-catching policy, however, is the introduction of the so-called "GX Economy Transition Bonds" and the "Growth-Intended Carbon Pricing Mechanism" as described below.

In its GX policy, the Japanese government intends to issue GX Economy Transition Bonds to generate JPY150 trillion (approximately USD1 trillion) from both public and private sources until around 2032. Its intention is to redeem such bonds by way of generating funds through its Growth-Intended Carbon Pricing Mechanism, which will consist of both a nationwide carbon credit exchange scheme to be introduced in 2026 and a carbon surcharge scheme to be introduced in 2028. It is anticipated that the funds generated by the issuance of GX Economy Transition Bonds will be utilised to achieve Japan's carbon-neutral target by 2050, and that Japan can generate funds for redeeming such bonds through a gradual increase in the monetary burden on private corporations in the carbon pricing mechanism above (ie, the carbon credit exchange scheme and carbon surcharge scheme). This ambitious policy materialised in the new legislation promulgated in April 2023, called the GX Facilitation Act.

Climate change-related litigation

Litigation relating to global warming could pose major ESG-related risks for corporations in Japan. Such risks are particularly acute for energy companies that own conventional power plants, especially coal-fired power plants. There have already been several instances of local residents bringing lawsuits against operating coal-fired power plants or coal-fired power plant construction projects. Local resident plaintiffs led by NGOs and NPOs (non-profit organisations) have brought civil suits to stop the operation of power plants, as well as administrative law actions alleging illegality in the environmental assessment process. Nevertheless, as of September 2023, no such plaintiffs have won their cases.

The Japanese government has published an updated energy-mix target for FY2030 in which coal-fired power plants provide 20% of the country's power. Pursuant to this target, the government needs to allow a certain number of coal-fired power plants to run in order to ensure a stable electricity supply, while it strives to achieve carbon neutrality by 2050. The relatively high percentage of coal-fired power plants stems from circumstances particular to Japan, where it is difficult to start constructing or even to restart existing nuclear power plants due to the Fukushima Daiichi meltdown disaster in 2011. Striking a reasonable balance between the need to run efficient coal-fired power plants that produce fewer GHGs (using new GHG-reduction technology such as CCS, hydrogen and ammonia), while simultaneously securing a stable energy supply, is one of the biggest energy-related issues in Japan.

Recent Trends in Social Matters – Human Rights Due Diligence and Social Bonds

Human rights due diligence

It is notable that, responding to demands from human rights-conscious customers and investors and the enactment of strict human rights-related regulations in Europe and the US, an increasing number of Japanese corporations are realising the importance of human rights-related due diligence. In a recent trend, many corporations are now carrying out in-depth human rights due diligence when they perform M&A deals, invest in projects and companies, and contract with suppliers.

Unlike in Europe and the US, Japan has no hard law or regulation mandating that corporations in Japan conduct human rights due diligence. Nevertheless, the competent Japanese government authority promulgated the first guideline with respect to human rights due diligence in September 2022. The Guidelines on Respecting Human Rights in Responsible Supply Chains, or the "Guideline" as it is known, has no legally binding nature, but provides that, "regardless of the business enterprise size, sector and other factors, all business enterprises engaging in business activities in Japan should strive to respect human rights in their business enterprise, group companies, suppliers, etc. inside and outside Japan to the fullest extent possible, in line with the Guideline, which [is] based on international standards". The Guideline is obviously important for corporations engaging in business activities in Japan.

Social bonds

Together with Green Bonds, Social Bonds have begun to play a significant role in the Japanese market. According to the Japan Securities Dealers Association, the total issued value of Social Bonds in Japan in 2022 was approximately

JPY1,900 billion (representing 97 transactions). Such figure is relatively small compared to Europe and the US; however, considering that the total amount in 2016 was merely around JPY35 billion (only two deals) and around JPY511 billion in 2019 (22 deals), it is evident that the market for Social Bonds has recently expanded rapidly.

As an example of a Social Bond, the Japanese mega banks have issued bonds for medical, educational, job-creating and affordable housing matters. Also, it is reported that the Tokyo metropolitan government recently launched Social Bonds, all the proceeds of which are allocated to the enhancement of education, job creation, and similar public projects; and the Japan Student Services Organization also launched Social Bonds to support students. Furthermore, it is notable that the Japanese Financial Service Agency issued Social Bond Guidelines in October 2021, which provide guidance in relation to the issuance of Social Bonds.

On the other hand, in comparison to Social Bonds, Sustainability-Linked Bonds have not yet played a significant role in Japan. If we follow the definition set by the International Capital Market Association, however, which states that "[s]ustainability 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 Green Bond Principles and Social Bond Principles", it appears difficult for issuers to meet such requirements.

Recent Trends in Governance-Related Matters – Engagement and Disclosure

Engagement with shareholders

In Japan, NGOs and NPOs, as shareholders, are active in exerting influence over corporations and investors with respect to ESG. This influence is often exhibited at shareholders' meetings. For example, NGOs acting against climate change exercise their shareholders' proposal right, under the Companies Act, at the shareholders' meetings of financial institutions, energy companies and trading house companies. The first such case, which attracted a great deal of attention, was that in which the NGO Kiko Network made a proposal to Mizuho Financial Group, one of the biggest financial groups in Japan, to disclose a business plan that complied with the 2020 Paris Agreement. Although such 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 shareholders support the proposal.

After the case above, similar shareholders' proposals by Kiko Network or other NGOs, such as Market Forces (an Australian NGO acting against global warming), were made at shareholders' meetings. All such proposals have been rejected and there have been cases where the rate of support fell below that in the Mizuho case above; however, similar actions (including proposals relating to environmental matters other than climate change, eg, biodiversity) are likely to be taken by NGOs and NPOs at future shareholders' meetings. It is crucial for corporations in Japan that proper engagement with shareholders and related parties, including advisory companies, is made in a timely manner.

ESG disclosure

The most notable recent development with respect to ESG disclosure in Japan was the January 2023 amendment to the Implementation Regulation of the Financial Instruments Exchange Act (FIEA), requiring certain disclosure of sustainability-related matters. It was the first legislation requiring ESG disclosure in Japan. This amendment provides (i) for the creation of a new section in securities reports for corporate initiatives relating to sustainability; and (ii) that certain factors relating to diversity (eg, the number of female employees in administrative positions, the number of male employees with childcare leave, and the difference between the salaries of male and female employees) are required to be disclosed in securities reports, etc. It should be noted that this amendment applies to corporations with account settlements as of the end of March 2023 onwards. There are likely to be more developments in ESG disclosure in Japan as a result of the issuance of the global sustainability disclosure standards by the International Sustainability Standards Board (ISSB) in June 2023.

Before the amendment to the FIEA described above, ESG disclosures in Japan were made on a voluntary basis – for example, in the form of corporate social responsibility or similar reports. One statutory basis for such voluntary disclosure is General Principle 3 of the Corporate Governance Code (the "CG Code"), which provides:

"Companies should appropriately make information disclosures 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."

Furthermore, 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 that companies listed on the Prime Market of the Tokyo Stock Exchange should collect and analyse data regarding the effect of climate change risk on their business activities, etc, and develop their disclosures in accordance with the Task Force on Climate-Related Financial Disclosures ("TCFD") or an equivalent framework. Examples of ESG-related matters that are subject to voluntary disclosure include the amount of GHG emissions, etc, diversity in human resources, contribution to social welfare, the corporate governance system and internal education for compliance.

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