Corporate governance code revisions set to drive Japan's ESG and sustainability push

Toshiyuki Sawai and Yoshinori Hirai of Oh-Ebashi LPC & Partners describe how Japan's revised corporate governance code will assist businesses develop their ESG and sustainability commitments

In June 2021, Japan's corporate governance code (the CGC) was revised. The first CGC was released in Japan in 2015 to set out the fundamental principles on corporate governance, and was incorporated into the Tokyo Stock Exchange's rule on a 'comply-or-explain' basis. As a distinction of the CGC, the definition of 'corporate governance' included, from the very beginning, "due attention to the needs and perspectives of shareholders and also customers, employees and local communities," which is compatible with sustainability management for the interest of stakeholders as well as shareholders.

One of the main aims of the 2021 revisions to the CGC is to increase the attention of Japanese companies to sustainability, as well as to environmental, social and governance (ESG) matters. The revised CGC has greatly reinforced sustainability-related principles throughout the code, setting forth the framework to promote sustainability management and dialogue with investors in its various provisions.

This article will explain the role of the revised CGC in relation to how the companies should address various factors related to sustainability (including ESG factors).

The requirement of positive and proactive responses to sustainability issues

Recently, it has been recognised that ESG issues significantly impact long-term corporate value. In addition, due to the influence of the change in consumer consciousness about sustainability, companies can no longer avoid addressing ESG issues in order to keep or increase their market competitiveness.

With this background, the revised CGC specifies in its Notes to the General Principle 2 that "it is important for Japanese companies to further promote positive and

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proactive responses to sustainability issues." This revision intends to recommend to companies to consider sustainability issues as an agenda that companies should positively and proactively deal with, and not merely treat it as an inevitable topic forced upon them by institutional investors engaging in ESG investment.

The Note to the General Principle 2 also explains that "mid- to long-term sustainability including ESG" is an important management issue from the perspective of increasing mid-to long-term corporate value. This view of sustainability is in line with the view expressed under the Japan Stewardship Code (the SSC). Under the SSC, institutional investors should conduct a constructive, purposeful engagement with investee companies based on the consideration of sustainability. Such engagement on the issue of sustainability should be consistent with their investment management strategies and lead to a mid- to long-term increase in corporate value and the sustainable growth of companies. It is expected that the linkage of the notion of sustainability between the CGC and SSC will facilitate more constructive dialogue between investors and companies under the common understanding of the concept of sustainability.

The revised CGC not only has such general provisions but also has various individual principles that relate to sustainability, each of which we will explain below.

Role of the board of directors in sustainability

Prior to the revision, Supplemental Principle 2.3.1 of the CGC required the board to recognise sustainability issues as an important element of risk management and take appropriate actions to address such matters. Supplemental Principle 2.3.1 of the revised CGC amended this and now specifies as follows:

"The board should recognise that dealing with sustainability issues, such as taking care of climate change and other global environmental issues, respect of human rights, fair and appropriate treatment of the workforce including caring for their health and working environment, fair and reasonable transactions with suppliers, and crisis management for natural disasters, are important management issues that can lead to earning opportunities as well as risk mitigation, and should further consider addressing these matters positively and proactively in terms of increasing corporate value over the mid-to long-term."

It is noteworthy that the revised CGC refers not only to global environmental issues, which have already been addressed before, but also to the "respect of human rights, fair and appropriate treatment of the workforce including caring for their health and working environment, fair and reasonable transactions with suppliers," among others, as examples of social factors that need to be recognised.

The experiences from the Covid-19 pandemic have made companies more aware of the importance of the safety of employees, respect of human rights, and investment in human resources to improve labour productivity in order for a business survive.

It is also remarkable for the revised CGC to position the board as the body in charge of sustainability issues within companies. Boards are required to demonstrate leadership through positive and proactive efforts in tackling sustainability issues. Specifically, the boards' more significant roles include assessing the materiality of ESG factors, both from the perspective of risk management and earning opportunity, and monitoring sustainability-related business execution.

Governance structure

Diversity of the board of directors

In order to properly conduct the assessment and monitoring mentioned above, the board *"experiences from the Covid-19 pandemic have made companies more aware of the importance of the safety of employees"*

is required to take on various viewpoints, including on environmental and social issues. Principle 4.11 of the revised CGC requires the board to be constituted in such a manner that will allow it to achieve diversity in gender, international experience, work experience, and age, among other areas.

In addition, to make the diversity meaningful and substantial, the board should identify the skills that it needs to have in view of its management strategy and the results of its self-evaluation of its effectiveness as a whole, which is required each year under the CGC. Supplementary Principle 4.11.1 specifies that the board should disclose the combination of skills, etc. that each director possesses in an appropriate form according to the business environment and business characteristics, etc, such as through what is known as a 'skills matrix'.

Although a skills matrix is currently not common in Japan, there are signs of some forward-looking companies using such skills matrices, where they incorporate some ESG skills such as 'environment and sustainability' or 'human resource management'.

Establishment of governance system regarding supervision and execution

Since the ESG issues that should be prioritised differ from company to company, it is important for the management of each company to exercise discretion in assessing ESG issues, with proper discipline. As will be mentioned later, the basic policy for the company's sustainability initiatives, which the board should develop, will serve as a guide in governing the exercise of such discretion.

Also, like in many countries in the world, it is frequently discussed in Japan that independent outside directors should have an important role in strengthening the supervision of management. In particular, constituting a sustainability committee consisting of outside directors under the board is a useful method that companies should consider to adopt.

The revised CGC itself does not mention a sustainability committee; on the other hand, the Guidelines for Investor and Company Engagement (the Guidelines), which is compiled by the Japan Financial Services Agency and provides agenda items for engagement, asks the following question as one of the agenda: "does the company have a structure in place, such as the establishment of a committee on sustainability under the board or the management side, to review and promote sustainability-related initiatives on an enterprise-wide basis?"

As can be seen from this quote, in Japan, unlike the common practice in the EU countries or the US, a sustainability committee is not necessarily put in place as a committee under the board. The reality is that companies that have established such a committee as an execution-side body are increasing very gradually, probably because such an execution-side body requires expert knowledge and a wide range of views on ESG as a first step to address sustainability issues. The board of the company that places such a committee under the execution side should have oversight over the activities of the committee through periodic reporting to the board.

Integration of ESG-related metrics in directors and officers' compensation

Although it is not common in Japan, there are increasing examples of management compensation integrated with ESG-related metrics as an incentive plan to motivate and supervise the management's efforts with respect to ESG. The revised CGC does not mention anything about ESG-related incentive plans; it merely requires the board to "determine actual remuneration amounts appropriately through objective and transparent procedures" under Supplementary Principle 4.2.1.

Therefore, when introducing a compensation plan with ESG-related metrics and choosing ESG metrics and setting goals for such plan, the board has to properly conduct an ESG materiality assessment consistent with the basic policy of the company's sustainability initiatives in order to avoid any arbitrary decision on compensation.

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Whistleblowing for a wide range of stakeholders

It is noteworthy that Principle 2.5 and Supplemental Principle 2.5.1 of the revised CGC expects listed companies to establish an appropriate framework for whistleblowing. Through the whistleblowing mechanism, companies are expected to receive and address complaints covering a wide range of topics, including ESG-related topics, not only from their employees, but from various stakeholders such as their customers, employees of other companies in their supply chains, and local communities.

Policies for sustainability initiatives

In order for the boards to consistently conduct ESG assessments and monitoring of execution, as mentioned in Part II above, it is important to incorporate ESG factors into the "business principles" in Principle 2.1 of the CGC and "codes of conduct" for their employees in Principle 2.2. Companies should review their business principles or codes of conduct so that they are able to include therein principles on environmental preservation, respect of human rights, and social corporate responsibility, among other issues.

Also, Supplementary Principle 4.2.2 specifies that "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." It also requires boards to effectively supervise the allocation of management resources, including human capital and intellectual properties, to ensure that they contribute to the sustainable growth of the company.

In addition, under Section 1.3 of the Guidelines, companies are expected to engage in a dialogue with investors on whether they are able to appropriately respond to changes in the environment surrounding the business, such as the increasing social demand for and interest in ESG and sustainable development goals (SDGs), progress in digital transformation, need to address cyber security, and need for fair and appropriate transactions throughout their supply chain in their management strategies.

ESG disclosure

Because ESG factors will influence the corporate value with respect to risk or earning opportunities over the mid- to long-term, the proper disclosure of relevant information to investors would lead to a fair valuation in the market.

A survey focusing on the amount of ESG information disclosed by listed companies in Japan indicates that these companies' efforts with respect to ESG disclosures are largely divided between those that are behind in their disclosures and those that are actively working on it. The revised CGC has added new provisions such as Supplementary Principle 3.1.3. These new principles require companies to appropriately disclose their initiatives on sustainability and provide information on investments in human capital and intellectual properties in an understandable and specific manner. These new principles also encourage companies to increase the amount of ESG information in each disclosure framework.

In addition, Supplementary Principle 3.1.3 requires companies listed on the Prime Market (the highest market division in the new market segmentation of the Tokyo Stock Exchange; scheduled to start in April 2022) to enhance the quality and quantity of their disclosures on the Task Force on Climate-related Financial Disclosures (TCFD) recommendations, or on an equivalent framework, as well as collect and analyse data on the impact of climate change-related risks and earning opportunities on their business activities and profits.

The requirement of TCFD recommendations as a disclosure framework for climate-related information in the CGC follows a recent world trend where disclosures on TCFD recommendations are being considered to be imposed on certain companies in some approaches.

Although Japan has been a world leader in the number of organisations supporting TCFD since mid-2019, there are few listed companies in the country that are providing disclosures based on TCFD. It is highly expected that this supplementary principle will accelerate companies' commitment to climate change issues.