ClientEarth

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Public comments on the revision of Japan's Corporate Governance Code based on the proposal of the council

ClientEarth comments

Top Lines

- The proposal to introduce climate change-related disclosure principles in Japan's Corporate Governance Code is much needed, but could be further strengthened. This will contribute to enhancing financial market integrity and promoting competition.
- In order to ensure that investors have the information they need, Japan's Corporate Governance Code should:
    - provide granular and comparable data to investors regarding a company's plans to achieve net zero emissions;
    - require issuers to disclose a 'Paris-aligned' strategy, with a credible plan for how they can achieve 'net zero' GHG emissions by 2050 (TCFD+);
    - apply the climate disclosure principles to all issuers, not just those listed on the Prime Market;
    - require the board of each company to develop a detailed climate business strategy and align the compensation system with the implementation of such strategy.

Background

ClientEarth is a non-profit environmental law organisation with offices in London, Brussels, Warsaw, Beijing, Berlin, Madrid, Los Angeles, and Luxembourg. In total, ClientEarth currently has over 250 staff, mostly lawyers, working on projects in more than 50 countries. Globally and in Asia, ClientEarth is working with governments, the private sector and civil society to support strengthened climate and energy policy, sustainable finance and business strategies aligned with the goals of the Paris Agreement.

On 7 April 2021, the Financial Services Agency of Japan (**FSA**) published a Call for Public Comments on the "Guidelines for Investor and Company Engagement" (Revision Draft).[1] On the same day, the Japan Exchange Group (**JPX**) published a call for public comments on the revision of Japan's Corporate Governance Code based on the proposal of the council (the **Draft Amended CGC**).

ClientEarth welcomes the FSA's and JPX's stated intention to clarify and enhance climate-related disclosure principle for issuers listed in the Prime Market. However, in our view, the new principles proposed are insufficient. In order to provide investors and consumers with the consistent, comparable and high-quality climate-related information needed to support well-functioning markets, the proposals should be strengthened to ensure that clear climate principles, aligned with investors' evolving expectations (TCFD+), apply consistently to all listed issuers.

ClientEarth's key recommendations

1 In relation to amended principle 3.1. on full disclosure

1.1 Ensuring decision-useful information disclosure and materiality assessment by the board in relation to climate change risks

ClientEarth welcomes the introduction of a reference to climate change in the second paragraph of the new principle 3.1.3 and the recognition that disclosure based on TCFD – or equivalent framework – will provide investors with "*necessary data on the impact of climate change-related risks and earning opportunities on their business activities and profits*".

While we welcome the new supplementary principle 3.1.3 requiring climate change-related disclosure based on the TCFD model – or equivalent framework –, climate disclosure needs to make it possible for investors to effectively assess materiality of (i) climate change risks, (ii) business opportunities and (iii) the resilience of the company facing climate change and the company's response and actions in proportion to its materiality.

[1] Available at https://www.fsa.go.jp/en/news/2021/20210407.html

In that regard, ClientEarth proposes that the following provisions should be added as a third paragraph to 3.1.3:

> *"The board of a company should assess the short-, medium- and long-term materiality of (i) climate-related risks and (ii) opportunities and (iii) the resilience of the company in facing climate change on an ongoing basis, and ensure the company's actions and responses are in proportion to its materiality such that climate-related disclosure should be decision-useful for investors and the company."*

1.2 Require issuers to disclose a 'Paris-aligned' strategy (TCFD+)

A requirement for issuers to align their disclosures with the TCFD recommendations – or equivalent framework – is a necessary starting point to ensuring better quality climate-related disclosures.

However, on its own, this will not be sufficient to provide the information that investors are now demanding. In order to adequately meet investors' current and emerging needs, the JPX must amend the proposed New Supplemental Principle 3.1.3 to require issuers to also disclose a 'Paris-aligned' strategy, with a credible plan for how they can achieve 'net zero' GHG emissions by 2050 (to be referred to as TCFD+). The information to be disclosed pursuant to TCFD+ would permit investors to assess the resilience of companies facing climate change and their progress towards achieving net zero emissions. Also, in order to allow for streamlined assessment by investors, the disclosures should be made sufficiently in advance of the AGM, with sufficient detail and in a format allowing for further data processing.

This is because:

- growing awareness of the urgency of the climate emergency and escalating government action mean that global investor information needs and issuer disclosure practices now go beyond the TCFD;
- investors are now demanding disclosures about issuers' strategic alignment with the Paris Agreement objectives, including sector-specific short- and medium-term GHG emission reduction targets (Scopes 1-3), and capital expenditure plans and accounts aligned with these targets;[2]
- as investors increasingly attempt to mitigate systemic climate risks, such disclosures are now widely being used in asset allocation and stewardship decisions and are therefore material.[3]

[2] See 2 Degrees investing initiative, *Passing the baton: climate-related shareholder resolutions and their contribution to investor climate pledges, 2019,* available at https://2degrees-investing.org/resource/passing-the-baton-shareholder-resolutions-their-contribution-to-investor-climate-pledges/ ; UNFCC, *Race to Zero*, 2020 available at https://unfccc.int/climate-action/race-to-zero-campaign ; UNEPFI, *Net Zero Asset Owner Alliance,* available at https://www.unepfi.org/net-zero-alliance/ ; Sarasin & Partners, Paris-aligned accounting is vital to deliver climate promises, 2020, available at https://sarasinandpartners.com/stewardship-post/paris-aligned-accounting-is-vital-to-deliver-climate-promises/ ; Carbon Tracker, *When Capex met climate*, 2019, available at https://carbontracker.org/when-capex-met-climate/

[3] See, e.g. list of investor signatories to Climate Action 100+ at https://www.climateaction100.org/whos-involved/investors/

ClientEarth therefore proposes that the following provisions should be added as a new supplementary principle 3.1.4.

> *"3.1.4 In order to meet the needs of a net zero economy as part of a long-term strategy, the board of a company should set and disclose a plan with short-, medium- and long-term targets to reduce carbon emissions and a specific period for achievement.*
>
> *"Annual climate disclosure based on the TCFD recommendations or an equivalent framework by companies need to make it possible for investors to effectively assess the company's actions and progress towards achieving net zero. For this purpose, the disclosure shall be made sufficiently early, contain sufficient detail, and in a format allowing for further data processing, in particular, annual climate disclosures should:*
>
> - *(i) be made prior to the AGM including carbon emission reductions achieved in the previous fiscal year.*
> - *(ii) be made in an annual securities report (Yuho) which is required by Financial Instruments and Exchange Act of Japan.*
> - *(iii) be enhanced through digitization of climate related information with separate XBRL tags to make data analysis by investors more efficient.*"

1.3 Applying the new supplemental principle 3.1.3 to all issuers in the Prime Market and Standard Market.

Because of the scale and systemic nature of climate change, issuers across every geography and sector will be affected, regardless of size or market capitalisation. The JPX's proposal to limit the scope of the New Supplemental Principle 3.1.3 to issuers listed on the Prime Market only would therefore be a mistake and a missed opportunity.

It would deprive investors of consistent, high quality and material information for a significant segment of the listed market, increase legal risks and lead to the concentration of climate-related risks in smaller and less resilient issuers and investors exposed to them.

The New Supplemental Principle 3.1.3 should ideally apply to all issuers' reports published in 2022, and at the very least those on the Standard Market.

This is because:

- issuers on the Standard Market are a significant segment of the issuers listed on the JPX (Currently, the JASDAQ Standard Market and TSE Second Section represent over 1,100 issuers[4] and 2.1% of total market capitalisation as of 31 March 2021[5]);
- the Draft Amended CGC provides no explanation about why non-prime market listed issuers might be less exposed to climate-related risks and impacts, which might justify lower standards of disclosure;

[4] 上場会社数・上場株式数 | 日本取引所グループ (jpx.co.jp)
[5] その他統計資料 | 日本取引所グループ (jpx.co.jp)

ClientEarth therefore proposes that the new supplemental principle 3.1.2 and 3.1.3 be therefore amended as follows:

> *"3.1.2 Bearing in mind the number of foreign shareholders, companies should, to the extent reasonable, take steps for providing English language disclosures.*
>
> *In particular, Companies ~~listed on the Prime Market~~ should disclose and provide necessary information in their disclosure documents in English.*
>
> *"3.1.3 Companies should appropriately disclose their initiatives on sustainability when disclosing their management strategies. They should also provide information on investments in human capital and intellectual properties in an understandable and specific manner, while being conscious of the consistency with their own management strategies and issues.*
>
> *"In particular, companies ~~listed on the Prime Market~~ should collect and analyze the necessary data on the impact of climate change-related risks and earning opportunities on their business activities and profits, and enhance the quality and quantity of disclosure based on the TCFD recommendations, which are an internationally well-established disclosure framework, or an equivalent framework."*
>
> *[Amended version in red. ClientEarth further recommendations in green]*

1.4 Increasing the visibility of the importance of climate-related disclosure

While ClientEarth welcomes the addition of supplementary principles directly referring to climate change under supplementary principle 3.1.3, we would suggest that General Principle 3 of the Draft Amended CGC itself be amended to clearly increase the visibility of the importance of climate-related disclosure.

> *"This includes both financial information, such as financial standing and operating results, and non-financial information, such as business strategies and business issues, risk, including climate risks, and governance."*
>
> *[ClientEarth further recommendations in green]*

2 In relation to amended section 4 on the responsibilities of the board

2.1 Board's responsibility regarding company's sustainability initiatives and sustainable growth

ClientEarth welcomes the new principle inserted under amended principle 4.2.2 requiring the board to develop a basic policy for the company's sustainability over the mid- to long-term growth. This principle should be strengthened in order to address the company's material climate issues in a consistent, timely and effective manner. A consistent drafting would address both:

- strategic and organizational integration, and
- incentivization of the management

In that regard, ClientEarth suggest that principle 4.2.2 should be further amended as follows:

> "*The board should develop a basic policy for the company's sustainability initiatives from the perspective of increasing corporate value over the mid- to long- term. In addition, in light of the importance of investments in human capital and intellectual properties, the board should effectively supervise the allocation of management resources including such investments, and the implementation of business portfolio strategies to ensure that they contribute to the sustainable growth of the company."*
>
> *"The board should develop a holistic mid- to long-term climate business strategy and ensure that climate considerations are incorporated to investment planning and other decision-making processes and integrated across the organization.*
>
> *"In order to effectively implement a plan with short-, medium- and long-term targets to reduce carbon emissions and a specific period for achievement, the board should align executive director and officer bonus systems with the plan."*
>
> *[Amended version in red. ClientEarth further recommendations in green]*

2.2 Preconditions for Board and Kansayaku Board Effectiveness

ClientEarth notes that the new requirements as to identifying and diversifying skills of the board members included in the revised version of supplementary principles 4.11.1 are important preconditions for board effectiveness. However, they do not include any skills related to climate change or sustainability of the company's growth and company's impact.

We recommend that supplementary principle 4.11.1 includes a few more preconditions in order for the board to perform its accountability in tackling climate change.

We therefore recommend that Principle 4.11.1 be amended as follows:

"4.11.1 The board should identify the skills, etc. that it should have in light of their managing strategies, and have a view on the appropriate balance between knowledge, experience and skills of the board as a whole, and also on diversity and appropriate board size. Consistent with its view, the board should establish policies and procedures for nominating directors and disclose them along with the combination of skills, etc. that each director possesses in an appropriate form according to the business environment and business characteristics, etc., such as what is known as a "skills matrix". When doing so, independent director(s) with management experience in other companies should be included."

"4.11.1.(a) The board should ensure that its composition is sufficiently diverse in knowledge, skills, experiences and background to effectively debate and take decisions informed by an awareness and understanding of climate-related risks and opportunities.

"4.11.1.(b) The board should have independent directors who have sufficient expertise and knowledge about sustainability issues including climate change.

"4.11.1.(c) The board should establish a voluntary 'sustainability committee' which is led by such independent directors, and ensure that the board is supported and advised appropriately by such sustainability committee."

[Amended version in red. ClientEarth further recommendations in green]

2.3 Director and Kansayaku Training

We note that the current version of the Draft Amended CGC principle 4.14 has not been amended to address education and training of the board members in relation to climate change and sustainability.

Furthermore, even and if a board has a sufficient composition of directors who have the diversified skills to address climate issues at the company, measures should be taken to maintain and enhance the board's command of the climate issues by continuing education and training of the subject

We therefore recommend that Principle 4.14 be amended as follows:

"Principle 4.14 - Director and Kansayaku Training

"New and incumbent directors and kansayaku should deepen their understanding of their roles and responsibilities as a critical governance body at a company, and should endeavor to acquire and update necessary knowledge and skills. Accordingly, companies should provide and arrange training opportunities suitable to each director and kansayaku along with financial support for associated expenses. The board should verify whether such opportunities and support are appropriately provided.

Supplementary Principles

"4.14.1 Directors and kansayaku, including outside directors and outside kansayaku, should be given the opportunity when assuming their position to acquire necessary knowledge on the

company's business, finances, organization and other matters, and fully understand the roles and responsibilities, including legal liabilities, expected of them. Incumbent directors should also be given a continuing opportunity to renew and update such knowledge as necessary.

"4.14.2 In order to effectively respond to climate change risks and opportunities, companies should provide and arrange at their expense education and training opportunities by external experts to equip directors and kansayaku, including outside directors and outside kansayaku, to enhance understanding of the implications of climate change and how it applies to the role of the boards.

"4.14.3 Companies should disclose their training policy for directors and kansayaku. The board should verify whether such opportunities and support are appropriately provided."

[ClientEarth recommendations in green]

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