

C L I F F O R D
C H A N C E



INSIGHTS INTO ESG IN JAPAN

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INSIGHTS INTO ESG IN JAPAN

Environmental, Social and Governance (ESG) considerations are essential to businesses for the opportunities they bring, and for the reputational and economic risks that arise from making the wrong decisions. In this briefing we look at the efforts being made by the Japanese government to implement ESG initiatives in light of the growing interest and scrutiny in ESG matters from within Japan and abroad.

ENVIRONMENTAL

Stakeholders are increasingly demanding that environmentally sustainable practices be placed at the forefront of executive decision-making and planning. In Japan, the “E” pillar’s expansion has been accelerated by the government’s commitment to the environment.

At COP26 in Glasgow in November 2021, Japan’s Prime Minister, Fumio Kishida, pledged up to USD10 billion over the next five years to support Asia’s transformation of fossil-fuel-fired thermal power into zero-emission thermal power, such as ammonia and hydrogen.

In 2020, the government announced a new initiative, the Green Growth Strategy, to reduce GHG emissions to net zero by 2050. This lists 14 growth sectors for achieving this ambitious goal by 2050, including offshore wind, solar and geothermal power; hydrogen and ammonia; energy storage; and carbon capture technologies. Following the introduction of the Green Growth Strategy, the government announced that it would raise its GHG emission reduction target to 46% compared with 2013 levels at the Leaders’ Summit on Climate hosted by the United States in April 2021. In May 2021, the government entrenched this strategy in law by an amendment to the Act on Promotion of Global Warming Countermeasures setting out its aim of reaching carbon neutrality by 2050 and encouraging local municipalities and enterprises to implement or strengthen necessary measures for a carbon-neutral society. The statutory inclusion of this target demonstrates the national commitment to Japan pursuing this goal, regardless of any change in government.

Energy strategy

Japan’s energy and power sector is entering a new phase.

Japan has promoted renewable energy for a number of years: feed-in-tariffs for renewable energy were introduced in Japan in 2012, and by 2020, renewables had almost doubled to comprise 20% of Japan’s overall power resources. However, whereas previously solar PV plants have led the way in providing renewable energy in Japan, offshore wind power is expected to account for much of the future growth. The government completed an auction process for first-round promotion areas for offshore wind farms in December 2021, and further auction process for subsequent rounds will be repeated.

However, although generally seen as a positive development, the growing share of renewable energy is not without its issues. As in other countries, one problem is grid frequency management. As electrical output from renewable energy depends on varying natural conditions and grid system operators must co-ordinate variable power supply with actual demand for electricity, we expect batteries to play a key role in achieving the Green Growth Strategy. There is some ambiguity around a regulatory framework for grid-connected energy storage and we expect developments in this area to be based on lessons learned in other developed markets.

In the Green Growth Strategy, the Japanese government also announced that it will boost hydrogen use in several areas in the future – the government expects hydrogen to be one of the key elements in realising carbon neutrality by 2050. This is on top of the “Basic Hydrogen Strategy” that the Japanese government introduced in December 2017, which was the world’s first national strategy for hydrogen. Fuel cell vehicles have gradually been introduced into Japanese society and the government believes the large-scale use of hydrogen-powered vehicles to be on the cards. One major approach to be tested is generating power from hydrogen by burning it instead of fossil fuels (coal or natural gas) in thermal power plants, with particular focus on utilising green hydrogen, produced by renewable energy. Research and development of the value chain for hydrogen is progressing and it is clear hydrogen will be key future industry in Japan.

In terms of international cooperation, Japan has also continued its effort to expand a joint crediting mechanism (JCM) whereby Japan provides low-carbon technologies, products and services to other countries, and credit the reduction in GHG emissions achieved by such projects towards Japan’s emission reduction target.

Climate risks and opportunities disclosure

Japanese businesses are committing to climate-related reporting, and constitute the largest group of supporters of the international body, the Task Force for Climate-related Financial Disclosures (TCFD), making up almost one fifth of the total as of October 2021. One factor that helps explain this commitment is the Japan TCFD Consortium, which was formed in May 2019 as a public-private partnership bringing together institutional investors, financial institutions and business corporations to promote climate-related financial disclosures, with the backing of Japan’s Ministry of Economy, Trade and Industry (METI), Ministry of the Environment (MOE) and the Financial Services Agency of Japan (FSA). This Consortium, amongst others, published guidance on the TCFD to provide Japanese companies with commentaries on what investors are looking for and, which has resulted in improved depth and breadth of disclosures by Japanese companies.

Climate disclosures is on track to shift from being voluntary to mandatory. The TSE will implement a new market division in April 2022, and will encourage companies listed on the Prime Market (the top section) to disclose climate-related risks under a new corporate governance code. Further, it is reported that the FSA will impose a climate-related risk disclosure obligation on listed companies from sometime in 2023 or later. The TSE’s corporate governance is soft law, so a “comply or explain” approach will be taken; however, if the FSA imposes such obligation, it will be a hard obligation and non-compliant companies may be held liable through the possible imposition of fines or other penalties.

Green Bond Guidelines and Climate Transition Finance Guidelines

The MOE introduced the Green Bond Guidelines (Japanese GBGs) in 2017 and updated the Guidelines in 2020 with a view to: increasing the visibility of green bonds; maintaining their creditability; and to help reduce the cost and administrative burden of issuing green bonds. The Japanese GBGs align with the International Capital Market Association's Green Bond Principles (ICMA GBPs) and provide issuers, investors (both domestic and international) and other market participants with examples of specific approaches tailored to Japan's bond market.

The Guidelines seek to prevent "green-washed" bonds from being issued and traded as "green bonds". The Japanese GBGs provide a general overview of green bonds, and the criteria and procedures for their issuance. In the same way as the ICMA GBPs, the Japanese GBGs have four core components: (i) use of proceeds; (ii) process for project evaluation and selection; (iii) management of proceeds; and (iv) reporting. The Japanese GBGs also cover considerations relating to external reviews. These components are not legally binding and there are no governing law requirements in the Japanese GBGs. However, by following the Japanese GBGs, Japanese issuers may avail themselves of the support of the MOE under the Support Programmes for Green Bond Issuances. The Japanese GBGs also apply to Sustainability Bonds that have green characteristics. The TSE also launched a dedicated platform for green and social bonds listed on its TOKYO PRO-BOND Market (a debt listing market targeting professional investors only) in 2018. The platform allows issuers to post information relating to its green or social bonds directly on the TOKYO PRO-BOND Market website. Information that can be posted includes use of proceeds, external reviews, reporting and other related information (such as eligible projects). Following such effort, the total amount of green and sustainability bonds issuances by Japanese issuers in 2021 had reached 2,866 billion yen, an almost nine-fold increase compared with 2017.

In May 2021, METI, together with the FSA and MOE, formulated the Climate Transition Finance Guidelines (Japanese TFGs) as a handbook for conducting transition financing. The aim of the Japanese TFGs is to contribute to achieving carbon neutrality in Japan by 2050 through the introduction of more funding, by establishing a position for transition finance as a means of procuring financing for transitions particularly in sectors where emissions are difficult to reduce. The Japanese TFGs intend to promote the spread of climate transition financing which has just begun, and increase the credibility of financing labelled as "transition finance". Transition finance focuses not only on individual projects that require funding (the targets for the funding), but also makes a comprehensive judgement on the project operators' "transition strategies" toward decarbonisation, and the reliability and transparency with which those strategies are implemented. The Japanese TFGs, based on ICMA's Climate Transition Finance Handbook published in December 2020, cover discussion points regarding disclosure, matters to be disclosed and supplementary information, and issues related to independent reviews.

SOCIAL

The 'S' in ESG covers a wide range of issues, from business practices to employment issues and diversity. We are focusing on a number of recent developments in Japan relating to social issues – new anti-trust regulations for digital platforms, further efforts towards gender equality, and human rights due diligence.

Japan's digital platform regulations

In 2019, the Japanese government established a new organisation, the Headquarters for Digital Market Competition, to address certain issues perceived in the digital market, and in February 2021, the Act on Improving Transparency and Fairness of Digital Platforms (TFDPA) became effective. The TFDPA currently covers online mall operators, and requires greater transparency and fairness in transactions in online malls and app stores. Some operators which meet certain category and size criteria (which includes Google, Amazon and Apple) have been designated as "Specified Digital Platform Providers" and are subject to regulation and discipline under the TFDPA.

The regulation employs an approach called "co-regulation", meaning that, while the government presents a broad framework for discipline, it leaves it to the voluntary efforts of each operator to a certain degree to accomplish the purposes of the regulation. Companies designated as "Specified Digital Platform Providers" have three types of obligations: (i) disclosure of terms and conditions and prior notices of changes to vendors; (ii) setting up of a procedure to secure fairness, such as complaints handling; and (iii) annual reporting to the Japanese government, including self-assessment of their compliance with disclosure and fair process obligations. These reports are expected to be reviewed by consumers, academics and other stakeholders and the results will be made public. Through this monitoring process, operators providing digital platforms are also expected to be able to avoid violating the Japanese Antimonopoly Act.

To supplement the effectiveness of the new regulatory framework, in case of potential violation of the Japanese Antimonopoly Act, METI may request measures from the Japan Fair Trade Commission (JFTC). If the JFTC finds that an operator has violated the Japanese Antimonopoly Act, such operator may be subject to an order to pay an administrative monetary penalty under the Japanese Antimonopoly Act. METI also intends to actively monitor and continue to make improvements to the effectiveness of the TFDPA by looking at the situation surrounding digital platforms, including information to be provided by vendors.

The TFDPA's approach is different from the EU drafts of the Digital Services Act and Digital Markets Act, which aim to impose prior obligations, speedy enforcement and deterrent sanctions with regard to digital platforms, and contain a list of DOs and DON'Ts. The obligations under the TFDPA are relatively light due to the concept of co-regulation. It is not clear whether Japan will go in a direction similar to the drafts of the Digital Services Act and Digital Markets Act in the future. Having said that, the TFDPA is an important and meaningful step in the regulation of digital platforms in Japan, and we will have to see how the co-regulation approach under the TFDPA works in practice.

Gender parity – promotion of women’s participation and advancement

Japanese companies are being urged to improve women’s advancement, and a series of measures is likely to push companies towards further gender equality in the workplace. The TSE has introduced a requirement for listed companies to disclose the gender ratio of their board of directors in their annual securities reports and corporate governance codes to ensure diversity, including the active participation of women in boards of directors.

Under the Women’s Success Promotion Act, employers are required to: assess and maintain an understanding of the status in respect of female participation in the company and analyse improvement areas and issues; set numerical targets and publish action plans; and disclose the recruitment and managerial position ratios of women in the company. Employers making outstanding efforts to promote women’s participation and advancement could be awarded or are able to enjoy advantages in public procurement contracts.

In addition, requirements to extend child-care leave will shortly come in force and certain measures – to prevent sexual harassment and harassment relating to pregnancy, childbirth and child-care leave – have already been enshrined in law. These measures have been recently strengthened through amendments to the relevant law which prohibits disadvantageous treatment following a report of harassment. In addition, a cooperation obligation in dealing with sexual harassment committed by an employer’s own employee against an employee working for another employer, has been added.

National Action Plan on business and human rights

Legislation on business and human rights is rapidly being developed, particularly in Europe and Japan is following suit. In October 2020, an inter-ministerial committee launched a National Action Plan (NAP) on business and human rights. The NAP is based on the OECD Guidelines for Multinational Enterprises issued in 1976, the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy issued in 1977, and the UN Guiding Principles for Business and Human Rights: Implementing the United Nations “Protect, Respect, and Remedy” Framework (UNGPs) issued in 2011. It aims to promote further understanding and raise awareness around business and human rights, and to enhance the international competitiveness and sustainability of Japanese companies. However, the NAP is not a legally binding plan and the Government of Japan ‘expects’ (but does not oblige) companies to introduce “human rights due diligence” (HRDD) and engage in dialogue with stakeholders in their supply chains. HRDD is a process that companies should undertake to identify, prevent and mitigate the actual and potential negative impact of their operations, supply chains and other business relationships, and to require the companies to address any negative impact.

As disclosure regulations are becoming more common in many countries, Japan could be said to be lagging. However, there are companies that are making significant efforts on human rights issues, including the convenience store chain, Lawson Inc. Whether they conduct HRDD has become one of the factors to take into account when evaluating Japanese companies.

Social Bond Guidelines

In October 2021, the FSA published the Social Bond Guidelines (Japanese SBGs). These are intended to promote the wider adoption of social bonds (i.e., bonds that limit the use of proceeds to social projects that contribute to solving social issues) by the private sector in Japan, by ensuring the credibility of the social benefits of social bonds while reducing the cost to and administrative burden on issuers.

The Japanese SBGs, which are designed to be consistent with the ICMA's social bond principles originally formulated in June 2017, describe the elements that social bonds are expected to possess, and provide practical examples and interpretations of the possible approaches that could ensure that a bond has these elements. The Japanese SBGs also recommend that issuers:

- develop a framework for issuing social bonds or explain to investors their alignment to the four core components of social bonds set out in the guidelines: use of proceeds, process for project evaluation and selection, management of proceeds, and reporting;
- summarise relevant information to investors within the context of their own overarching sustainability strategy; and
- undergo external reviews, if the issuer determines that it needs an objective assessment of its own actions in relation to the four core components of the framework for issuing social bonds, and disclose the results of review.

GOVERNANCE

Of the three elements that make up ESG, many institutional investors place the highest priority on the “G” pillar. Corporate governance is an issue related to corporate management and is recognised as a major premise for dealing with various environmental and social issues.

Corporate governance is a concept that has various meanings, but recently it has come to be regarded as a measure for improving corporate value over the medium to long term. Among them, “independence of the board of directors” and “effectiveness of executive compensation” related to the effectiveness of the board of directors are issues that are of great interest to institutional investors and ESG evaluation institutions.

Corporate Governance Code and Guidelines for Investor and Company Engagement

The FSA and TSE published a revised Corporate Governance Code and Guidelines for Investor and Company Engagement in June 2021. The new points include (i) enhancing board independence, (ii) promoting diversity and (iii) attention to sustainability and environmental, social and governance factors.

Board independence is intended to be implemented by:

- increasing the number of independent directors of companies listed on the Prime Market, up from the current recommendation of at least two members to one third. Further, the revised code recommends Prime Market-listed companies that have a parent company to have independent outside directors making up the majority of the board;

- establishing a nomination committee and a remuneration committee (and, with respect to companies listed on the Prime Market, a majority of the members of those committees is recommended to be independent outside directors);
- disclosing a skills matrix of board members conforming to the company's business strategy; and
- appointing independent directors having managerial experience at other companies.

Diversity is intended to be realised by:

- setting policies and voluntary and measurable goals for ensuring diversity in the promotion of women, non-Japanese nationals and mid-career hires to managerial positions; and
- disclosing human resource development policies ensuring diversity, including the status of implementation of the policies.

Attention to sustainability and environmental, social and governance is intended to be implemented by:

- enhancing corporate disclosures by companies listed on the Prime Market by having their annual securities reports and notices of convocation of the general shareholders' meetings translated into English; and
- promoting the establishment of electronic voting platforms for companies listed on the Prime Market.

Stewardship code

The stewardship code was updated in March 2020. This expanded the scope of the code beyond listed shares to other asset classes (such as corporate bonds). The amended code is positioned to require asset managers to have accountability for their portfolio. For example, it expects investors to explain the reason for voting for or against a proposed resolution at shareholders' meetings. Also, it incorporated the concept of "consideration of sustainability" in the context of investment management strategies, but the code does not yet require investors to consider sustainability if it does not conform with their investment strategy. The code also encourages asset owners (such as pension funds) to steward their assets – it explicitly states that the responsibility for stewardship should not involve just asset managers or investment managers, but include asset owners. As yet, few corporate pension funds have adopted the stewardship code. The new code expects asset owners to monitor their investment managers from the perspective of their own stewardship. In conjunction with the development of asset owners' stewardship and global trends towards ESG, a growing number of Japanese pension funds and institutional investors are making more socially responsible investments.

Whistle-blower protection

In order to promote good corporate governance, it is important to foster awareness of compliance management and to nurture a free and open corporate culture. In this regard, an amendment to the Whistle-blower Protection Act is scheduled to come into

force by June 2022. This amendment is viewed as introducing requirements similar to the EU Whistleblowing Directive (Directive (EU)2019/1937) in Japan, although the detailed requirements will differ from those in the EU.

The amendment will impose an obligation on business operators with 301 or more employees to establish a system necessary to respond appropriately to whistleblowing such as setting up a whistle-blower hotline and planning internal investigation system and corrective actions. Small or mid-sized businesses with 300 or fewer employees are only subject to such requirements on a best efforts basis. In order to ensure the effectiveness of this new requirement, the amendment introduces administrative as well as criminal penalties. The administrative penalties include advice and recommendation to the company from the Consumer Affairs Agency. The names of businesses that do not comply with the recommendations issued by the Consumer Affairs Agency could be made public. This amendment also obliges the persons who engage in the internal investigations not to disclose information that identifies the whistle-blowers.

In addition, cases where dismissal of whistle-blowers can be invalidated will be widened: the conditions for whistle-blowers to notify administrative bodies and media without the risk of dismissal will be made less stringent. The current law also limits protected persons to employees, but the revised law will add those who have left the company within one year, as well as company directors. Whistle-blowers will also be exempt from liability for damages incurred by the company.

CONCLUSION

ESG initiatives are being actively developed in Japan and the failure to address these rapid and public facing initiatives can lead to risk. In addition, like other markets, we are seeing a significant increase in ESG-related investments, from both domestic and international investors. Japanese companies are now even more aware of the importance of ESG and recognise that ESG is becoming a tool to obtain trust from all stakeholders, and developing policies and standards to incorporate ESG considerations into how they manage their investments and businesses, including their interaction with supply chains, employees, customers, public officials, and the general public.

More ESG publications:

[Offshore wind: Next stop Japan](#)

[Sustainable finance: JPX publishes survey of TCFD disclosures in Japan](#)

[METI publishes interim report on disclosure policies relating to non-financial information](#)

[The Renewable Energy Transition and Solving the Storage Problem: A Look at Japan](#)

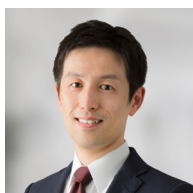
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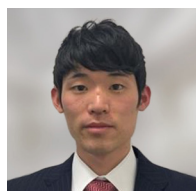
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