The ESG landscape and next steps for Japanese companies

Vanessa Havard-Williams, Partner, Linklaters, London
James Marlow, Associate, Linklaters, London

Introduction

Environmental, social and governance ("ESG") considerations are rapidly becoming a focal point for governments, investors and companies globally, with a particular emphasis on climate risks. The Paris Agreement of 2016 was a landmark agreement to combat climate change and to accelerate and intensify the actions and investment needed for a low carbon future.

The importance of ESG for companies can be seen in the figures reported by As You Sow, the Sustainable Investments Institute and Proxy Impact in their Proxy Preview 2020 report released at the end of March 2020. This report indicated that in the US alone 429 ESG-related shareholder resolutions were filed for the 2020 proxy season, with nearly a third of these focusing on climate change and environmental issues. This is an increase from the 366 in the same period in 2019.

This trend is not just limited to the US either. In mid-March 2020, the Kiko Network, an activist investor, filed the first shareholder resolution in relation to climate change in respect of a listed Japanese company. The resolution calls on the company to disclose the climate-related risks facing the business and to publish a plan on how it is going to align its investments with the Paris Agreement, which looks to set the world on a track of well below 2oC temperature increase. The resolution comes following a BankTrack report published in December 2019 which revealed that the company was reported to have provided $16.80 billion in coal project funding between the start of 2017 and the end of the third quarter of 2019. Over the same period Japanese organisations represented the top three funding providers to new coal plants, giving rise to the potential for further shareholder resolutions in the near future should this trend continue.

Recognising that the focus on ESG is part of a global shift embodied in part by the increased numbers of climate-related resolutions, this article provides an overview of the developments in the global market and sets out steps that Japanese financial institutions and listed companies can take both generally and to respond to the investor concerns underlying the anticipated resolutions.

The ESG landscape – Legislative and regulatory developments

EU and UK perspective

In the EU and UK, the ESG landscape is rapidly developing as a new legislative framework dealing with ESG issues is being put into place. As part of its programme to fulfil Paris Agreement commitments, the EU Commission adopted a sustainable finance action plan ("Sustainable Finance Action Plan") in March 2018 which aims to: (i) reorient capital flows towards sustainable investment to achieve sustainable and inclusive growth; (ii) manage the financial risks stemming from climate change, environmental degradation and social issues; and (iii) foster transparency and long-termism in financial and economic activity. To implement several of the key actions announced in the Sustainable Finance Action Plan, in May 2018, the EU Commission adopted a package of legislative measures (the "Sustainable Finance Package")

The Sustainable Finance Package, formed of three different regulations, is to be phased in over the period from 2020 to 2022. The regulations, which are the Taxonomy, Disclosure and Benchmarks Regulations, aim to impose ESG-related disclosure obligations on financial institutions and listed companies to provide greater consistency and clarity to evaluate which financial investments are contributing to, and facilitating, sustainable investment.

These regulations have been accompanied by a significant number of other legislative measures, again with a particular focus on the financial sector. This includes: (i) MiFID II (Markets in Financial Instruments Directive II), which affects European asset managers and broker-dealers; (ii) AIFMD (Alternative Investment Fund Managers Directive) and the UCITS (Undertakings for Collective Investment in Transferable Securities) Directive, which impacts fund managers; (iii) the Solvency II Directive, which focuses on insurers and reinsurers; and (iv) the IDD (Insurance Distribution Directive), the focus of which is on insurance distributors. Further proposals on corporate reporting are in train.

In June 2019, the EU Commission also adopted guidelines on reporting climate-related information. These guidelines supplement the existing guidance on the disclosure of non-financial and diversity information by, broadly, EU-listed entities, banks and insurers with over 500 employees.

There are numerous other measures and initiatives being put in place that incorporate ESG, from prudential standards for the financial sector to proposals regarding an EU Green Bond Standard and a voluntary "EU Ecolabel" for financial products. On a wider level, the EU's Green Deal also contains a proposal for a carbon border adjustment mechanism. The proposed mechanism would work to prevent the EU's efforts to go climate-neutral by 2050 from being undermined by international partners by placing a carbon price on imports of certain goods from outside the EU. This proposed directive has just finished the 'roadmap' stage of the EU legislative process which sought feedback on the proposal from corporates, financial institutions, public authorities, NGOs and individual citizens over a four week period. The proposal is due to go to public consultation in Q3 2020. The potential impact, if introduced, could be material for those companies based outside the EU but with regular trade with those in the EU. The net-zero 2050 target is enshrined in the EU draft Climate Act, which also proposes a review of the European Commission's existing 2030 target of an at least 40% domestic reduction in economy-wide greenhouse gas emissions compared to 1990. The draft proposals suggest considering reviewing the existing target and setting a new 50% to 55% reduction goal by September 2020, which could push further scrutiny and tougher actions onto companies and financial institutions.

This focus has been mirrored in the UK who, along with Italy, is due to co-host the COVID-19 delayed COP26 in Glasgow in 2021. The Bank of England launched the agenda for COP26 at the end of February 2020, making it clear that private finance has a role to play in supporting the whole economy transition to net zero. Describing 2020 as a year that 'must be a year of climate action', the Bank of England set out that every professional financial decision needs to take climate change into account and that all companies, banks, insurers and investors will need to adjust their business models for a low carbon world. The Bank of England has been vocal in its support for climate-related action and implemented a number of initiatives to assist with the transition to a low carbon economy. This includes its various stress test initiatives. The recent COVID-19 outbreak has impacted on these slightly, with the annual cyclical scenario stress test of the eight major UK banks and building societies being cancelled for 2020. However the Bank of England has not as yet paused its review of the responses to the discussion paper on the climate risk biennial exploratory scenario which tests the resilience of the business models of the largest banks and insurers and the wider financial system to climate-related risks. It is proposed that the biennial exploratory stress test by the Bank of England would be conducted based on the scenario framework of the Network for Greening the Financial System ("NGFS").It is possible that the Bank of England's methods could become the de facto standard for the stress tests to be conducted by other jurisdictions' central banks/regulators. The Bank of Japan and the Financial Services Agency of Japan (which are members of NGFS) could follow the Bank of England's approach if they decide to introduce similar stress testing in Japan. The Bank of England is expected to announce a way forward for this exercise in Summer 2020.

United States perspective

In contrast, in the United States, there has been little to no work on developing a comprehensive regulatory framework for mandatory ESG-related disclosures. The approach is instead that ESG disclosures are made where the relevant company decides that such disclosures are material to an understanding of the company's business, would be reasonably likely to have a material effect on its financial conditions and/or results of operations or are a significant risk factor. The lack of action and the path taken in the future will likely turn on the outcome of the 2020 presidential election.

Beyond the political will to change the landscape, at the regulatory level the SEC itself has expressed no interest in mandating ESG disclosures or addressing the issues that exist regarding the lack of a uniform definition of ESG. The SEC has indicated that it does not want to impede the 'marketplace evolution of sustainability disclosures', putting the onus on companies themselves to develop disclosures and their own practice in this area.

Despite this lack of engagement, however, the one area where the SEC might take action is to ensure that where companies disclose statistics or figures they are not misleading. This point was highlighted in the SEC's most recent MD&A guidance and the SEC has been undertaking some work in this area. Firstly, they have been looking into how investment advisers determine whether an investment is an ESG investment and how that approach is to be applied to making investments. Secondly, they have been asking for public comment on its 'Names Rule' which requires that if a fund's name suggests a particular type of investment, the fund must invest at least 80% of its assets in that perceived type of investment. The SEC are interested in views on how this rule should apply to terms such as 'ESG' and 'sustainable'. This is potentially significant given the expected substantial increase of inflows into ESG funds and the challenges that may result from having properly to diligence the status of such investments.

The ESG landscape – Voluntary initiatives and corporate pressure

Absent engagement at the United States federal government level, the pressure on companies with respect to ESG disclosure has come mainly from state and local governments and private actors such as asset managers, shareholders and proxy advisory companies. This is a trend we expect to continue, at least in the near-to medium-term.

The pressure from private actors on public companies in the United States is largely coming from shareholders, including State public pensions, asset managers and private equity funds. In 2017, shareholder proposals on environmental and social issues surpassed the number of corporate governance proposals for the first time and, in 2018, Institutional Shareholder Services introduced the Environmental & Social Quality Score. In addition, legislation is pending in several states seeking to restrict the investment of public funds in fossil fuel companies. The world's largest asset manager, BlackRock, has announced that it will be placing sustainability at the centre of its investment approach going forwards. This stance includes the removal from its discretionary active investment portfolios the public securities of companies that generate more than 25% of their revenues from thermal coal production. BlackRock has also said that it will ask companies in which it invests to disclose climate-related risks in line with the Task Force on Climate-Related Financial Disclosures ("**TCFD**") and publish in line with the industry-specific guidelines issued by the Sustainability Accounting Standards Board ("SASB"), in each case by the end of 2020. Similarly State Street Global Advisors have launched their new 'R-factor' rating which is based on ESG metrics and has been developed with reference to the SASB guidelines. From the upcoming proxy season onwards, State Street has announced it will 'take appropriate voting action' against the board members of large companies in which it invests should their business fall behind industry peers based on this measure and cannot explain how they intend to improve their performance.

In the EU and UK, both the TCFD and (to a lesser extent) SASB have become widely adopted reporting standards. The TCFD, established by the OECD's Financial Stability Board in 2016 after the Paris Agreement, provides for four pillars of reporting: (i) governance; (ii) strategy; (iii) risk management; and (iv) metrics and targets. The SASB guidelines are issued on the basis of a new industry-specific classification system covering eleven sectors and 77 industries. The purpose of the system is to assist companies seeking to identify the financially material sustainability issues reasonably likely to impact the financial condition or operating performance of the company.

Many of the legislative initiatives at the EU and UK level set out in the previous section above are serving to make TCFD-style reporting a mandatory requirement for listed companies, large asset owners and some regulated financial institutions. The UK government announced in their Green Finance Strategy that mandatory TCFD-reporting was to be the aim for such companies by the end of 2022. The consultation paper published by the UK's Financial Conduct Authority on 6 March 2020 set out proposals to make TCFD reporting mandatory for UK premium-listed companies in the first instance. This may be extended to standard listed companies in due course. The paper also sets out the FCA's interpretation of existing requirements as they may be applied to climate change-related financial risks.

The ESG landscape – Shareholder action

As the BlackRock and State Street announcements show, the shifting landscape and increased focus on ESG issues has driven increased stakeholder pressure on companies. Across the United States, UK and EU, a growing number of shareholder resolutions addressing climate change are being proposed, often seeking the publication of company targets and/or strategies which are aligned to the Paris Agreement or pushing the company to make improved disclosures on climate-related risks and opportunities.

Examples include the 'Follow This'[1] resolutions filed against various energy companies in 2019. BP, Shell and Equinor were all targeted, as 'Follow This' sought to push them to establish Paris Agreement-aligned targets for greenhouse gas emissions. While BP's shareholders rejected the resolution, the Shell and Equinor resolutions both resulted in climate targets being agreed with investors and BP announced in February 2020 that it is aiming to become a net zero carbon company by 2050 or sooner. This builds on the BP's commitment to describe in its reporting how its strategy is consistent with the Paris Agreement goals, which was made as a result of constructive engagement with the investor participants of Climate Action 100+[2] who also proposed a resolution be put to shareholders at the

[1] Follow This was founded in 2015 as a campaign by responsible shareholders in oil and gas companies to get the biggest industry players to set Paris-aligned targets for all emissions (Scope 1, 2 and 3).

[2] Climate Action 100+ was launched in December 2017 as an investor initiative to ensure that the world's largest greenhouse gas emitters take necessary action on climate change.

2019 AGM.

Similarly, in the mining sector, following a Climate Action 100+ resolution, Glencore has agreed to: (i) begin disclosing longer-term projections for emission reductions; (ii) cap its coal production; and (iii) take steps to align with the Paris Agreement. BHP also faced a resolution that sought to secure the suspension of its memberships in industry associations undertaking lobbying, advertising and/or advocacy activities inconsistent with the Paris Agreement, although this was unsuccessful.

Most recently, shareholder attention has turned to financial institutions perceived as funding 'dirty' businesses. This includes a January 2020 resolution filed by 11 of Barclays' institutional investors seeking the phasing out of the financing of energy sector and electric and gas utilities companies not aligned with the Paris Agreement target of limiting global warming to 1.5oC. J. P. Morgan has also announced this year that it will no longer advise or lend to companies that obtain the majority of their revenue from coal extraction, amongst a number of other climate-related divestment initiatives, including those announced by BlackRock, BNP Paribas Asset Management and Norges.

The trend has been similar in the United States, although the SEC has recently announced some proposed changes to its proxy rules which would make it significantly more difficult for shareholders to advance any proposals, including those related to ESG. These changes have been proposed by the SEC as a result of the evolution over recent decades of how shareholders engage with companies. The SEC hopes the changes will "facilitate constructive engagement by long-term shareholders in a manner that would benefit all shareholders and our public capital markets". The Sustainable Investments Institute has reported that should these new eligibility requirements be introduced, this would mean that 614 ESG-related resolutions raised between 2010 and 2019 could not be raised under the new rules. This is three times as many as the 206 resolutions excluded under the current rules.

It should be noted that it is not just NGOs leading the way on these resolutions. Institutional investors continue to have a significant impact on corporate practice in this area. While eight of the ten largest asset managers (by assets under management) are headquartered in the United States, the majority also have sizeable European operations, bringing them in-scope for the purposes of EU ESG regulations. This will in turn impact the investee companies in those firms' portfolios, who will need to start providing increased ESG-related disclosures. Given the complex and intricate delegation arrangements of asset managers and institutional investors, the impact will not stop there. It is anticipated that many will find it easier to manage their global portfolios in order to ensure compliance with EU and UK ESG regulations – that is, the EU and UK ESG regulations may become the minimum standard to which asset managers and institutional investors hold themselves accountable on a global basis.

The recent history of shareholder activism on ESG matters demonstrates how far some shareholders are willing to go and that they will no longer be placated by companies making commitments that do not translate into reality. As such, companies need to be cognisant of the risk that such challenges (including legal action) could be brought on the basis that companies are not holding themselves to the standards they claim to have set themselves. This may well lead to significant adjustments in strategic approach to climate-related risk and opportunity management.

The ESG landscape – Litigation risk

Beyond the risk of shareholder activism, there is also the increasing risk of ESG-related litigation being brought against companies.

This has been most notable in the United States, where states and local governments and shareholders have initiated a number of climate change-related lawsuits. These have faced numerous legal challenges and the trend is still in its nascent phase. The impact and success of such litigation should not only be measured in successfully argued claims, given the wider business and reputational impacts of being involved in such litigation. That is, a "win" at court is in many cases not the primary (or only) objective of the claimant(s). In the United States, lawsuits are progressing based on a number of theories of liability, including public and private nuisance, negligence, failure to warn, trespass, unjust enrichment and violations of consumer protection laws.

A similar trend is developing in the EU and UK, with various legal theories being used to advance claims and challenge climate policy ambition and its implementation by government agencies. This includes litigation concerning the Dutch national greenhouse gas emission targets, Germany's emission reduction record and its alleged impact on the right to life, health, property and occupational freedom and a recent claim challenging a UK government decision to approve a large-scale gas plant on the basis that the project is inconsistent with the UK government's 2050 net zero target. A similar challenge was made, successfully, in relation to the proposed expansion of Heathrow airport.

This final category of claims, aimed at governmental decisions, has the potential for a particularly significant impact on companies and institutions looking to undertake or finance energy or infrastructure projects. Recent EU claims have also taken this one step further, with claimants bringing actions directly against companies. This includes claims against a Polish power plant operator alleging liability for damage to the environment and a major French oil company for an alleged failure to adequately asses the threats posed to human rights and the environment by oil projects in Tanzania and Uganda as required under the French corporate duty of vigilance.

Conclusion and next steps

Presently, Europe and the UK are leading the way on ESG through the rapid and seemingly revolutionary imposition of mandatory legal requirements to align companies and financial institutions with climate-related goals. While the pace of change in the United States at the federal government level is lagging behind this rate of progress, the momentum to effect change is clearly in evidence at the 'grassroots', stakeholder level, whether that be in the boardroom or the courts. The stepping up of key players in the globally dominant, United States-headquartered asset management industry will drive changes similar to those being legislated in Europe as they change their investment criteria and impose new reporting requirements on the companies in which they invest.

The global shift has been set and like climate change itself, it is no longer a question of if but rather when, where and in what format climate-related reporting requirements will be manifested and felt most acutely. The resolution filed against the Japanese company referred to at the beginning of this article could represent the first step down the road for Japanese companies and industry, while the Japanese Stock Exchange has also released an ESG Handbook with guidance on making ESG disclosures, which it is worth Japanese listed companies reviewing and becoming familiar with.
In order to get ahead of and prepare for further developments similar to those seen across the EU and United States, Japanese financial institutions and companies may wish to consider the following steps.

Governance[3]

・Make sure ESG, and in particular climate change, is on the board's agenda and the directors are briefed and up to speed on the relevant developments and

[3] These governance measures are beginning to be tested in Europe by company auditors as audit functions in the major accountancy firms attract regulatory scrutiny in respect of their approach to climate risk.

issues (including, where necessary, procuring advisory training).

・Consider allocating responsibility to one director to lead on ESG and climate change issues.

・Consider whether ESG and climate change issues should be incorporated into a (special) committee or relevant department for reporting to the board.

・Start a timeline with some key milestones and performance indicators.

Understanding the current position

・Establish a cross-disciplinary business team to help identify what measures need to be taken to begin preparing for the anticipated developments and to assess the organisation's strength and weaknesses in different climate scenarios.

・Identify what you already do and disclose in relation to ESG issues, and in particular climate change, that are salient to your business.

・Review your policies and procedures to identify the gaps compared with recommendations of leading global or local initiatives e.g. TCFD and prioritise resolving these gaps in terms of relevance, importance and ease of delivery.

Stakeholder engagement

・Talk to key contacts at banks, finance providers, rating agencies and other relevant firms to get a sense as to their approach to ESG issues, and in particular climate change.

・Listen to investors about their expectations, the information they want and find useful and their timelines.

・Engage with other members of your industry and regulatory actors on those ESG-related areas of concern most relevant and urgent for your business

If you have any questions about this article, please contact us at:
vanessa.havard-williams@linklaters.com
or
Tokyo_ClimateChangeInitiative@linklaters.com.

（本文はJOI機関誌「海外投融資」2020年5月号に掲載した和文のオリジナル版です）