



COMMONWEALTH  
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# Directors' Duties Regarding Climate Change in Japan

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by  
Dr. Yoshihiro Yamada  
Dr. Janis Sarra  
Dr. Masafumim  
Nakahigashi





## COMMONWEALTH Climate and Law Initiative

### Oxford Sustainable Finance Programme

Smith School of Enterprise and the Environment  
University of Oxford  
South Parks Road  
Oxford, OX1 3QY  
United Kingdom

Email: [enquiries@smithschool.ox.ac.uk](mailto:enquiries@smithschool.ox.ac.uk)

Telephone: +44 (0)1865 614963

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### Executive Summary

Japan's primary prudential regulator, the Bank of Japan, has acknowledged that climate change poses a systemic risk to the Japanese economy and financial system. There is now overwhelming scientific and financial evidence of the material impacts of climate change on businesses. Since climate change has been recognized by governments, courts, and investors as a material issue affecting the sustainability of almost all companies, corporate directors need to recognize their obligation to address climate-related risks and opportunities.

Directors in Japan have three primary duties, a duty of loyalty, a duty to be in compliance with all laws, regulations, and ordinances, and the company articles, and a duty of care. Directors' duties are set out in the *Companies Act of Japan*, the articles of incorporation, and the Civil Code. The obligation of directors to consider the implications of climate change risk is grounded in the duties each director owes to the corporation they serve. In their oversight of management of climate risks, directors must meet the objective standard of what a reasonably prudent person would do in comparable circumstances.

The *Companies Act of Japan* specifies that the directors of large companies must develop the systems necessary to ensure that execution of their duties complies with laws and regulations to ensure the proper operations of a stock company. The Regulation for Enforcement of the Companies Act requires directors of these companies to develop systems related to management of the risk of loss to the stock company and any of its subsidiaries. In such companies, a director's duty of care will not be effectively performed without a proper internal control system, and directors can be found personally liable if they breach these statutory requirements. These requirements mean that climate governance should be embedded in a board committee responsible for risk management or sustainability. Directors must establish effective proper internal control and risk management systems to support exercise of their duty to supervise business operations. Directors must have sufficient capability to scrutinize climate risks to the company and then interact with management and the board to oversee management of these risks. The committee with responsibility for risk management needs to be able to assess and analyze both the physical risks and transition risks associated with climate change. Where directors lack climate-governance expertise and that expertise is not available among the executives of the company, directors would hire outside professional expertise that can support their climate-related risk management decisions in the best interests of the company.

Even though directors have broad discretionary decision-making authority to design their board committees, arguably directors could be held liable under the *Companies Act* and the Regulation for Enforcement of the Companies Act for failure to establish a climate risk management system with sufficient capabilities to perform their responsibilities to oversee and manage climate-related financial risks and opportunities. Depending on the size and kinds of business lines, the system adopted needs to be capable of performing the required proper controls in light of the likelihood and magnitude of climate risks to the company. If directors of a large stock company fail to establish a proper internal control system that appropriately addresses climate-related risks, they could be found personally liable for breach of their duty of care.

Directors in Japan have a duty of care, to act as a mandatary in the best interest of the company. Directors who neglect their duties are jointly and severally liable to the company for any resulting damages; and where they are grossly negligent or knowingly fail to perform their duties, they are also liable to shareholders or third parties for resulting damages. Since climate change is affecting almost all businesses, failure by corporate directors to recognize their obligation to address climate-related risks and opportunities could result in personal liability for failure to act with due care and in the best interests of the company. This liability for breach of their duties is in addition to their potential personal liability for failure to meet the requirements of any statutes or ordinances.

For duly diligent directors, the Supreme Court of Japan's recognition of a business judgment rule may offer a defence to specific actions to address climate mitigation and adaptation, when hindsight information suggests that the directors should have made a different decision. However, the business judgment rule does not offer a safe haven to directors that fail to act on climate-related risk. Japanese courts have been clear that they will examine not only the process used to reach the business decision, but also undertake a review of the duty of care, from an objective standpoint, to assess whether a director acted unreasonably at the time of the decision. Where directors neglect to undertake reasonable research and analysis of the relevant facts, fail to get expert advice on climate-related risk management, and fail to exercise due care in respect of climate risks, the courts are unlikely to defer to their business judgment because directors will have failed to exercise any judgment at all or failed to engage in a reasonable assessment of the risks.

The Japanese Government has signalled to companies that climate change is a material financial risk that they must address. The Ministry of Environment has advised companies to engage in scenario analysis to assess the resilience of their business in the face of global warming in line with the recommendations of the Financial Stability Board's Taskforce on Climate-related Financial Disclosures. Japan's *Climate Change Adaptation Act* and its *Act on Promotion of Global Warming Countermeasures*, read together, create regulatory expectations that all sectors of Japanese society must make efforts to control climate change through mitigation and adaptation. A company must make efforts to realize the government's climate policy, although these statutes currently impose no legal liabilities on directors for non-compliance.

In contrast, financial services law in Japan, both the *Financial Instruments and Exchange Law* and securities listing regulations published by the securities exchanges, require disclosure of material risks and strategies to address such risks. Climate change is now viewed by investors globally as a material risk.

Finally, the Corporate Governance Code, which is non-binding, also offers strong normative guidance for directors to effectively manage material climate-related financial risks and opportunities. The impact of soft law such as the Corporate Governance Code has the potential to be instrumental in shifting climate governance, as the principles adopted by companies form part of their fundamental rules of operation.



## **About the Authors**

Dr Yoshihiro Yamada is Vice Dean and Professor of Law, College of Law, Ritsumeikan University, Japan.

Dr Janis Sarra is Professor of Law, University of British Columbia Peter A. Allard School of Law, Canada, Principal Co-Investigator of the Canada Climate Law Initiative ([ccli-info@allard.ubc.ca](mailto:ccli-info@allard.ubc.ca)), and a director of the Commonwealth Climate and Law Initiative, Oxford UK.

Dr Masafumi Nakahigashi is Vice President of Nagoya University, Professor of Law at the School of Law, Nagoya University, and Vice Director, Sustainable development with realization of a carbon-free economy, Nagoya University Applied Social System Institute of Asia, Japan.

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## **About the Commonwealth Climate and Law Initiative**

The Commonwealth Climate and Law Initiative (CCLI) is a legal research and stakeholder engagement initiative founded by Oxford University Smith School of Enterprise and the Environment, ClientEarth, and Accounting for Sustainability (A4S). The CCLI examines the legal basis for directors and trustees to manage and report on climate change-related risk and climate mitigation and its research is at the forefront of the intersection of climate and biodiversity risks under existing companies and securities laws. Founded to focus on four Commonwealth countries: Australia, Canada, South Africa, and the United Kingdom, the CCLI has expanded its remit to the United States, Hong Kong, India, Singapore, Japan and Malaysia. The CCLI leverages the inter-disciplinary and cross-jurisdictional perspectives provided by its global experts from academia and the legal, accountancy, business, and scientific, communities.

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## Abbreviations

°C	degrees Celsius
CEO	chief executive officer
ESG	environmental, social and governance
<i>FIEA</i>	<i>Financial Instruments and Exchange Act</i> , Japan
GHG	Greenhouse gas
GPIC	Government Pension Investment Fund, Japan
IASB	International Accounting Standards Board
IPCC	Intergovernmental Panel on Climate Change
JPX	Japan Exchange Group
KPI	key performance indicators
METI	Ministry of Economy, Trade and Industry, Japan
MOE	Ministry of Environment, Japan
NGFS	Network for Greening the Financial System
SASB	Sustainability Accounting Standards Board
SSE	Sustainable Stock Exchanges
TCFD	Taskforce on Climate-related Financial Disclosures
TSE	Tokyo Stock Exchange
UK	United Kingdom
UN	United Nations
UN PRI	United Nations Principles for Responsible Investing
US	United States



## 1. INTRODUCTION

Globally, climate change has been recognized as an existential threat to humanity and a serious threat to economic activity.<sup>1</sup> The Intergovernmental Panel on Climate Change (IPCC), comprised of more than 800 scientists representing 150 governments, has concluded that at 1°C (Celsius) above pre-industrial temperatures, which is what Earth is experiencing currently, 4 per cent of global land area is undergoing transformation of ecosystems with long-lasting impacts.<sup>2</sup> At 2°C warming, there will be irreversible serious consequences for human and ecological systems.<sup>3</sup> There is now broad scientific consensus that global emissions must drop by 50 per cent over the next decade for the world to have any chance of staying below 1.5°C.<sup>4</sup> Even at 1.5°C warming, there will be irreparable damage to assets, operations, and ecosystems. Thus, the goal must be net-zero carbon emissions as soon as reasonably possible. Investors, companies, and governments are grappling with ways to effectively address the risks of climate change and implement strategies to decarbonize economic activity in order to save the planet.

Japan is particularly susceptible to the physical risks of climate change, particularly sea-level rise, inundation into fresh water sources, sustained heat waves, and increased typhoon frequency and intensity. It also faces economic transition risks as global investors increasingly signal that they will shift capital to decarbonized sustainable investments.

Japan has started to respond to these impacts. Prime Minister Yoshihide Suga, in his first general policy speech to both Houses of the Diet in October 2020, committed Japan to working to meet the goal of net-zero greenhouse gas (GHG) emissions by 2050.<sup>5</sup> He stated:

My administration will devote itself to the greatest possible extent to bring about a green society, while focusing on a virtuous cycle of the economy and the environment as a pillar of our growth strategy. We hereby declare that by 2050 Japan will aim to reduce greenhouse gas emissions to net-zero, that is, to realize a carbon-neutral, decarbonized society. Addressing climate change is no longer a constraint on economic growth. We need to adjust our mindset to a paradigm shift that proactive climate change measures bring transformation of industrial structures as well as our economy and society, leading to dynamic economic growth.<sup>6</sup>

As the world's third largest economy, this announcement aligns Japan with major economies committed to building a sustainable, carbon neutral, and resilient world.<sup>7</sup>

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<sup>1</sup> Intergovernmental Panel on Climate Change (IPCC), *Global warming of 1.5°C – An IPCC Special Report on the impacts of global warming of 1.5°C above pre-industrial levels and related global greenhouse gas emission pathways, in the context of strengthening the global response to the threat of climate change, sustainable development, and efforts to eradicate poverty*, (October 2018) IPCC <<https://www.ipcc.ch/sr15/>>.

<sup>2</sup> *Ibid.*

<sup>3</sup> *Ibid.*

<sup>4</sup> *Ibid.*, European Union Technical Expert Group, 2020.

<sup>5</sup> The speech in provisional English version is available at Prime Minister of Japan, 'Policy Speech by the Prime Minister to the 203rd Session of the Diet', (28 October 2020), [https://japan.kantei.go.jp/99\\_suga/statement/202010/\\_00006.html](https://japan.kantei.go.jp/99_suga/statement/202010/_00006.html).

<sup>6</sup> *Ibid.* See also Nikkei staff, 'Suga vows to meet Japan's zero-emissions goal by 2050', Nikkei Asia (26 October 2020), <https://asia.nikkei.com/Politics/Suga-vows-to-meet-Japan-s-zero-emission-goal-by-2050>.

<sup>7</sup> United Nations Secretary General, 'Statement attributable to the Spokesperson for the Secretary-General – on Japanese Prime Minister Suga's net-zero announcement', (26 October 2020), <https://www.un.org/sg/en/content/sg/statement/2020-10-26/statement-attributable-the-spokesperson-for-the-secretary-general-%E2%80%93-japanese-prime-minister-suga%E2%80%99s-net-zero-announcement>.

## 1.1 Context - Climate Change as a Material Financial and Health Risk

Climate change is a systemic risk. The Bank of Japan, as Japan's primary prudential regulator, has acknowledged that climate change poses a systemic risk to the Japanese financial system.<sup>8</sup> It reports that asset prices could fall substantially as climate-related risks materialize, and misvaluation of climate risks can lead to the misallocation of resources.<sup>9</sup> The Bank states that when physical risks and transition risks materialize, the financial system is affected through both direct channels and indirect channels, with interrelated impacts on the real economy and financial system.<sup>10</sup>

The Financial Stability Board's Taskforce on Climate-Related Financial Disclosures (TCFD) was commissioned by the G20 Finance Ministers and Central Bank Governors out of their concern for the disruptive changes due to climate change across economic sectors and industries in the near to medium term, with implications for the global financial system, in terms of avoiding financial dislocations and sudden losses in asset values.<sup>11</sup> The TCFD reported that the two principal types of climate-related risk, physical risks and transition risks are inextricably linked. Within transition risks, there are a number of related sub-risks, as briefly discussed below.

### A. Physical Risks

Physical risks resulting from climate change can be event driven (acute) or longer-term shifts (chronic) in climate patterns. Acute physical risks refer to increased severity of extreme weather events, such as cyclones, hurricanes, or floods; and chronic physical risks refer to longer-term shifts in climate patterns, such as sustained higher temperatures that may cause sea level rise or chronic heat waves.<sup>12</sup>

Scientists attribute a recent acceleration in global sea-level rise to global warming, resulting in more severe storms in Japan.<sup>13</sup> The Union of Concerned Scientists has reported that a sea-level rise of 1 metre could place 4.1 million people in Japan at risk of flooding and inundate more than 2,339 square kilometers of land in major cities.<sup>14</sup> It reports that the city of Osaka, population 2.5 million people, has over \$200 billion worth of assets threatened by sea-level rise.<sup>15</sup> For example, in July 2018, a devastating downpour in western Japan forced 2 million people to evacuate their homes due to flooding, claiming over 200 lives.<sup>16</sup> In the aftermath of the event, experts agreed that the intensity of the storm was exacerbated by climate change.<sup>17</sup> Continued coastal flooding and storm surges are likely

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<sup>8</sup> Bank of Japan, Bank of Japan joins the Network for Greening the Financial System (NGFS)' (28 November 2019), [https://www.boj.or.jp/en/announcements/release\\_2019/rel191128a.htm/](https://www.boj.or.jp/en/announcements/release_2019/rel191128a.htm/). See also Kakuho Furukawa, Hibiki Ichiue and Noriyuki Shiraki, 'How Does Climate Change Interact with the Financial System?', Bank of Japan Working Paper (24 December 2020), [https://www.boj.or.jp/en/research/wps\\_rev/wps\\_2020/wp20e08.htm/](https://www.boj.or.jp/en/research/wps_rev/wps_2020/wp20e08.htm/) (hereafter Bank of Japan working paper).

<sup>9</sup> Bank of Japan working paper, *ibid* at 5.

<sup>10</sup> *Ibid* at 9.

<sup>11</sup> TCFD, 'Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures' (June 2017), at iii, <https://www.fsb-tcfd.org/publications/final-recommendations-report/>; Japanese translation at: [https://www.fsb-tcfd.org/wp-content/uploads/2017/06/TCFD\\_Final\\_Report\\_Japanese.pdf](https://www.fsb-tcfd.org/wp-content/uploads/2017/06/TCFD_Final_Report_Japanese.pdf).

<sup>12</sup> *Ibid* at 6.

<sup>13</sup> Union of Concerned Scientists, 'Climate Hot Map', <https://www.climatehotmap.org/global-warming-locations/osaka-japan.html#end9#end9#end9#end9#end9>.

<sup>14</sup> *Ibid*.

<sup>15</sup> R J Nicholls, S Hanson, C Herweijer, N Patmore, S Hallegatte, J Corfee-Morlot, J Chateau, and R Muir-Wood, 'Ranking port cities with high exposure and vulnerability to climate extremes. Environment working paper no 1', (2008) Paris: Organisation for Economic Co-operation and Development, <http://www.oecd.org/officialdocuments/displaydocumentpdf?cote=ENV/WKP%282007%291&doclanguage=en> (hereafter Nicholls *et al*).

<sup>16</sup> The Climate Reality Project, 'How the Climate Crisis Impacts Japan', (2020), <https://www.climateRealityproject.org/blog/how-climate-crisis-impacts-japan>.

<sup>17</sup> *Ibid*.

to put millions of people and valuable assets in Osaka and other cities at risk. Another study documents Japan's high exposure to asset damage due to more frequent, higher winds.<sup>18</sup>

Global warming also has chronic impacts on Japan. Its temperature is rising at a faster rate than the global average. The number of days with a maximum temperature of 30°C to 35°C or above is increasing.<sup>19</sup> In 2018, Japan's temperature record was broken by a heatwave that peaked at a 41°C (106° Fahrenheit), a heat wave that the Japan Meteorological Agency declared a natural disaster, hospitalizing over 30,000 and claiming at least 80 lives.<sup>20</sup> The Japan Government's synthesis report on climate impacts observed that the projected number of cases where heat illness patients will be carried by ambulance will increase nationwide in the period between the present and mid-21st century (2031-2050), projected to at least double in eastern and northern Japan.<sup>21</sup>

Inundation of sea water into freshwater and sustained heat may also place agricultural production of rice, a key staple of Japanese diet, at risk.<sup>22</sup> The Japanese government reported the impacts of climate change on rice yield and quality:

Cases of white immature grain (high temperature or other damaging condition causes insufficient starch production in the grain, making it look milky white), cracked grain (high temperature causes cracks in the grain) and other degraded quality rice have already been reported throughout Japan. Some cases of reduction in yield have also been reported in specific areas or in extremely warm years.<sup>23</sup>

Another impact of climate change on agriculture in Japan is that high temperatures, solar radiation, and decreased precipitation in the summer are negatively affecting fruit production, including causing sunburn damage.<sup>24</sup> Temperature rise during the summer is also negatively affecting Shiitake mushroom production due to the increased generation of pathogens and decreased generation of the edible parts, requiring further research.<sup>25</sup> The problem of abandoned bamboo forests, primarily in western Japan, means intrusion into mixed-use forests, which will possibly cause adverse effects on local ecosystems and biodiversity, as well as rural landscape management.<sup>26</sup>

With the increase in ocean temperature caused by climate change, spawning and feeding grounds of marine organisms in offshore and coastal areas of Japan, as well as migration routes, are likely to change, causing a direct impact on their distribution.<sup>27</sup> In shallow waters, areas for seaweed cultivation and tidal flats may be reduced or species diversity may decline or disappear due to global warming, causing concerns about the impact on industry.<sup>28</sup>

<sup>18</sup> Nicholls *et al*, *supra* note 15 at 37.

<sup>19</sup> Japan Government, *Synthesis Report on Observations, Projections and Impact Assessments of Climate Change, 2018 Climate Change in Japan and Its Impacts*, Ministry of the Environment Ministry of Education, Culture, Sports, Science and Technology Ministry of Agriculture, Forestry and Fisheries Ministry of Land, Infrastructure, Transport and Tourism Japan Meteorological Agency at3, [https://www.env.go.jp/earth/tekiou/pamph2018\\_full\\_Eng.pdf](https://www.env.go.jp/earth/tekiou/pamph2018_full_Eng.pdf) (hereafter Synthesis Report).

<sup>20</sup> Jason Samenow, 'Japan soars to its highest temperature ever recorded: 106 degrees', *The Washington Post*, (23 July 2018), <https://www.washingtonpost.com/news/capital-weather-gang/wp/2018/07/23/japan-soars-to-its-highest-temperature-ever-recorded-106-degrees/?noredirect=on>.

<sup>21</sup> Synthesis Report, *supra* note 19 at 6.

<sup>22</sup> Kenji Washio, 'The Prediction of Climate Change and Rice Production in Japan' (2013) *Rice Research*,

<https://www.omicsonline.org/open-access/the-prediction-of-climate-change-and-rice-production-in-japan-jrr.1000e103.php?aid=23457>, finding that the reproductive phase of rice is highly sensitive to high temperature, and hotter conditions lead to increasing sterility.

<sup>23</sup> Synthesis Report, *supra* note 19 at 3.

<sup>24</sup> *Ibid* at 3.

<sup>25</sup> *Ibid.*

<sup>26</sup> *Ibid* at 4.

<sup>27</sup> *Ibid.*

<sup>28</sup> *Ibid.*

Physical risks and impacts due to climate change have financial implications for companies, such as direct damage to assets and indirect impacts from supply chain disruption.<sup>29</sup> Direct damage to assets leads to reduction of the value of collateral and write-downs on balance sheets, which can negatively affect annual revenues. It can increase the costs of raising capital, particularly where the company is located in areas such as coastal shorelines where the physical risks are higher. When physical risks materialize, fixed assets such as factories and equipment are damaged, leading to economic losses from irreparable assets or loss of production time, deterioration in the company's creditworthiness and ability to borrow, all of which, in turn, affect both companies' and banks' balance sheets.<sup>30</sup>

Both acute and chronic physical effects can also negatively affect the cost and availability of insurance. Companies' financial performance may also be affected by changes in water availability, sourcing, and quality. Extreme temperature changes can negatively affect organizations' premises, operations, transport needs, and employee safety.<sup>31</sup> When companies have inadequate information about the physical risks, there is risk that they have mispriced assets and misallocated capital.<sup>32</sup> Changing weather patterns also have indirect impacts, such as changes in natural ecosystems and impacts on fisheries, which can cause a wide variety of secondary effects on industrial and economic activities.<sup>33</sup>

In summary, unabated climate change will continue to have a negative impact on short-, medium-, and long-term economic performance.

## **B. Transition Risks**

Japan is also vulnerable to transition risks. In its trade relationships with foreign nations and investments in other countries, businesses in Japan are dealing with different legal regimes and standards for reporting on climate change or meeting scope 1, 2 and 3 emissions reductions targets. Policy uncertainty in some jurisdictions and liability risk for investee companies in countries like the United States (US) are also becoming evident. The time horizons for climate-related risk are not only manifested over the long term; climate change is disrupting businesses today. Thus, oversight and management of climate-related risks must become embedded in governance processes for risk management, strategic planning, and financial reporting in the short, medium, and long term. Within transition risks are numerous types of financial risks, including market risks, legal and policy risks, technology risks, and reputational risks.

### *i. Market Risks*

As institutional investors shift to net-zero carbon emissions investments, there is risk of shifting away from Japan as a market unless investee companies demonstrate that they are effectively managing climate risk. As investors shift their investment priorities, there are direct impacts on supply and demand for different products, services, and commodities, with investors increasingly taking account of climate-related risks and opportunities.<sup>34</sup>

Companies' failures to act to address market pressure to engage in climate mitigation and adaptation strategies are likely to increase the cost of capital or reduce its availability. The chief executive officer (CEO) of the world's biggest institutional asset manager BlackRock, Larry Fink, sent a letter in 2020

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<sup>29</sup> TCFD, *supra* note 11 at 6.

<sup>30</sup> Bank of Japan working paper, *supra* note 8 at 10.

<sup>31</sup> TCFD, *supra* note 11 at 6.

<sup>32</sup> *Ibid* at 1.

<sup>33</sup> *Ibid*.

<sup>34</sup> *Ibid* at 6.



addressed to all its investee companies, including a number of Japanese companies, warning that climate change is a financial risk that could shake the stability of economic growth and the financial system, and asking companies for disclosure based on the Sustainability Accounting Standards Board (SASB) standards and the TCFD recommendations, stressing that companies need effective disclosure so that investors can ascertain whether they are properly managing sustainability risks and opportunities.<sup>35</sup>

Also in 2020, Hiro Mizuno, then Executive Managing Director and Chief Investment Officer of Japan's US\$1.4 trillion (¥151 trillion assets) Government Pension Investment Fund (GPIF) issued a letter, signed also by two other global asset managers, pointing out that climate change alone has the potential to destroy US\$ 69 trillion in global economic wealth by 2100 and calling on companies to develop sustainable long-term strategies to address climate-related risks and to consider the environment, employees, and society in their business strategies.<sup>36</sup> GPIF has stated that it is

committed to fulfilling our fiduciary duty to secure adequate retirement funds for both current and future beneficiaries. We believe that improving the governance of the companies that we invest in while minimizing negative environmental and social externalities – that is, ESG (environment, social and governance) integration – is vital in ensuring the profitability of the portfolio over the long term.<sup>37</sup>

A study by Choi, Gao, and Jiang recently found that financial institutions around the world have reduced their exposure to stocks of high-emission industries since 2015, and firms in such sectors have experienced lower price-to-earnings and price-to-book ratios, which make equity financing costlier.<sup>38</sup> At the same time, they have increased research and development capital expenditures, suggesting that high-emissions firms are investing in methods to reduce emissions.<sup>39</sup> The authors observe that divestment by financial institutions exerts pressure on companies to adopt climate-friendly policies and decrease their carbon footprint.<sup>40</sup>

## ii. Policy and Legal Risks

Policy risks can include government policy actions aimed at constraining company actions that contribute to the adverse effects of climate change and policy aimed at promoting mitigation and adaptation. Examples include implementing carbon-pricing mechanisms to reduce GHG emissions, shifting energy use toward lower-emission sources, adopting energy-efficiency measures, and encouraging greater water efficiency and sustainable land-use practices.<sup>41</sup> For example, a carbon tax introduced to reduce GHG emissions may result in the market value of fossil fuels such as oil and coal dropping substantially, leaving companies with stranded assets that are no longer able to earn an economic return, in turn, negatively affecting the balance sheet.<sup>42</sup>

There are increasing expectations by Japanese regulators that companies will address climate-related financial risks. Japan's Ministry of the Environment (MOE) Climate Change Policy Division has reported

<sup>35</sup> Larry Fink, BlackRock, 'A Fundamental Reshaping of Finance', Letter to CEOs, (January 2020), <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>.

<sup>36</sup> Hiro Mizuno *et al*, 'Our Partnership for Sustainable Capital Markets' (March 2020), [https://www.gpif.go.jp/en/investment/Our\\_Partnership\\_for\\_Sustainable\\_Capital\\_Markets.pdf](https://www.gpif.go.jp/en/investment/Our_Partnership_for_Sustainable_Capital_Markets.pdf) (hereafter Mizuno *et al*).

<sup>37</sup> Government Pension Investment Fund, 'For All Generations, ESG Report 2019', at 2, [https://www.gpif.go.jp/en/investment/GPIF\\_ESGREPORT\\_FY2019.pdf](https://www.gpif.go.jp/en/investment/GPIF_ESGREPORT_FY2019.pdf).

<sup>38</sup> Darwin Choi, Zhenyu Gao, Wenxi Jiang, 'Global Carbon Divestment and Firms' Actions' (29 May 2020), SSRN 358995, at 9, 13, 14, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3589952](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3589952).

<sup>39</sup> *Ibid*.

<sup>40</sup> *Ibid* at 3.

<sup>41</sup> TCFD, *supra* note 11 at 5.

<sup>42</sup> Bank of Japan working paper, *supra* note 8 at 10.

that climate-related risks can result from reassessment of the value of a large range of assets with a large volume of GHG emissions during the process of adjustment towards a lower carbon economy.<sup>43</sup> It has issued guidance on disclosure of climate-related risks and opportunities in line with the TCFD, discussed in part 6.3 below. Given that the TCFD framework includes guidance on the robust climate governance processes that necessarily underlie the disclosures, it is an indication of growing regulatory expectations that directors should put in place effective climate governance mechanisms.

Japan's Financial Services Agency reports that '2019 marked a major shift in the way Japan addressed the challenge of the climate emergency.'<sup>44</sup> These policy shifts have encouraged a substantial increase in the number of Japanese firms committed to reporting their approach to climate change using TCFD recommendations, growing from 44 to 223 in 2019.<sup>45</sup> In addition, 23 per cent of Japanese TCFD-supporting companies disclosed the results of their climate-related scenario analysis in 2019.<sup>46</sup>

Another example of regulatory policy likely to impact Japanese companies is Japan's *Climate Change Adaptation Act*, enacted in 2018.<sup>47</sup> It is aimed at promoting climate change adaptation through establishing necessary measures such as formulating plans for adaptation to global warming and providing information on climate change impacts and adaptation in order to contribute to the health and cultural life of the Japanese people, both now and in the future. Article 3 requires the national government to promote the enhancement of scientific knowledge on climate change, its impacts and adaptation, and to use this knowledge to comprehensively establish and promote policies for climate change adaptation.<sup>48</sup> Article 4 directs local governments to endeavor to promote policies for climate change adaptation in accordance with natural, economic, and social factors in their region, providing information on measures and policies to promote climate change adaptation. Governments at all levels are to help promote business activities that contribute to adaptation.<sup>49</sup>

'Climate change impact', as defined in the *Climate Change Adaptation Act*, means impact by climate change that negatively affects human health and the living environment, causes a decline in biodiversity, and impacts daily life, society, economy, and the natural environment.<sup>50</sup> 'Climate change adaptation' means 'reacting to the climate change impact so as to prevent or reduce damage, and to contribute to a stable living environment, sound development of a society and economy, and to preserve the natural environment.'<sup>51</sup>

While the term 'mitigation' and references to GHG are not mentioned in the *Climate Change Adaptation Act*, article 1 makes reference to article 2(1) of the 1998 *Act on Promotion of Global*

<sup>43</sup> The Ministry of the Environment, Government of Japan Climate Change Policy Division, *Practical Guide for Scenario Analysis in line with the TCFD recommendations*, 2nd edition (March 2020), at 1-5,

[http://www.env.go.jp/policy/policy/tcfd/TCFDguide\\_2nd\\_EN.pdf](http://www.env.go.jp/policy/policy/tcfd/TCFDguide_2nd_EN.pdf) (hereafter Japan MOE); Japanese version available at: TCFD を活用した経営戦略立案のススメ～気候関連リスク・機会を織り込むシナリオ分析実践ガイド～, [http://www.env.go.jp/policy/policy/tcfd/TCFDguide\\_2nd\\_JP.pdf](http://www.env.go.jp/policy/policy/tcfd/TCFDguide_2nd_JP.pdf) (env.go.jp).

<sup>44</sup> Satoshi Ikeda, Chief Sustainability Officer, Financial Services Agency, Japan, 'Why Japan is leading the TCFD wave', Commentary, London School of Economics Grantham Research Institute, (March 2020), <https://www.lse.ac.uk/granthaminstitute/news/why-japan-is-leading-the-tcfd-wave/>.

<sup>45</sup> *Ibid*, citing TCFD 2019 Status Report.

<sup>46</sup> *Ibid*.

<sup>47</sup> *Climate Change Adaptation Act*, Act No 50 of June 13, 2018, 気候変動適応法 平成 30 年 6 月 13 日法律第 50 号, at article 1, English translation, <http://www.japaneselawtranslation.go.jp/law/detail/?id=3212&vm=04&re=01>. Please note, for translation of Japanese laws generally, see the website of Japanese Law Translation - <http://www.japaneselawtranslation.go.jp/?re=01>.

<sup>48</sup> *Ibid*, article 3(1).

<sup>49</sup> *Ibid*, articles 3(1) and (2).

<sup>50</sup> *Ibid*, article 2(1).

<sup>51</sup> *Ibid*, article 2(2).

*Warming Countermeasures*.<sup>52</sup> That article expressly refers to global warming affecting the planet as a whole, and the increasing concentration of GHG in the atmosphere as a result of human activity. Article 2(2) of the *Act on Promotion of Global Warming Countermeasures* discusses 'global warming countermeasures' to control GHG emissions and to maintain and improve the absorption of GHG, as well as other measures to take in international cooperation for the prevention of global warming. The two statutes read together clearly indicate that adaptation measures include measures to reduce emissions, referred to as 'mitigation' internationally.

The *Climate Change Adaptation Act* specifies that businesses must endeavor to adapt to climate change in accordance with the content of their business activities, and in cooperation with national and local governmental programs for climate change adaptation.<sup>53</sup> The *Act* sets out the obligations of national and local governments, the private sector, and citizens to promote climate change adaptation efforts. One challenge in respect of enforcing the goals of the *Act* is that the direction to businesses is not expressly enforceable; the *Act* does not, by itself, provide a legal basis for directors' duties in respect of climate change.

Another policy signal is that the Bank of Japan has joined the Network for Greening the Financial System (NGFS), a group of central banks and supervisors concerned with the systemic risks of climate change to the financial system.<sup>54</sup> Other member banks, such as in the United Kingdom (UK), the European Union, and Australia, are now requiring stress-testing of domestic and cross-border financial institutions, which indicates where the Japan's central bank may be moving in the near future.

The Japan Government's synthesis report on climate impacts also discusses the opportunities that climate change presents. It uses, as examples, businesses developing information technologies, such as agriculture support services and services to project and assess risks from disasters; technologies to improve the heat-tolerance environment and the comfort of buildings and houses; as well as financial instruments that provide insurance or a hedge against possible damage due to abnormal weather events.<sup>55</sup> All of these government policy reports reveal that there are risks to Japanese directors that fail to read regulatory signals in respect of the need to manage climate-related financial risks and that fail to disclose the effectiveness of measures taken.

Regulation from other jurisdictions will also impact Japanese businesses. For example, automobile emission regulations introduced in Europe effective 2021 have resulted in some Japanese companies expressing concern that they may not be able to achieve emissions reductions targets, which could result in substantial fines and loss of business.<sup>56</sup>

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<sup>52</sup> Article 2(1), *Act on Promotion of Global Warming Countermeasures* (Act No. 117 of 1998, 地球温暖化対策の推進に関する法律 平成10年法律第117号 ([japaneselawtranslation.go.jp](http://japaneselawtranslation.go.jp))). English translation can be found at <http://www.japaneselawtranslation.go.jp/law/detail/?id=97&vm=&re>. Article 1 states: In recognition of the serious impact of global warming on the environment of the entire planet, and the importance of efforts on the part of all humankind to actively and voluntarily address the universal issue of stabilizing greenhouse gas concentrations in the atmosphere at levels where human interference does not pose a danger to climate systems, the purpose of this Law is to promote global warming countermeasures by formulating a plan for attaining targets under the Kyoto Protocol and taking measures to promote the control of greenhouse gas emissions due to social, economic, and other activities, thereby contributing to the health and cultural life of the Japanese people, both now and in the future, as well as contributing to the wellbeing of all humankind.

<sup>53</sup> *Climate Change Adaptation Act*, *supra* note 52, article 5.

<sup>54</sup> Bank of Japan, *supra* note 8.

<sup>55</sup> Synthesis Report, *supra* note 19 at 7.

<sup>56</sup> Nikkei Business Newspaper, Nihon Keizai Simbun morning edition, (8 September 2020) (in Japanese only). The title of the article in English is 'Climate change risk, disclosure 4 times, 264 companies in the previous term (気候変動リスク、開示4倍前期 264社).

Another important risk is litigation or legal risk. Globally, there has been a huge increase in the number of climate-related lawsuits, which include claims by investors in respect of breaches of directors' duties, securities law claims regarding the failure of companies to disclose climate-related risks and financial impacts, and lawsuits commenced by regional and local governments and public interest organizations against companies that are major GHG emitters.<sup>57</sup> As companies and financial institutions experience more financial losses due to climate change, the risk of litigation for directors' failure to act is also likely to increase.

### iii. Technology Risks

Technologies are rapidly developing to respond to the risks created by climate change, aimed at shifting businesses and economies to more sustainable and climate-friendly economic activities. Disruptive technologies can pose either risks or opportunities for Japanese companies. As the TCFD observed, to the extent that new technology displaces old systems and disrupts some parts of the existing economic system, winners and losers will emerge from this 'creative destruction' that is inevitable, even though the exact timing is still uncertain.<sup>58</sup>

There is growing interest in investing in new technologies that are energy efficient, use renewable energy sources, and reduce GHG emissions. Innovations in battery storage, energy efficiency, and carbon capture and storage will affect the competitiveness of many companies, their production and distribution costs, and demand for their products and services from end users.<sup>59</sup>

### iv. Reputational Risks

The TCFD has also identified climate change as a source of reputational risk tied to changing customer or community perceptions of an organization's contribution to or detraction from the transition to a low-carbon economy.<sup>60</sup> Consumer trends and civil society pressure to develop a serious path to decarbonization can affect the company reputationally, and thus financially, if the directors fail to recognize and act on climate-related risks and opportunities. Also, with a growing number of institutional investors endorsing the United Nations (UN) Sustainable Development Goals, there is a growing social risk to companies in terms of their reputation and 'social licence' to operate.<sup>61</sup>

Having briefly canvassed the context in Japan regarding climate change and its attendant risks, the next part gives an overview of corporate directors' duties in Japan and the various options that companies have in terms of type of company and governance structure.

## 2. OVERVIEW OF CORPORATE BOARDS IN JAPAN

Directors' duties in Japan are set out in the *Companies Act* and in the companies' articles.<sup>62</sup> Publicly-listed stock companies are also regulated by the *Financial Instruments and Exchange Law*,<sup>63</sup> and

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<sup>57</sup> Janis Sarra, *From Ideas to Action, Governance Paths to Net Zero* (2020, Oxford University Press), chapter 7.

<sup>58</sup> TCFD, *supra* note 11 at 6.

<sup>59</sup> *Ibid.*

<sup>60</sup> *Ibid.*

<sup>61</sup> Sarra, *From Ideas to Action, Governance Paths to Net Zero*, *supra* note 57; United Nations Sustainable Development Goals, <https://www.un.org/sustainabledevelopment/sustainable-development-goals/>.

<sup>62</sup> *Companies Act of Japan*, Act No 86 of July 26, 2005 (会社法 平成 17 年 7 月 26 日法律第 86 号), English translation at <http://www.japaneselawtranslation.go.jp/law/detail/?id=2035&vm=04&re=02> (hereafter *Companies Act of Japan*).

<sup>63</sup> *Financial Instruments and Exchange Act (FIEA)*, <https://www.fsa.go.jp/en/policy/fiel/>, *The Act for the Amendment of the Securities and Exchange Act, etc (Act No 65 of 2006) and the Act for the Development, etc of Relevant Acts for Enforcement of*



securities listing regulations published by the securities exchanges, as well as the Corporate Governance Code, the latter of which is non-binding guidance.<sup>64</sup> The governance structures of Japanese companies arise from a deep history of cross-shareholdings and cultural norms regarding the relationship between directors and the myriad interests implicated in the corporation's activities.<sup>65</sup> The evolution of corporate law in Japan, particularly in the past decade, has begun to focus on directors' duties, particular in respect of ensuring that proper governance and internal control systems are in place.<sup>66</sup>

A 'stock company' (*kabushiki kaisha*) pursuant to the *Companies Act of Japan* includes all privately-held and publicly-listed companies that are incorporated and have issued shares.<sup>67</sup> A 'public company' is defined as any stock company, the articles of incorporation of which do not require, as a feature of all or part of its shares, the approval of the stock company for the acquisition of such shares by transfer.<sup>68</sup> Stock companies, whether privately-held or public companies, have options, pursuant to Japanese corporate law, to organize their governance structures in a number of ways. Of note, is that 'company' is defined in the *Companies Act* more broadly than stock companies and includes a general partnership company, limited partnership company, or limited liability company.<sup>69</sup> A limited liability company does not issue stock. As of 2018, 93.8 per cent of Japanese corporate entities are *kabushiki kaisha* (stock companies).<sup>70</sup>

## 2.1 Options for Corporate Governance Structures

The structure of corporate boards in Japan differs from many countries in that most of Japan's largest publicly-listed companies have been overwhelmingly dominated by corporate insiders, with very few outside or independent directors.<sup>71</sup> Nakahigashi and Puchniak observe that even when the *Companies Act of Japan* was amended to allow companies the option of more US-style corporate boards and the Tokyo Stock Exchange Listing Rules were amended in 2010 to require all listed companies to have at least one independent director or statutory auditor (*kansayaku*),<sup>72</sup> the vast majority of corporate boards in publicly-listed Japanese companies remain insider dominated.<sup>73</sup> That situation has started to change with the issuing of the Corporate Governance Code, as discussed in part 4.3 below, although the majority of directors continue to be inside directors.

Effective May 2015, companies in Japan may choose one of three main forms of organizational structure under the *Companies Act of Japan*: a 'Company with *Kansayaku* Board' (audit and supervisory board);

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the Act for the Amendment of the Securities and Exchange Act, etc (2006 Act No 66), promulgated on 14 June 2006. Translation of the Act is available at <http://www.japaneselawtranslation.go.jp/law/detail/?id=3538&vm=04&re=01&new=1>.

<sup>64</sup> Tokyo Stock Exchange, 'Japan's Corporate Governance Code Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term' (as revised 1 June 2018) at 16, [https://www.jpex.co.jp/english/news/1020/b5b4pj000000jvrxr-att/20180602\\_en.pdf](https://www.jpex.co.jp/english/news/1020/b5b4pj000000jvrxr-att/20180602_en.pdf) (hereafter Corporate Governance Code). For a discussion of early corporate law, prior to the modernization of company law, see Janis Sarra and Masafumi Nakahigashi, 'Balancing Social and Corporate Culture in the Global Economy: The Evolution of Japanese Corporate Culture and Norms' (2002) 24 *Law & Policy* 4 at 299-354.

<sup>65</sup> Sarra and Nakahigashi, *ibid*.

<sup>66</sup> See for example, article 348(4), *Companies Act of Japan*.

<sup>67</sup> *Companies Act of Japan*, article 25.

<sup>68</sup> *Companies Act of Japan*, article 2(v).

<sup>69</sup> *Ibid*, article 2(i).

<sup>70</sup> Katsuyuki Yamaguchi, Kaoru Tatsumi, and Mamiko Komura, 'Corporate governance and directors' duties in Japan: overview' (1 May 2020), Thompson Reuters Practical Law, [https://uk.practicallaw.thomsonreuters.com/1-502-Q177?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/1-502-Q177?transitionType=Default&contextData=(sc.Default)&firstPage=true) (hereafter Yamaguchi *et al*). *Kabushiki kaisha* are generally classified according to the transfer restrictions imposed on their shares.

<sup>71</sup> Dan W Puchniak and Masafumi Nakahigashi, 'Case No. 21: Corporate Law – Business Judgment Rule – Derivative Action – Supreme Court, 15 July 2010', in Moritz Bälz *et al* eds, *Business Law in Japan ---- Cases and Comments* (Kluwer Law International; 2012) at 215-226 (hereafter Puchniak and Nakahigashi).

<sup>72</sup> Tokyo Stock Exchange, Securities Listing Regulations Rule 436-2; Tokyo Stock Exchange, Enforcement Rules for Securities Listing Regulations Rule 436-2. English translation at <<http://www.tse.or.jp/english/rules/regulations/>>.

<sup>73</sup> Puchniak and Nakahigashi, *supra* note 71 at 10.

a 'Company with Three Committees' – a nomination, audit, and remuneration committee;<sup>74</sup> or a 'Company with Supervisory Committee'.<sup>75</sup> The latter two forms of organizational structure under the *Companies Act* are similar to companies in other countries where committees are established under the board and assigned certain responsibilities with the aim of strengthening oversight and monitoring functions.<sup>76</sup> All three forms of company governance structures have a board of directors. The differences in governance structures are discussed in more detail in Appendix I; however, the key governance and director oversight features are summarized here.

For a Company with a *Kansayaku* Board, the *Companies Act* allocates specific governance functions to the board of directors, the *kansayaku* (auditors), and the *kansayaku* board, the latter of which must have three or more auditors. Thus, under this governance model, listed companies are required to have two boards, a board of directors and a board of *kansayaku*. The *kansayaku* audit the performance of duties by directors and the management and have investigation powers by law. The *kansayaku* board decides audit policy and the execution of each *kansayaku*'s authority. However, the *kansayaku* board's decision may not preclude *kansayaku* from exercising their authority.<sup>77</sup> The *kansayaku* serve an oversight function over the directors and the board of directors. In the exercise of their audit powers, the *kansayaku* can bring a lawsuit against directors seeking an injunction or damages for director misconduct.<sup>78</sup>

No one can be elected as director and *kansayaku* at the same time. In order to ensure independence and high-level information gathering power, not less than half of *kansayaku*, as appointed at the general shareholder meeting, must be outside *kansayaku*, and at least one full-time *kansayaku* must be appointed.

A Company with Three Committees must appoint one or more *shikkoyaku* (executive officers) from directors or non-directors, by a resolution of the board, and delegate business administration and certain kinds of business decisions to the *shikkoyaku*.<sup>79</sup> The board can delegate substantial decision-making authority over the management of the company to the executive officers. The board must appoint one or more 'representative executive officers' from among the executive officers, who have responsibility for carrying out decisions made by the board or the executive officers, and have authority to represent the company. As of May 2020, only 76 of the approximately 3,700 publicly-listed companies on the Tokyo Stock Exchange (TSE) had the three-committee structure.<sup>80</sup>

A Company with Supervisory Committee has only one board, and it is represented by the representative director. If independent directors do not comprise a majority of the board, the Corporate Governance Code recommends, as best practice, establishing an independent advisory committee under the board, in which independent directors approve remuneration and some executive hiring decisions.<sup>81</sup>

All three forms of companies can create a position with the title of *shikkoyaku* or *shikkoyakuin* for persons who are delegated by the board to exercise a specified range of decisions regarding business administration.<sup>82</sup>

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<sup>74</sup> Yamaguchi *et al*, *supra* note 70.

<sup>75</sup> Corporate Governance Code, *supra* note 64.

<sup>76</sup> *Ibid.*

<sup>77</sup> Article 390(2), *Companies Act of Japan*.

<sup>78</sup> Articles 385, 386, *Companies Act of Japan*.

<sup>79</sup> *Ibid.*

<sup>80</sup> *Ibid.*

<sup>81</sup> *Ibid*, Supplementary Principle 4.10.1.

<sup>82</sup> Corporate Governance Code, *supra* note 64 at 16.

The 2019 amendments to the *Companies Act of Japan* now require public companies to have at least one 'outside director'.<sup>83</sup> Outside director, in this context, does not mean 'independent' within the meaning of the TSE rules. Publicly-listed companies that are not large companies defined by *Companies Act* are not required to have at least one outside director, but the number of such listed companies in Japan is small.<sup>84</sup> Article 2(15) of *Companies Act* defines the standard of 'outside' director, but makes no reference to independence. The TSE adds a requirement of 'independent director', but does not make the criteria of independence clear in the Securities Listing Regulations. Publicly-listed companies set their own criteria regarding the independence of directors and must disclose that criteria. However, the TSE may publicly announce or impose a listing agreement violation penalty if a company's criteria does not satisfy TSE requirements of independence in accordance with the TSE 'Guidelines Concerning Listed Company Compliance'.<sup>85</sup> Rule 436-2(1) states that directors are independent if they are unlikely to have conflicts of interest with general investors,<sup>86</sup> giving the TSE authority to impose a listing violation penalty on them for failure to comply.

No matter which of the three types of corporate board structures permitted in Japan have been adopted, all companies have directors and all the directors have duties pursuant to corporate law and, where they are publicly-listed, pursuant to financial services law.

Directors in Japan have three primary duties, a duty of loyalty, a duty to be in compliance with all laws, regulations, and ordinances, and the company articles, and a duty of care to act with the care of a prudent manager,<sup>87</sup> discussed in detail in the next three parts. Japan is a civil law country, and thus the statutes set out the legal basis for the scope of directors' and officers' duties.

### 3. DIRECTORS' DUTIES OF LOYALTY AND ADHERENCE TO THE LAW

#### 3.1 Duty of Loyalty

The *Companies Act of Japan* sets out the duty of loyalty that directors owe to the company. Articles 355 specifies:

Duty of Loyalty

Article 355 Directors shall perform their duties for the Stock Company in a loyal manner in compliance with laws and regulations, the articles of incorporation, and resolutions of shareholders meetings.<sup>88</sup>

In general, the duty of loyalty includes a duty on directors to avoid conflicts of interest and self-dealing transactions. However, article 355 of the *Companies Act of Japan* requires directors to perform their duties for the company in a loyal manner; so article 355's duty sets out not only a duty to avoid conflicts of interest and self-dealing transactions, but also a duty of care in their oversight and management of the company. The duty of loyalty is not distinguished from a duty of care in Japan,<sup>89</sup> and most directors' duties in respect of oversight and management of climate change are likely to arise under the duty of

<sup>83</sup> *Companies Act of Japan*, article 327-2.

<sup>84</sup> *Companies Act of Japan*, Article 2(vi), see Appendix I for a definition of large companies.

<sup>85</sup> TSE, 'Guidelines Concerning Listed Company Compliance', Part III. See Appendix I for more discussion.

<sup>86</sup> Securities Listing Regulations Rule 436-2. [https://www.jpx.co.jp/english/rules-participants/rules/regulations/tvdivq0000001vyt-att/securities\\_listing\\_regs1-826\\_20190716.pdf](https://www.jpx.co.jp/english/rules-participants/rules/regulations/tvdivq0000001vyt-att/securities_listing_regs1-826_20190716.pdf).

<sup>87</sup> Civil Code of Japan, Act No. 89 of April 27, 1896, as amended, article 644, 民法 明治 29 年 4 月 27 日法律第 89 号); *Companies Act of Japan*, article 355.

<sup>88</sup> *Ibid.*

<sup>89</sup> 24-6 Saikosaibannsyō Minjihanreisyū 625, Japanese Supreme Court's decision June 2 of 1970.

care part of article 355, as well as article 330 of the *Companies Act* and article 644 of the Civil Code, as discussed in part 4.

Directors also have a duty to report any information that is likely to harm the company. Article 357(1) specifies that if directors detect any fact likely to cause substantial detriment to the stock company, they shall immediately report such fact to the shareholders, or, for a company with auditors, to the company auditors. Article 357(2) states that for the purpose of application of article 357(1) to a company with a *kansayaku* board, the report is to be made to that board.<sup>90</sup>

### 3.2 Directors' Duty to Obey Specific Laws, Regulations, and Ordinances, and the Corporate Articles

Note that Article 355 above specifies that in being loyal to the company, directors shall perform their duties in compliance with laws and regulations, the articles of incorporation, and resolutions of shareholders meetings.

The *Companies Act of Japan* specifies that the directors of large companies must develop the systems necessary to ensure that the execution of duties by the directors complies with the laws and regulations and the articles of incorporation, and other systems prescribed by ordinance necessary to ensure the proper operations of a stock company.<sup>91</sup> This statutory obligation is reinforced by Article 100 of the Regulation for Enforcement of the Companies Act, which requires directors to develop systems related to management of the risk of loss to the stock company and any of its subsidiaries.<sup>92</sup> It thus requires the board of directors of a large stock company to establish a proper internal control and risk management system to support directors' duty to supervise business operations.<sup>93</sup> In such companies, a director's duty of care to supervise the business will not be effectively performed without a proper internal control system.

Companies in a corporate group should each act in their own interests. Where transactions enhance the interests of the whole of group, they are permissible; however, directors of a company in a corporate group should not make decisions if they are not in the interests of the entity of which they are directors.

The duty to obey laws and regulations is straightforward. Statutes set out the standards, and if a director violates specific provisions that require a corporation to act, it is a breach of the director's duties, as well as a breach of statutory obligation by the company. Various Japanese laws impose civil, criminal, and administrative penalties or other liabilities both on the corporation and on directors as the decision-makers. A number of environmental laws, such as the *Soil Contamination*

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<sup>90</sup> *Companies Act of Japan*, article 357(2).

<sup>91</sup> *Companies Act of Japan*, article 348(4), referencing also 348(3)(iv), specifies that directors of a company without a board of directors must develop a system of internal controls if it is a large company, a decision that cannot be delegated to a single director. The obligation is reinforced by Article 98 of the Regulation for Enforcement of the Companies Act. Article 362(5), referencing (4)(vi) of the *Companies Act of Japan* specifies that board of directors of a company with *Kansayaku* Board must develop the system if it is a large company. The obligation is reinforced by Article 100 of the Regulation for Enforcement of the Companies Act. Article 399-13(2), referencing (1)(i)(c) of the *Companies Act of Japan* specifies that board of directors of a company with supervisory board must develop the system. The obligation is reinforced by Article 110-4 of the Regulation for Enforcement of the Companies Act. Article 416(2), referencing (1)(i)(e) of the *Companies Act of Japan* specifies that board of directors of a company with three committees must develop the system. The obligation is reinforced by Article 112 of the Regulation for Enforcement of the Companies Act.

<sup>92</sup> Regulation for Enforcement of the Companies Act, article 100(ii), Japanese Law Translation 会社法施行規則平成 18 年 2 月 7 日法務省令第 12 号 Ministry of Justice Order No 12 of February 7, 2006, <http://www.japaneselawtranslation.go.jp/law/detail/?ft=1&dn=1&x=52&y=13&co=01&ia=03&ja=04&ky=companies+act+enforcement+regulation&page=9>.

<sup>93</sup> Large company is a defined term under Article 2(vi) of the *Companies Act of Japan*.



*Countermeasures Act*<sup>94</sup> and the *Water Pollution Prevention Act*,<sup>95</sup> regulate the actions of the company; and directors who violate environmental and health and safety laws can be subject to both civil and criminal liabilities.<sup>96</sup>

### 3.3 Application of these Duties to Climate Change

Directors' duty of loyalty to the company means that they are required to act in its best interests. Arguably, best interests includes the long-term sustainability of the company. As noted above, the *Climate Change Adaptation Act* requires that businesses endeavour to adapt to climate change in accordance with the content of their business activities, and to cooperate with governments at all levels, so directors have a duty to endeavour to adapt.

The MOE has advised companies to engage in scenario analysis to assess the resilience of their business in the face of global warming. As the World Economic Forum has observed, as stewards for long-term performance and resilience, the board of directors should determine the most effective way to integrate climate considerations into its structure and committees.<sup>97</sup> It suggests that regardless of board structure, 'the approach to embedding climate considerations should enable sufficient attention and scrutiny to climate as a financial risk and opportunity.'<sup>98</sup> Moreover, it is important to remember that the board of directors as a whole retains legal responsibility for addressing climate-related financial risks, notwithstanding any allocation of risk management or disclosure of climate-related risks to a specific board committee.

Even though directors have a broad business discretion to design board committees, arguably directors could be held liable under articles 423(1), 348(4), 362(5), 399-13(2), and 416(2) of the *Companies Act of Japan* and articles 98, 100, 110-2, and 114 of the Regulation for Enforcement of the Companies Act for failure to establish a climate risk management system with sufficient capabilities to perform their responsibilities to oversee and manage climate-related financial risks and opportunities, including both physical and transition risks. Depending on the size and kinds of business lines, the risk management system adopted needs to be proper and sufficiently capable of performing the above-mentioned responsibilities in light of the likelihood and magnitude of climate risks to the company.

In the future, any strengthening of statutes that would require companies to set targets towards decarbonization or that require companies to disclose governance, strategy, risk management, and metrics in line with an international framework would add those duties to other duties of directors.

## 4. DIRECTORS' DUTY OF CARE

Japanese directors also have a duty of care in their oversight and management of the company. This obligation is both a positive obligation of exercising due care in the performance of their duties and a defence to personal liability where directors have acted with due care.<sup>99</sup> These duties apply to all stock

<sup>94</sup> *Soil Contamination Countermeasures Act*, Act No 53 of May 29, 2002, as amended.

<sup>95</sup> *Water Pollution Prevention Act*, Law No 138 of 1970, as amended by Law No 75 of 1995, 水質汚濁防止法 昭和 45 年 12 月 25 日法律第 138 号.

<sup>96</sup> Yamaguchi *et al*, *supra* note 70.

<sup>97</sup> World Economic Forum, *How to Set Up Effective Climate Governance on Corporate Boards: Guiding principles and questions*, (19 January 2019), principle 3, <https://www.weforum.org/whitepapers/how-to-set-up-effective-climate-governance-on-corporate-boards-guiding-principles-and-questions>.

<sup>98</sup> *Ibid* at 13.

<sup>99</sup> *Companies Act of Japan*, examples of where due care are a defence include article 52.2(2)(ii), article 120.4(4), and article 213.2(2)(ii).

companies, regardless of whether they are publicly- or privately-held. The duties are set out in articles 355 and 330 of the *Companies Act of Japan* and article 644 of Japan's Civil Code.

The statutory requirement that directors of a large stock company establish a proper internal control and risk management system means that climate governance should be embedded in a board risk management committee or a sustainability committee. The committee allocated with this responsibility must have directors that have sufficient capability to scrutinize climate risks to the company and then to interact with the management and the board to manage and oversee management of these risks. More specifically, such risk management committee needs to be able to assess and analyze both the physical risks and transition risks of climate change discussed in part 1. Where directors lack the expertise and that expertise is not available among the executives of the company, directors should hire outside professional expertise that can support their climate-related risk management decisions in the best interests of the company.

Directors have a broad business discretion to design internal control and risk management systems. Where they determine that a separate risk management committee is necessary, they can embed oversight of climate risk in that committee. With or without a separate risk management committee, the board of directors as a whole still has the overall responsibility to ensure that the company is identifying and addressing material climate-related financial risks and opportunities. The duty of care in the context of climate change mitigation and adaption can be derived from articles 355 and 330 of the *Companies Act of Japan* and article 644 of the Civil Code duties to act in the company's best interests.

Under corporate law, for example, directors can be found personally liable under their duty of care if they did not respond to changes in law in a timely and effective manner.<sup>100</sup> One example would be a failure to comply with articles 348, 362(5), 399-13(2), and 416(2) of the *Companies Act*, as discussed above. If directors of a large stock company fail to establish a proper internal control system that appropriately addresses climate-related risks, they could be found personally liable for breach of their duty of care.

The financial risks of climate change are so broadly acknowledged by governments, scientists, financial institutions, companies, investors and civil society, that it is no longer a defence for directors to say that they were unaware of the risks. Failure to manage climate-related financial risks is likely to be found to be a failure of directors' duty of care. Some scholars have suggested that Japanese courts will look to outcomes more often than process to assess whether directors have met their duty of care.<sup>101</sup> In this respect, there may be heightened risk of Japanese directors being found in breach of their duty of care if they fail to act on climate change, as compared with other jurisdictions, as discussed in part 4.6 below on the business judgment rule.

Legal opinions in Australia, New Zealand, and Canada have all concluded that the duty of care of corporate directors includes a duty of oversight and effective management of climate-related risks and opportunities.<sup>102</sup> In the Canadian legal opinion, Carol Hansell opines:

<sup>100</sup> Janis Sarra and Masafumi Nakahigashi, 'Kigyo No Shakai-Teki Sekinin: Challenges for Corporate Social Responsibility in Japan' (2012) 45:3 *UBC Law Review* 779 at 828.

<sup>101</sup> J Mark Ramseyer and Masayuki Tamaruya, 'Fiduciary Principles in Japanese Law' (2017) Discussion Paper No. 935 09/2017 Harvard Law School, at 8, 10, citing [No names given], 2063 Hanrei jiho 138 (Sup. Ct. 27 November 2009). The Supreme Court similarly used an ex post analysis of the outcome to declare loans by the Hokkaido Development Bank to a troubled real estate firm to constitute a duty of care violation in [No names given], 1997 Hanrei jiho 143 (Sup. Ct. Jan. 28, 2008); [http://www.law.harvard.edu/programs/olin\\_center/papers/pdf/Ramseyer\\_935.pdf](http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ramseyer_935.pdf).

<sup>102</sup> Noel Hutley SC and Sebastian Hartford Davis, 'Climate Change and Directors' Duties, Supplementary memorandum of Opinion' (26 March 2019), Australia Centre for Policy Development; Noel Hutley SC and Sebastian Hartford Davis, 'Climate Change and Directors Duties, Memorandum of Opinion' (7 October 2016), commissioned by the Future Business Council and the Centre for Policy Development, <<https://cpd.org.au/wp-content/uploads/2016/10/Legal-Opinion-on-Climate->

Since there can be little doubt that directors are aware of climate change risk, they must inform themselves of the risk that climate change poses to the corporation and how that risk is being managed. If this information is not already included in management reports to the board, the board should direct management to deliver the necessary information to them . . .

As is the case for any disclosure, misrepresentations about climate change risk can expose the corporation, its officers and its directors to both regulatory and civil liability. In respect of potential civil liability, an important factor for directors is that investors need not be aware of a misrepresentation about climate change to seek damages based on it; securities law deems them to have relied on the misrepresentations. Directors should also be aware that their decisions about disclosure are not protected by the business judgment rule.<sup>103</sup>

Similarly, directors in Japanese companies may have such a duty, given some of the similarities between Canada's and Japan's corporate governance systems. Directors' duties in Japan are set out in the *Companies Act of Japan*,<sup>104</sup> the Civil Code of Japan,<sup>105</sup> and the *Financial Instruments and Exchange Act (FIEA)*.<sup>106</sup>

#### 4.1 Duty of Care Owed to the Company

The duties of care and diligence are set out in Japan's *Companies Act* article 330 and the Civil Code article 644. *Companies Act* article 330 specifies that the relationship between a stock company and its officers or accounting auditors shall be governed by the provisions on mandate, including Civil Code article 644. The Civil Code specifies:

##### Duty of Care of Mandatary

Article 644 A mandatary shall assume a duty to administer the mandated business with the care of a good manager in compliance with the main purport of the mandate.

A 'mandatary' in the corporate context is one that has been given a mandate to oversee or manage the affairs of the company. Article 644 thus requires directors to exercise the care that a good manager would exercise. Article 355 of *Companies Act of Japan* also sets out a duty of care in their oversight and management of the company as mentioned Part 3.1. Directors are to act with due care; and proving due care is a defence to liability for a number of directors' actions.<sup>107</sup> Equally, where directors are negligent in the performance of their duties, they can be personally liable for the misconduct. Article 429 of the *Companies Act* provides for directors' monetary liability where they are 'with knowledge or grossly negligent in performing their duties' to the third party, and article 423 sets out directors' liability to the company:

##### Liability of Officers to Stock Company for Damages

Article 423(1) If a director, accounting advisor, company auditor, executive officer or financial auditor (hereinafter in this Section referred to as "Officers, Etc.") neglects their duties, they are liable to such Stock Company for damages arising as a result thereof.<sup>108</sup>

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Change- and- Directors- Duties.pdf> ; Chapman Tripp, 'Climate Change Risk— Implications for New Zealand Company Directors and Managed Investment Scheme Providers' (October 2019) Legal Opinion; Carol Hansell, 'Putting Climate Change Risk on the Boardroom Table', <https://law-ccli-2019.sites.olt.ubc.ca/files/2020/06/Hansell-Climate-Change-Opinion.pdf>.

<sup>103</sup> Hansell, *ibid* at 21.

<sup>104</sup> *Companies Act of Japan*, article 355.

<sup>105</sup> Civil Code, article 640.

<sup>106</sup> *Financial Instruments and Exchange Act*, *supra* note 63.

<sup>107</sup> *Companies Act of Japan*, article 52(2)(i), including for actions in the incorporation of a company, liabilities of directors in case of shortfall in value of property contributed, and liability where shares are acquired in response to demand for purchase

<sup>108</sup> Articles 423 (2), (3), (4), *Companies Act of Japan*, relate to interested transactions and potential director conflicts of interest and are not relevant for this paper.

Directors in Japan have a duty of care, to act as a mandatary in the best interest of the company, its shareholders and stakeholders. Directors who neglect their duties are jointly and severally liable to the company for any resulting damages; and where directors are grossly negligent or knowingly fail to perform their duties, such directors are also liable to third parties or shareholders for the resulting damages.<sup>109</sup> However, if directors can demonstrate that they did not fail to exercise their duty of care in the performance of their duties, they will not be held liable.<sup>110</sup>

#### 4.2 Application of Due Care and Diligence in a Climate Risk Context

Since climate change is affecting almost all businesses and has been recognized by governments, courts, and investors as a material issue affecting the sustainability of the company, corporate directors need to recognize their obligation to address climate-related risks and opportunities. Directors could be found in breach of their duties and found personally liable for failures of the duty to act with due care in the best interests of the company in failing to address climate-related risks and opportunities. This liability for breach of their duties is in addition to their potential personal liability for failure to meet the requirements of any statutes or ordinances.

Examples of breach of the duty of care would be a complete failure to engage in oversight of the management of climate-related financial risks; failure to set up appropriate risk management committees or other governance mechanisms to manage risks pursuant to article 348 of the *Companies Act*; failure to make relevant enquiries to management regarding physical and transition risks to the business due to climate change; or failure to seek outside expertise where the directors do not possess the knowledge or expertise to devise a strategy to address climate risk. Other examples might include failure to robustly assess the assumptions underlying revenue/cost projections for climate-related disruption, and failure to ensure assets and supply chains are resilient to foreseeable physical climate risks.

In Canada and the UK, directors' duty of care is assessed by an objective standard, as has also been suggested by the Supreme Court of Japan.<sup>111</sup> The obligation of directors to consider the implications of climate change risk is grounded in the duties each director owes to the corporation he or she serves. In their oversight of management of climate risks, directors must meet the objective standard of what a reasonably prudent person would do in comparable circumstances.<sup>112</sup> As Hansell as observed:

Among other things, directors must put aside their own preconceptions about the reality or imminence of climate change risk. They may not demure to management and simply wait for presentations to be made to them. Directors must put climate change on the board agenda. They must require reports and recommendations from management and external sources as necessary, and be satisfied that the corporation is addressing climate change risk appropriately.<sup>113</sup>

This insight arguably also applies in the Japanese corporate context.

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<sup>109</sup> Yamaguchi *et al*, *supra* note 70.

<sup>110</sup> *Ibid*, see the discussion below on the business judgment rule.

<sup>111</sup> Please see the discussion in part 4.6 of this report.

<sup>112</sup> See for example, the Supreme Court of Canada judgments in *Peoples Department Stores Inc (Trustee of) v Wise*, 2004 SCC 68 at para 63 and *BCE Inc v 1976 Debentureholders*, 2008 SCC 69 at para 44.

<sup>113</sup> Hansell, *supra* note 102 at 1.

#### 4.3 The Duty of Care for Public Companies is Reinforced by Japan's Corporate Governance Code

Japan's Corporate Governance Code, published by Tokyo Stock Exchange, requires publicly-listed companies to address ESG and other sustainability issues proactively.<sup>114</sup> The Corporate Governance Code specifies that 'Companies should take appropriate measures to address sustainability issues, including social and environmental matters' and that 'given the increasing demand and interest with respect to sustainability issues in recent years, the board should consider addressing these matters positively and proactively'.<sup>115</sup> The Corporate Governance Code states that 'while the quantitative part of financial statements of Japanese companies conform to a standard format and therefore excel with respect to comparability, qualitative and non-financial information, such as financial standing, business strategies, risks and ESG (environmental, social and governance) matters, is often boiler-plate and lacking in detail, therefore less valuable'.<sup>116</sup> The board should actively commit to ensuring that disclosed information, including non-financial information, is as valuable and useful as possible.<sup>117</sup>

The Corporate Governance Code is non-binding on companies, but it does strongly influence governance norms. Since climate-related financial risks and opportunities are part of ESG, the Code supports directors' efforts to effectively manage climate change impacts. The Corporate Governance Code has the potential to be instrumental for certain companies, particularly in light of the fact that many companies are voluntarily adhering to it. The impact of soft-law and its appreciation by the Japan Financial Services Agency is influenced by developments in the UK by financial services regulators, and Japan can draw on the experiences of regulators internationally. For example, New Zealand and the UK have announced that TCFD disclosure will become mandatory for companies subject to their jurisdiction, and the UK is moving towards mandatory disclosure of company efforts to reach net-zero emissions.<sup>118</sup>

Arguably, the principles of the Corporate Governance Code that are adopted by a company should be treated as 'fundamentally important internal rules' of the company such that directors have a duty of care not to ignore these principles. A stock company listed on the TSE may choose to comply with each principle of the Corporate Governance Code or explain the reasons why it is not complying. However, once the company, through its legitimate decision-making process, has chosen to comply with specified principles of the Code, directors, officers, and employees must adhere to the company's decision and have no freedom to choose to comply or not.

Adoption of the Corporate Governance Code is communicated to the TSE in a statement. While it does not create a new contractual obligation, the company has committed to board governance practices that comply with the principles endorsed. Failure to comply with the principles adopted could jeopardize the company's listing. Thus, any failure to meet the commitments the company has made to the listing exchange would be assessed as part of the directors meeting their statutory duty of care to act in the best interests of the company. The obligations owed to the company are to comply with all the adopted principles, unless the board subsequently decides to officially change its decision from compliance to non-compliance by explaining their reasons for the change.

<sup>114</sup> Corporate Governance Code, *supra* note 64.

<sup>115</sup> *Ibid*, Principle 2.3, at 10.

<sup>116</sup> *Ibid* at 13

<sup>117</sup> *Ibid*.

<sup>118</sup> Ministry for the Environment, Government of New Zealand, *Climate Related Financial Disclosures*, (21 September 2020), <https://www.mfe.govt.nz/climate-change/climate-change-and-government/mandatory-climate-related-financial-disclosures>; HM Treasury, *Chancellor sets out ambition for future of UK Financial Services*, (9 November 2020), [https://www.gov.uk/government/news/chancellor-sets-out-ambition-for-future-of-uk-financial-services?utm\\_source=POLITICO.EU&utm\\_campaign=f1fb3a3a16-EMAIL\\_CAMPAIGN\\_2020\\_11\\_09\\_05\\_28&utm\\_medium=email&utm\\_term=0\\_10959edeb5-f1fb3a3a16-190626680](https://www.gov.uk/government/news/chancellor-sets-out-ambition-for-future-of-uk-financial-services?utm_source=POLITICO.EU&utm_campaign=f1fb3a3a16-EMAIL_CAMPAIGN_2020_11_09_05_28&utm_medium=email&utm_term=0_10959edeb5-f1fb3a3a16-190626680).

The Corporate Governance Code principles chosen by corporate boards determine the fundamental governance structure of the company together with the company articles. Given the fundamental nature of the governance principles chosen, arguably all the directors of the company owe a duty of care not to simply ignore the principles chosen by the company for compliance. The decision of the board on which principles to adopt is examined through the lens of the business judgment rule. If a non-compliant director is trying to persuade the board to change the company's official decision, that action would also be assessed in terms of whether or not the director has met his or her duty of care.

Principle 2.1 of the Corporate Governance Code states that 'Guided by their position concerning social responsibility, companies should undertake their businesses in order to create value for all stakeholders while increasing corporate value over the mid- to long-term. To this end, companies should draft and maintain business principles that will become the basis for such activities.'<sup>119</sup> The setting of corporate goals and strategic direction is a major aspect of directors' responsibilities.<sup>120</sup> Principle 4.5 of the Code specifies that the fiduciary responsibilities of directors and *kansayaku* require that they 'secure the appropriate cooperation with stakeholders and act in the interest of the company and the common interests of its shareholders.'<sup>121</sup> In order to promote sustainable corporate growth over the mid- to long-term, the directors are to set corporate strategy, and carry out effective oversight of directors and the management from an independent and objective standpoint, regardless of the form of corporate structure.<sup>122</sup>

In the application of these basic principles to climate governance, of note is that the TSE reports that almost all of the principles have been adopted by companies listed on its exchange. Therefore, practically, it would be near-impossible for a non-compliant director to convince the board to switch from compliance to non-compliance of the Code as part of their duties of care and loyalty. As a result, it would be possible to argue that failure to consider climate risks and opportunities over the mid-to-long term in determining strategies for the company's sustainable growth constitutes a breach of duty of care.<sup>123</sup> For instance, directors of a company with very large fossil fuel positions in their business or investment portfolio are arguably obligated to create a mid-to-long term strategy to reallocate business resources from fossil fuels to new opportunities to achieve sustainable growth, embedding that strategy in their mid-term business plan.<sup>124</sup>

In addition to their articles of association, publicly-listed Japanese companies normally have a number of internal rules such as board meeting rules, risk management rules, and rules regarding operation of board committees, all of which directors must comply with. Internal approval processes tend to be formal based on such internal rules.<sup>125</sup> A company can change any internal rule if directors find it is unreasonable or impractical. Equally, a director can be held personally liable for a breach of duty of care when violating an important internal rule.<sup>126</sup>

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<sup>119</sup> *Ibid* at 10.

<sup>120</sup> *Ibid*, Principle 4.1.

<sup>121</sup> *Ibid*, Principle 4.5.

<sup>122</sup> *Ibid* Principle 4.

<sup>123</sup> Similar analysis has been undertaken in the UK, Canada and Australia, see Sarah Barker and Ellie Mulholland, *Directors' Liability and Climate Risk: Comparative Paper – Australia, Canada, South Africa, and the United Kingdom* (CCLI 2019), <https://ccli.ouce.ox.ac.uk/wp-content/uploads/2019/10/CCLI-Directors%E2%80%99Liability-and-Climate-Risk-Comparative-Paper-October-2019-vFINAL.pdf> (hereafter Barker and Mulholland).

<sup>124</sup> Mid-term business plans (*chuuki keiei keikaku*) for Japanese companies are typically 3-year plans. Corporate Governance Code, *supra* note 64.

<sup>125</sup> The terms *Kessai* and *Ringi* refer to a Japan-specific internal procedures to decide some issues in a company, and they are not relevant in the climate context as they do not relate to issues of the binding power of directors' decisions.

<sup>126</sup> In a Tokyo High Court judgment dated May 21 in the 20th year of Heisei, a director who executed a derivative transaction in contravention of the internal risk management rule was held liable for damages in breach of duty of care, *Yakult Honsha co, Ltd. Case*, 1281 Hanrei jiho 274 (Tokyo High Ct, 21 May 2008).

Similarly, the Corporate Governance Code principles adopted should be treated as important internal rules of the company. While there are not yet any Japanese court precedents in which any principles have been applied to a director's duty, since the Corporate Governance Code's early introduction, it has been aimed at making directors' duty of care and duty of loyalty effective in practice by providing an important framework.<sup>127</sup> For example, the notes to principle 4 state:

the reasonableness of the decision-making process at the time of the decision is generally considered an important factor in determining whether or not the management and directors should owe personal liability for damages. The Code includes principles and practices that are expected to contribute to such a reasonable decision-making process, and promote transparency, fairness, timeliness and decisiveness as well.<sup>128</sup>

The Corporate Governance Code offers an important framework and standards of objective reasonableness that are helpful in determining directors' duty of care and duty of loyalty. It will likely be relied on in any lawsuit seeking a director's personal liability for damages.

The Corporate Governance Code also contains principles for independent directors, notwithstanding that they are not currently the norm, linking their activities to sustainable growth.<sup>129</sup> As noted above, the Corporate Governance Code is non-binding, but it may have created some normative pressure on corporate directors to identify and oversee material ESG risks and opportunities, including climate related-financial risk. If ESG factors are part of the key performance indicators (KPI) of the company's mid- and long-term business plan and are indicators of medium-to-long-term performance-linked compensation, directors would have the obligation to make efforts to promote climate change mitigation and adaptation.<sup>130</sup> Almost all listed stock companies make mid- and long-term business plans and set non-financial factors as KPI. Several companies make ESG factors indicators of directors' performance-linked compensation, and management of climate-related risks and opportunities is therefore part of their mandate.

The United Nations Principles for Responsible Investing organization (UN PRI) has observed that Japan's Corporate Governance Code should result in improved disclosure of key ESG issues, including in cross-shareholdings, and should enhance corporate governance expectations.<sup>131</sup> In 2017, it concluded that Japan lagged in understanding that ESG integration refers to the systematic and explicit inclusion of material ESG factors into portfolio analysis and investment decisions.<sup>132</sup>

#### 4.4 Duty of Care to Other Stakeholders

There is currently no express duty of care to stakeholders set out in Japan's corporate legislation. However, Japan's corporate governance structure has a long history of concern for stakeholders beyond shareholder interests, situating the activities of companies within an elaborate framework of intercompany crossholdings and an understanding of the company as embedded in the community, with strong relationships with employees, customers, and stakeholders that are part of the company's supply chain.<sup>133</sup> Given this extensive history, normatively, directors should be thinking about the social and consumer risks of climate change, as discussed in part 1 above.

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<sup>127</sup> Corporate Governance Code, *supra* note 64, preamble.

<sup>128</sup> *Ibid* at 17.

<sup>129</sup> *Ibid*, Principle 4.5. See Appendix II.

<sup>130</sup> See the discussion of compensation in Appendix I.

<sup>131</sup> United Nations PRI, 'Fiduciary duty in the 21st century: Japan roadmap' (25 April 2017), <https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century-japan-roadmap/262.article>.

<sup>132</sup> *Ibid* at 6.

<sup>133</sup> For a discussion, see Sarra and Nakahigashi, *supra* note 64.



Directors have a responsibility to consider mid- and long-term interests of the company. Directors are allowed to consider stakeholders' interests, but in Japan, this consideration should contribute to long-term success of the company and thus ultimately to shareholders' benefit. In most cases, directors, who consider stakeholders' interests important will be protected by the business judgment rule, discussed below in part 4.6.

When shareholders' interests come into conflict with the other stakeholders' interests, directors must make decisions in the best interests of the company because they legally owe duties to company and shareholders. Their climate governance decisions must either arise out of their legal obligations to manage risks to the company or out of shareholder decisions amending the company articles to expressly embed policies such as targets to move to net-zero carbon emissions. As in many countries, leadership by the corporate board will be essential to managing climate-related risks and opportunities and to embedding consideration of stakeholder interests into climate governance.

The Corporate Governance Code, while stating that companies should 'take appropriate measures to fully secure shareholder rights and develop an environment in which shareholders can exercise their rights appropriately and effectively', also states:

Companies should fully recognize that their sustainable growth and the creation of mid- to long-term corporate value are brought as a result of the provision of resources and contributions made by a range of stakeholders, including employees, customers, business partners, creditors and local communities. As such, companies should endeavor to appropriately cooperate with these stakeholders. The board and the management should exercise their leadership in establishing a corporate culture where the rights and positions of stakeholders are respected and sound business ethics are ensured.<sup>134</sup>

The Code also states that the 'appropriate actions of companies based on the recognition of their stakeholder responsibilities will benefit the entire economy and society, which will in turn contribute to producing further benefits to companies, thereby creating a virtuous cycle.'<sup>135</sup> Although the Code is not part of the statutory directors' duty of care, it creates best practice norms that support management of climate-related financial risks and opportunities, and, as noted above, may ground an action in respect of the duty of care where the principles have been adopted by the company and a director has failed to comply.

### 4.5 Institutional Investors' Fiduciary Obligations Have an Impact on Corporate Directors' Duties

Institutional investors also have fiduciary obligations to address climate-related risk, as discussed in Appendix III. The fact that institutional investors are increasingly acknowledging that their fiduciary obligations include investing in companies that are reducing their carbon footprints and are developing innovative technologies for climate mitigation and adaptation means that investee companies are directly affected by these decisions shifting investment portfolios towards climate-mitigating activities. If company directors fail to recognize these strong shifts in capital markets activity, they may be in breach of their duty of care.

### 4.6 Deference to Business Judgment of Corporate Directors

It is only in the past ten years that the Japanese courts have recognized a 'business judgment rule' that gives deference to the decisions of directors in appropriate circumstances.<sup>136</sup> In the *Apamanshop* case,

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<sup>134</sup> Corporate Governance Code, *supra* note 64, Principle 2.

<sup>135</sup> *Ibid* at 9.

<sup>136</sup> Puchniak and Nakahigashi, *supra* note 72.

the Supreme Court of Japan overturned a High Court judgment finding that directors had breached their duty of care in agreeing to a deal carried out for the purpose of making a partially-owned subsidiary a wholly-owned subsidiary of Apamanshop as a part of the corporate group's restructuring plan.<sup>137</sup>

The Supreme Court of Japan held that 'so long as there are no significantly unreasonable aspects involved in the process and content of such decisions, it should be understood that the directors will not violate their duty of care as directors'.<sup>138</sup> In arriving at its decision, the Supreme Court placed considerable weight on the directors' reasonable deliberations of the relevant facts at the board meeting and on the directors' decision to seek and follow a lawyer's opinion.<sup>139</sup> The Court cited several specific factors, such as the short time period since the partially-owned subsidiary's public offering, the range in the value of its unlisted shares, the essential nature of the affiliated shops, the relationship between the entities, and the corporate group's future business, concluding that the content of the decision was not 'significantly unreasonable'.<sup>140</sup>

The decision was the first time that the business judgment rule was explicitly applied by the Supreme Court of Japan, particularly significant because of several judgments in the period prior that expressly did not defer to business judgment.<sup>141</sup> The framework used by the Supreme Court suggests that directors' managerial decisions should be protected from liability by the business judgment rule when: (1) the decision was based on reasonable research and analysis of the relevant facts; and (2) the decision was not irrational or inappropriate in comparison to what a reasonable manager in the specific business environment would have decided.<sup>142</sup> Thus deference to the directors' business judgment depends on the directors actually turning their minds to an issue. Courts are unlikely to defer to directors where there has been inaction on climate change or failure to exercise oversight of management of climate-related financial risks.

Puchniak and Nakahigashi observe that the willingness of courts in Japan to engage in a detailed examination of the reasonableness of the content of directors' decisions distinguishes the Japanese business judgment rule from the business judgment rule in the US.<sup>143</sup> Unlike the US rule, directors in Japan are unlikely to be released from the duty of care or duty of loyalty under the Japanese business judgment rule solely by their state of mind, *eg*, acting in good faith or in their belief for the best interest of the company. The Supreme Court of Japan's reasoning appears closer to the business judgment rule as defined by Canadian courts.

The Supreme Court of Canada has held that many decisions made in the course of business, although ultimately unsuccessful, are reasonable and defensible at the time they are made; and that provided the decision taken is within a range of reasonableness, courts are unlikely to substitute their opinion for that of the board, even though subsequent events may have cast doubt on the board's determination.<sup>144</sup> However, the Canadian Supreme Court has also held that the courts 'are capable, on the facts of any case, of determining whether an appropriate degree of prudence and diligence was

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<sup>137</sup> *Ibid* at 220.

<sup>138</sup> Supreme Court of Japan Decision, Part 4, para 2.

<sup>139</sup> *Ibid*, Part 4, para 3.

<sup>140</sup> Puchniak and Nakahigashi, *supra* note 72 at 8.

<sup>141</sup> *Ibid* at 222, citing M Kitamura, 'Hi-jōjō-kaisha no kabushiki no kaitori to keiei-handan-no-gensoku' [Purchase of Shares in Unlisted Corporations and the Business Judgment Rule], in *Juristo* 1420 (2011) 139; and R Kobayashi, 'Hi-jō-jōkaisha no kaitori kakaku no kettei to torishimariyaku no zenkan-chui-gimu-ihan no umu' [Decision of Purchase Price of Unlisted Companies and the Existence of Directors' Breach of the Duty of Care], in *Hanrei Select* 2010 [II] (2010) 18. For the Kitamura article in Japanese, 非上場会社の株式の買取りと経営判断の原則. For the Kobayashi article in Japanese, 非上場会社の買取価格の決定と取締役の善管注意義務違反の有無.

<sup>142</sup> Puchniak and Nakahigashi, *supra* note 72 at 223.

<sup>143</sup> *Ibid* at 9, 11.

<sup>144</sup> *BCE Inc v 1976 Debentureholders*, 2008 SCC 69 at para 39, (2008) 3 SCR 560 at para 64.

brought to bear in reaching what is claimed to be a reasonable business decision at the time it was made'.<sup>145</sup> The specificities of the elements necessary to find a breach of the duty of care in Japan may facilitate a finding by a court that directors breached their duty of care.

Given the scientifically predictable nature and magnitude of climate change risks, arguably directors are required by their duty of care under the *Companies Act of Japan* to be educated by appropriate external experts, to have the skills and information to appropriately assess material risks and opportunities to the company and maintain command of climate-related risks and opportunities. If they do not have climate expertise on the board, directors need to ensure that they have that expertise within the company's management or to hire external expertise.<sup>146</sup>

For duly diligent directors, the Court's recognition of a business judgment rule may offer a defence to specific actions to address climate mitigation and adaptation, when hindsight information suggests that the directors should have made a different decision. However, the business judgment rule does not offer a safe haven to directors that fail to act on climate-related risk. Japanese courts have been clear that they will examine not only the process used to reach the business decision but also undertake an objective review of the duty of care to assess whether a director acted significantly unreasonably from an objective standpoint at the time of the decision-making. This objective assessment by the courts is also reflected in case law in Canada, the UK, and Australia,<sup>147</sup> and if anything, is likely to be an even more stringent test applied by Japanese Courts.

The contours of Japanese courts' deference to business judgment are likely to develop further in the future. However, it seems evident that with respect to climate change, where directors neglect to undertake reasonable research and analysis of the relevant facts, fail to get expert advice on climate-related-risk management, and fail to exercise due care in respect of climate risks, the courts are unlikely to defer to their business judgment, because directors will have failed to exercise any judgment at all or will have failed to engage in a reasonable assessment of the risks.

Litigation is a less-used strategy for holding Japanese corporate directors accountable for breaches of their duties of care, loyalty, and adherence to the law. However, Japanese corporate law does allow for derivative actions by shareholders, which may offer an avenue for future litigation in respect of directors' failure to manage climate-related risks.<sup>148</sup> Shareholders who have continuously held shares for more than six months may demand that the company sue its directors, and if the company does not file the lawsuit within 60 days of the demand, the shareholders may bring a derivative action on behalf of the company.<sup>149</sup> Assuming the lawsuit is well-founded, a derivative action can overcome financial barriers to holding directors accountable as it can be funded from the company's assets.

Shareholder engagement with investee companies is another avenue to hold directors and officers accountable for their management and oversight of climate change risks and the next part turns to shareholder proposals as a growing corporate engagement strategy.

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<sup>145</sup> *Ibid.*

<sup>146</sup> See international authorities such as the World Economic Forum, *The Global Risks Report 2020*, (2020), <https://www.weforum.org/reports/the-global-risks-report-2020> and TCFD Final Report, *supra* note 11.

<sup>147</sup> See for example, Janis Sarra, *Fiduciary Obligations in Business and Investment: Implications of Climate Change* (CCLI, 2018) [janis-cover.pdf \(ubc.ca\)](#); Sarah Barker, *Directors' Liability and Climate Risk: Australia - Country Paper* (CCLI 2018), <https://ccli.ouce.ox.ac.uk/wp-content/uploads/2018/04/CCLI-Australia-Paper-Final.pdf>; and Alexia Staker and Alice Garton, *Directors' Liability and Climate Risk: United Kingdom - Country Paper* (CCLI April 2018), <https://ccli.ouce.ox.ac.uk/wp-content/uploads/2018/04/CCLI-UK-Paper-Final.pdf>.

<sup>148</sup> *Companies Act of Japan*, article 847.

<sup>149</sup> *Ibid.* Shareholders of a parent company may also file a derivative suit against directors of wholly owned subsidiaries if such subsidiary does not file the lawsuit within 60 days of the demand against the subsidiary by the parent company's shareholders.

## 5. SHAREHOLDER PROPOSALS UNDER THE *COMPANIES ACT*

In Japan, a shareholder can bring a shareholder proposal to the company's management to amend the articles of incorporation. A shareholder proposal that receives a majority of two-thirds or more of the votes of the shareholders present at the meeting is binding on directors.<sup>150</sup> Note that it is the votes exercised by shareholders present and voting at the meeting; it does not include any unexercised votes. To amend the articles of incorporation, a special resolution by shareholders' meeting is necessary, which can be approved by the same majority or the corporate articles can specify a higher threshold of votes required before the corporate articles can be revised.<sup>151</sup> Article 355 of the *Companies Act of Japan* requires directors and officers to obey resolutions of shareholders' meetings that receive the requisite level of shareholder support, similar to corporate legislation in the UK and elsewhere.<sup>152</sup>

Amendments to the *Companies Act* in 2019 included changes to the rules governing shareholder proposals. Only shareholders that hold at least 1 per cent of total votes (usually one unit of 100 shares) or 300 votes can make a shareholder proposal.<sup>153</sup> Pursuant to the amendments, shareholders are now limited in the number of proposals that they can make each year. The amendments will come into effect 1 March 2021, with some amendments, such as providing shareholder meeting materials through the internet, not in effect until 2023.<sup>154</sup>

### 5.1 The Growing Number of Climate-related Shareholder Proposals

If a resolution is passed at a shareholder meeting amending articles of incorporation by the requisite majority stating that the company must promote climate change mitigation and adaptation, directors and managers would have an obligation to comply in accordance with article 355 of *Companies Act*. Failure to comply could result in personal liability.

In Japan, shareholders that hold the requisite votes can propose agenda items, including amending the corporate articles to require consideration of ESG matters, including climate change. However, to date, institutional investors interested in ESG do not constitute the majority at shareholders' meetings in Japan, so it is difficult for them to have the articles of incorporation amended to state that the company must set targets for decarbonization and climate change mitigation and adaptation. That situation is likely to change as climate change becomes even more urgent.

Shareholder activism is starting to draw attention to the need for climate-related risk management. For example, in June 2020, a shareholder proposal at Mizuho Financial Group, Japan's third largest bank, proposed amending the articles of incorporation to state: 'Noting the company's support for the Paris Agreement and the Task Force on Climate-related Financial Disclosures (TCFD), the company shall disclose in its annual reporting a plan outlining the company's business strategy, including metrics and

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<sup>150</sup> *Companies Act of Japan*, article 309 (2).

<sup>151</sup> *Ibid*, article 309 (2)(xi) and Chapter 5, article 466.

<sup>152</sup> See for example, the Barclays' resolution. Resolution 29, setting the goals of Barclays to be net zero by 2050 and commits it to a strategy, with targets, for alignment of its entire financing portfolio to the goals of the Paris Agreement; Barclays PLC Notice of Annual General Meeting 2020, Letter from Group Chairman (2020), at 1, 4, 13, <https://home.barclays/content/dam/home-barclays/documents/investor-relations/reports-and-events/AGM2020/NOM-2020.PDF>. See also Barclays, 'Update on Barclays' ambition to be a net zero bank by 2050' (30 November 2020), <https://home.barclays/society/our-position-on-climate-change/highlights/>.

<sup>153</sup> *Companies Act of Japan*, article 303(2). Usually one unit of 100 shares gives one vote to the shareholders, therefore the Act indicates number of votes (not number of shares). Listed companies are requested to make one unit by 100 shares by Tokyo Stock Exchange and/or other domestic stock exchanges. 'Standardization of Trading Unit', <https://www.jpx.co.jp/english/equities/improvements/unit/>.

<sup>154</sup> Yamaguchi *et al*, *supra* note 70.

targets, to align its investments with the goals of the Paris Agreement'.<sup>155</sup> This resolution garnered 34.5 percent of votes cast, short of the two-thirds required to pass, but was supported by a significant number of global investors and two major proxy advisory services.<sup>156</sup>

Electric power companies, who operate coal-burning power plants, have received shareholder proposals (titled 'bill' with a number assigned) to add a 'forbidden clause' that would amend the corporate articles to prohibit the company from operating coal-burning power plants in order to adapt to climate change. An example is the general shareholder meeting of Chubu Electric Power Co, Inc on 25 June 2020, in which 28 shareholders with an aggregate of 428 votes proposed adding a clause to the company's articles to prohibit operating coal-burning power plants for the purpose of adapting to climate change.<sup>157</sup> The proposal was rejected, although it received 191,056 votes (3.3 percent of total votes) in favour.<sup>158</sup>

Similar proposals submitted to the annual general shareholder meetings of Tokyo Electric Power Company Holdings, Inc and The Kansai Electric Power Co, Inc in 2020 lost the vote, but garnered 550,632 and 225,715 votes in support respectively.<sup>159</sup> Two municipal governments, Osaka City and Kyoto City, which hold 724,965 votes in Kansai Electric Power Co, proposed (Bill No 29) adding a clause to replace atomic-power plants with renewable energy power plants for the purpose of building a sustainable electric supply service.<sup>160</sup> They called on other shareholders to support their proposal, and while it was rejected, it received 1.32 million votes in favour, about 18.7 per cent of total votes.<sup>161</sup> In

<sup>155</sup> Mizuho Financial Group, 'Mizuho Financial Group Convocation Notice of the 18th Ordinary General Meeting of Shareholders', (2020 at 55, [https://www.mizuhogroup.com/binaries/content/assets/pdf/mizuhoglobal/investors/financial-information/stock-information/meeting18\\_1\\_eng.pdf](https://www.mizuhogroup.com/binaries/content/assets/pdf/mizuhoglobal/investors/financial-information/stock-information/meeting18_1_eng.pdf)).

<sup>156</sup> 'Mizuho investors reject Japan's first shareholder climate resolution', *The Japan Times* (25 June 2020), <https://www.japantimes.co.jp/news/2020/06/25/business/corporate-business/mizuho-investors-reject-shareholder-climate-resolution/#:~:text=Mizuho%20investors%20reject%20Japan%27s%20first%20shareholder%20climate%20resolution,-Sorry%2C%20but%20your&text=Mizuho%20Financial%20Group%20Inc.,-investors%20rejected%20a&text=The%20resolution%2C%20which%20its%20sponsor,aligned%20with%20the%20Paris%20Agreement>.

<sup>157</sup> Chubu Electric Power Co, Inc, *Dai 96 kai Teijikabunushisoukai Syousyu-go-tuchi* [Notice of Calling of 96<sup>th</sup> general Shareholders Meetings] No 8 bill [in Japanese], [https://www.chuden.co.jp/resource/ir/ir\\_kabunushi/ir\\_sokai/ir\\_sokai\\_96\\_01.pdf](https://www.chuden.co.jp/resource/ir/ir_kabunushi/ir_sokai/ir_sokai_96_01.pdf).

<sup>158</sup> Chubu Electric Power Co, Inc, *Rinji Houkokusyo* [Extraordinary Report requested by Financial Instruments and Exchange Act] (2020/06/26) [in Japanese], [https://www.chuden.co.jp/ir/ir\\_siryu/yukashoken/\\_icsFiles/afiedfile/2020/06/26/96rinjihoukokusho\\_3\\_1.pdf](https://www.chuden.co.jp/ir/ir_siryu/yukashoken/_icsFiles/afiedfile/2020/06/26/96rinjihoukokusho_3_1.pdf).

<sup>159</sup> Tokyo Electric Power Company Holdings, Inc, general shareholder meeting on June 25<sup>th</sup> of 2020. No 4 bill, 215 shareholders who totally have 1753 votes proposed to add a forbidden clause to operate coal-burning power plants for the purpose of adapting climate change to the articles of incorporation. Tokyo Electric Power Company Holdings, Inc, *Dai 96 kai Teijikabunushisoukai Syousyu-go-tuchi* [Notice of Calling of 96<sup>th</sup> general Shareholders Meetings] No 4 bill [in Japanese], [https://www4.tepco.co.jp/about/ir/stockinfo/pdf/200526\\_1-j.pdf](https://www4.tepco.co.jp/about/ir/stockinfo/pdf/200526_1-j.pdf). This bill proposing a clause forbidding operation of coal-burning power plant was rejected, although 550,632 votes, about 2.12 per cent of the total votes, supported it. Tokyo Electric Power Company Holdings, Inc, *Rinji Houkokusyo* [Extraordinary Report requested by Financial Instruments and Exchange Act] (2020/07/02) [in Japanese], [https://www4.tepco.co.jp/about/ir/library/securities\\_report/pdf/200702-j.pdf](https://www4.tepco.co.jp/about/ir/library/securities_report/pdf/200702-j.pdf). The Kansai Electric Power Co, Inc, The 96<sup>th</sup> general shareholder meeting on June 25<sup>th</sup> of 2020, No 8 bill; 28 shareholders who totally have 424 votes suggested to add a forbidden clause to operate coal-burning power plants for the purpose of adapting climate change at the articles of incorporation.

<sup>160</sup> Osaka City, *Kansai Denryoku Kabusikaisya nitaisteno Kabunushiteian* [The shareholder's proposal to the Kansai Electric Power Co., Inc.] (2020.06.30) [in Japanese], <https://www.city.osaka.lg.jp/kankyo/page/0000264358.html#r020427>. The Office of Adopting Global Warming at the Bureau for Environmental Policy of Kyoto City, *Datsu Genpatu Syakai no Jitsugen he* [Getting out from depending Nuclear Plant] (2020.06.11) [in Japanese], <https://www.city.kyoto.lg.jp/kankyo/cmsfiles/contents/0000271/271137/R2koho.pdf>; The Kansai Electric Power Co, Inc, *Dai 96 kai Teijikabunushisoukai Syousyu-go-tuchi* [Notice of Calling of 96<sup>th</sup> general Shareholders Meetings] No 8 and No 29 bills [in Japanese], [https://www.kepco.co.jp/ir/stockholder/meeting/96kai/\\_icsFiles/afiedfile/2020/05/26/96\\_syosyu.pdf](https://www.kepco.co.jp/ir/stockholder/meeting/96kai/_icsFiles/afiedfile/2020/05/26/96_syosyu.pdf). It received 225,715 votes, about 3.2 per cent of total votes.

<sup>161</sup> The Kansai Electric Power Co, Inc, *Rinji Houkokusyo* [Extraordinary Report requested by Financial Instruments and Exchange Act] (2020/06/26) [in Japanese] (2020/06/29),

these examples, the company directors opposed the shareholders' bills (proposals) because they did not want a narrowing of their managerial discretion. The case of the Kansai Electric Power Co differs from the other two cases, as many shareholders agreed with the shareholder proposal to embed ESG in the articles of incorporation. In this case, there were two separate shareholder proposals that received different levels of support.

In electric power companies, local governments are influential shareholders. Osaka City has 7.64 per cent of issued shares of the Kansai Electric Power Company, and is its biggest shareholder. The mayor of Osaka, Ichiro Matsui, submitted the shareholder proposal (No 29 bill) with Kyoto City as co-sponsoring shareholder.<sup>162</sup> Even though the proposal did not succeed at the shareholder meeting, it sent messages to management of the Kansai Electric Power Co and citizens of these municipalities. Osaka City will continue to pursue its efforts to make Kansai Electric Power Company take positive action to replace atomic-power plants with renewable energy power plants, a particularly important safety issue after the Fukushima nuclear accident in 2011.<sup>163</sup>

Climate change is increasingly a financial issue for companies. As noted in part 1, investors have made it clear that climate change is a financial risk that needs to be managed, placing these proposals squarely within the duties of directors to undertake oversight and management in the best interests of the company.

There is growing interest in implementing climate mitigation and adaptation strategies utilizing shareholder proposals, and shareholders are increasingly persuaded that companies should act on climate change mitigation and adaptation. Given the binding nature of successful shareholder proposals, shareholders could eventually require companies to amend their articles of incorporation to require specific actions on climate change risk management, including disclosure of their action plans and measurable targets to decarbonize.

Increasing shareholder engagement has also resulted in direct meetings between institutional investors and corporate boards. The Climate Action 100+ network, which includes 540 investors responsible for over \$52 trillion in assets under management, is engaging companies on improving climate change governance, cutting emissions, and strengthening climate-related financial disclosures.<sup>164</sup> It is seeking commitments from corporate boards to Implement a strong governance framework that clearly articulates the board's accountability and oversight of climate change risk; to take action to reduce GHG emissions across the value chain, moving towards net-zero emissions by 2050 or sooner; and to provide enhanced corporate disclosure in line with the TCFD and sector-specific Global Investor Coalition on Climate Change Investor Expectations on Climate Change guidelines.<sup>165</sup> Climate Action 100+'s 'Net-Zero Company Benchmark', developed in 2020 in collaboration with EY and almost 50 signatory investors, investor network experts, and leading climate research and data non-governmental organizations, urges companies to establish assessment indicators that are robust, fair, and applicable to local markets and across sectors.<sup>166</sup>

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[https://www.kepcoco.jp/ir/stockholder/meeting/96kai/\\_icsFiles/afieldfile/2020/06/29/report\\_20200629\\_1.pdf](https://www.kepcoco.jp/ir/stockholder/meeting/96kai/_icsFiles/afieldfile/2020/06/29/report_20200629_1.pdf)

<sup>162</sup> The Mayor of Osaka is one of joint representative leaders of the national political party, *Nihon Ishin no Kai* [Japan Innovation Party], which is a nongovernmental party, but on several political issues, it cooperates with national government.

<sup>163</sup> Osaka City, *Kansai Denryoku Kabusikikaisya nitaisiteno Kabunushiteian* [The shareholder's proposal to the Kansai Electric Power Co., Inc.] (2020.06.30) [in Japanese], <https://www.city.osaka.lg.jp/kankyo/page/0000264358.html#r020427>.

<sup>164</sup> Climate Action 100+, <https://www.climateaction100.org/about/>.

<sup>165</sup> Climate Action 100+, 'The Three Asks', (2020), <https://www.climateaction100.org/approach/the-three-asks/>.

<sup>166</sup> Climate Action 100+ Net-Zero Company Benchmark, (2020), <https://www.climateaction100.org/progress/net-zero-company-benchmark/>.



## 6. DUTY OF DISCLOSURE

It is in the area of disclosure that Japan is moving most rapidly to identify and manage climate-related risks, generally as part of ESG factors that companies and investors are increasingly identifying as important. The 2018 revised Corporate Governance Code calls for companies to disclose non-financial ESG information in a valuable and useful way. The Code also states that listed companies should disclose information on governance in a corporate governance report. What is less clear is the extent to which Japan has recognized that many climate risks are financially material, not just non-financial risks. While the obligations under financial services laws are obligations of the company, the directors are responsible for ensuring the accuracy of the company's financial reporting, and both companies and directors can receive fines or other sanctions for failing to comply with the law.

### 6.1 Disclosure and Reporting Requirements

The duty to disclose is embedded in the *Financial Instruments and Exchange Act (FIEA)*, which, in 2006, replaced the former Securities and Exchange Act, the Law Concerning Foreign Securities Firms, and the Law Concerning the Regulation of Investment Advisory Services Relating to Securities.<sup>167</sup> As of October 2020, there has been no express direction by Japan's securities regulators that companies must disclose the breadth and nature of climate-related financial risks. However, the *FIEA* requires disclosure of material business risks, which means material business risks arising from climate change. To date, it is often reported as 'non-financial information' in annual reports. The Japan Stock Exchange has also strongly endorsed ESG disclosure, including disclosure of climate-related risks, as discussed in part 6.6 below.

There have been a number of recent regulatory and guidance developments aimed at enhancing the disclosure of ESG risks and opportunities, including climate-related risks and opportunities.

### 6.2 Financial Instruments and Exchange Act Disclosure

The *FIEA* was enacted to enhance fairness and transparency, and to restore confidence in the Japanese capital markets.<sup>168</sup> The 'Fair Disclosure Rule Guidelines' specify that 'material information' refers to the 'undisclosed material information about the operations, business, or assets of the listed company, etc, which has a material influence on investors' investment decisions'.<sup>169</sup> The provisions of Article 27-36 of the *FIEA*, generally referred to as the 'fair disclosure rule', were introduced to ensure fair disclosure of information to investors.<sup>170</sup> The rule is applicable to information of a precise nature that, if it were disclosed, is likely to have a material influence on the value of securities.<sup>171</sup> Where the relevant information falls under the category of material information, the listed company must promptly disclose it.<sup>172</sup>

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<sup>167</sup> *Financial Instruments and Exchange Act*, *supra* note 63.

<sup>168</sup> Financial Services Agency, Japan, 'New Legislative Framework for Investor Protection - Financial Instruments and Exchange Law', <https://www.fsa.go.jp/en/policy/fiel/20061010.pdf>.

<sup>169</sup> As provided in Article 27-36, paragraph (1) of the Act. Planning and Coordination Bureau, Financial Services Agency, 'Points to Note Regarding Article 27-36 of the Financial Instruments and Exchange Act (Fair Disclosure Rule Guidelines)', (April 2018), translation at [https://www.fsa.go.jp/en/laws\\_regulations/disclosure/20180206-2.pdf](https://www.fsa.go.jp/en/laws_regulations/disclosure/20180206-2.pdf). It specifies: 'These guidelines are not binding on determinations made by investigative authorities and judicial decisions including the application of penal provisions. In addition, these guidelines do not guarantee that the Financial Services Agency (FSA) will make the same interpretations as those shown in these guidelines in the future.'

<sup>170</sup> *Ibid* at 5.

<sup>171</sup> *Ibid*.

<sup>172</sup> *Ibid* at 6.



Introduction of the fair disclosure rule was aimed at promoting early disclosure of information by issuers and enhancing dialogue between issuers and investors.<sup>173</sup> Listed companies that are subject to application of the rule are expected to actively disclose information in light of the purpose and significance of the rule.

In terms of future-oriented information, the 'Fair Disclosure Rule Guidelines' specify that:

when specific details of the plan concerning operating profits or net profits that are planned to be disclosed as the contents of the medium-term management plan are pieces of information which, in themselves, can be used for making investment decisions and are likely to have a material influence on the value of securities if they were disclosed and when such details of the plan are to be provided to the investors immediately prior to the disclosure of the medium-term management plan, the provision of such pieces of information may constitute provision of material information.<sup>174</sup>

In January 2019, Japan's Financial Services Agency issued a Cabinet Office Ordinance on Disclosure of Corporate Affairs, which sets out new securities law filing requirements requiring disclosure of business risks.<sup>175</sup> This amendment is critically important as it significantly expands previous mandatory disclosure requirements from disclosing material facts and information to now include requirements to disclose material 'forward-looking risk'. The amendment requires the company to disclose:

- material risks that the management recognizes have the potential to impact the company's financial condition or the cash flow status, together with the explanation of the degree of possibility and time of the occurrence of the risk, and details of the impact the risk will have on operating results if it materializes;
- countermeasures the company is taking against the risk;
- material risks are to be described in an easily understandable way, taking into consideration the materiality of a risk and its degree of relevance to the business policies and strategies;
- the degree of impact that the material risk will have on corporate value, operating results, financial condition, etc;
- with regard to operational and financial issues, companies are required to explain matters that management recognizes as possibly having a material impact on operating results, such as changes to laws and systems that may greatly impact business; and
- in disclosures of the analysis and examination of the cash flow status as well as information on sources of funds and capital liquidity, companies are required to provide a specific, understandable description of the management's awareness of market trends in capital demands, including funding methods and state of affairs and major uses of capital.<sup>176</sup>

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<sup>173</sup> *Ibid* at 3.

<sup>174</sup> *Ibid* at 5.

<sup>175</sup> 企業内容等の開示に関する留意事項について（企業内容等開示ガイドライン），  
[https://www.fsa.go.jp/common/law/kaiji/200501\\_kaiji.pdf](https://www.fsa.go.jp/common/law/kaiji/200501_kaiji.pdf). Amendment in January 2019 to Cabinet Order concerning Corporate Disclosure ("Corporate Disclosure Order"), Filing Form No 2, Chapter 2 "Corporate Information," Section 2.2 (31) disclosure of "business risks, etc. Cabinet Office Order related to disclosure of corporate contents after amendment in accordance with Cabinet Office Order No 3 of 2019 (announced and enforced on January 31, 2019). An English translation is not yet available, but a discussion can be found in Japan Financial Services Agency, Principles Regarding the Disclosure of Narrative Information, (19 March 2020), <https://www.fsa.go.jp/en/news/2019/20190606-3/01.pdf>; and Financial Services Agency, 'Points to Note Regarding Disclosure of Corporate Affairs (Guideline for the Disclosure of Corporate Affairs)' (April 2020), [https://www.fsa.go.jp/common/law/kaiji/200501\\_kaiji.pdf](https://www.fsa.go.jp/common/law/kaiji/200501_kaiji.pdf).

<sup>176</sup> Financial Services Agency, Principles Regarding the Disclosure of Narrative Information, *ibid*.

While there is no express reference to climate change in the Ordinance, these new requirements align closely with the TCFD framework for disclosure of governance and management of financial risks in their obligation to disclose material risks and their management in the short, medium and long term. It sets the stage for more effective climate governance and disclosure, because once climate risk becomes material, directors need to meet these new requirements.

Also of note is that International Financial Reporting Standards (IFRS) are one of four permitted financial reporting frameworks in Japan.<sup>177</sup> For companies that use IFRS for accounting and financial reporting, the IFRS Foundation has recently issued guidance that states that material climate-related financial information should be reported under many of its standards, including IAS 1 Presentation of Financial Statements, IAS 2 Inventories, IAS 12 Income Taxes, IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets, IAS 36 Impairment of Assets, IAS 37 Provisions, Contingent Liabilities and Contingent Assets, IFRS 7 Financial Instruments: Disclosures, IFRS 9 Financial Instruments, and IFRS 13 Fair Value Measurement.<sup>178</sup> In addition to this specific disclosure, the IFRS states that it is important for companies whose financial position or financial performance is particularly affected by climate-related matters to provide overarching disclosure.<sup>179</sup> Directors of companies using IFRS need to ensure their financial reporting meets these standards.

### 6.3 Ministry of the Environment Practical Guide for Scenario Analysis in Line with the TCFD Recommendations

In March 2020, the MOE issued updated guidance on scenario analysis in line with the TCFD recommendations, expressly recognizing that climate change can present clear risks and opportunities for business management.<sup>180</sup> Its 'Practical Guide for Scenario Analysis in Line with TCFD Recommendations' offers practical examples from 12 companies and useful materials for scenario analysis.<sup>181</sup>

The Practical Guide also sets out the financial opportunities relating to adoption of effective climate governance, including reduced operating costs through efficiency gains; increased production capacity, resulting in increased revenues; increased value of fixed assets such as highly rated energy-efficient buildings; increased revenue through demand for lower emissions products and services; and increased reliability of supply chain and ability to operate under various conditions.<sup>182</sup> It reports that financial impacts from moving to more efficient renewable energy include reduced exposure to future fossil fuel price increases; reduced exposure to GHG emissions and therefore less sensitivity to changes in the cost of carbon; returns on investment in low-emissions technology; increased capital availability; and reputational benefits resulting in increased demand for goods and services; and a better competitive position to reflect shifting consumer preferences, resulting in increased revenues.<sup>183</sup> As of February 2020, 61 financial companies and 161 other companies in Japan were reporting in alignment with the TCFD recommendations.<sup>184</sup>

<sup>177</sup> The others are Japanese GAAP, Japan's Modified International Standards (JMIS), and US GAAP; IFRS Foundation, 'Japan' (2020), <https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/japan/>.

<sup>178</sup> IFRS, 'Effects of climate-related matters on financial statements', (20 November 2020), at 1, <https://www.ifrs.org/news-and-events/2020/11/educational-material-on-the-effects-of-climate-related-matters/>.

<sup>179</sup> *Ibid.*

<sup>180</sup> Ministry of the Environment, Government of Japan Climate Change Policy Division, *The Practical Guide for Scenario Analysis in line with the TCFD recommendations*, 2nd edition (March 2020), at 6, [http://www.env.go.jp/policy/policy/tcfd/TCFDguide\\_2nd\\_EN.pdf](http://www.env.go.jp/policy/policy/tcfd/TCFDguide_2nd_EN.pdf).

<sup>181</sup> MOEJ, 'Practical Guide for Scenario Analysis in Line with TCFD Recommendations, published in March 2019 (<https://www.env.go.jp/en/headline/2396.html>) and 2nd Edition (<https://www.env.go.jp/en/headline/2439.html>) in March 2020.

<sup>182</sup> *Ibid* at 1-13.

<sup>183</sup> *Ibid.*

<sup>184</sup> *Ibid* at 1-8.

#### 6.4 Ministry of Economy, Trade and Industry's (METI's) Guidance for Collaborative Value Creation

The Japan Ministry of Economy, Trade and Industry's (METI's) 'Guidance for Collaborative Value Creation', published in 2017, discusses ESG factors as an important part of a company's sustainability and sustainable growth, highlighting effective governance as core to the entire process of value creation.<sup>185</sup> The Guidance observes that often there have been complaints about a lack of disclosure concerning information on management strategies and their interrelationship with ESG matters, information that is often the basis for long-term investment decisions.<sup>186</sup> It suggests principles for communicating a company's values, business model, strategy, and governance to investors in an integrated manner, linking ESG and strategy.<sup>187</sup>

The Guidance proposes a basic framework for promoting dialogue between companies and investors and for enhancing the quality of information disclosure, serving as a guideline to assist corporate directors to comprehensively communicate key information to investors, including business models, strategies, and governance systems. The Guidance is also designed to be used as a framework for investors to monitor investee companies and conduct engagement activities to fulfill their stewardship responsibilities.

#### 6.5 Japan's TCFD Consortium

As noted in the introduction, the TCFD proposed a comprehensive framework for climate governance, strategy, risk management, and disclosure of targets and metric.<sup>188</sup> As of September 2020, support for the TCFD governance and disclosure framework has grown to over 1,500 organizations globally, representing a market capitalization of over US\$12.6 trillion.<sup>189</sup> As of July 2020, there are 290 Japanese supporters of the TCFD recommendations, making up more than 20 per cent of the total number of supporting organizations worldwide.<sup>190</sup> Japan's Financial Services Agency and the Japan Exchange Group have endorsed the TCFD framework.

In 2019, a Japanese 'TCFD Consortium' was launched as a platform for debate on how to make company disclosure based on the TCFD recommendations more effective, and how to make sure that it leads to more appropriate investment decisions from financial institutions.<sup>191</sup> The Financial Services Agency, the METI and MOE supported the establishment of this industry-led TCFD consortium.<sup>192</sup> METI had established the 'Study Group on Implementing the TCFD Recommendations for Mobilizing Green Finance through Proactive Corporate Disclosures' to consider methods of disclosure in accordance with the TCFD recommendations, leading to the development of the TCFD Consortium's guidance for

<sup>185</sup> Ministry of Economy, Trade and Industry (METI) 'Guidance for Integrated Corporate Disclosure and Company-Investor Dialogues for Collaborative Value Creation - ESG integration, non-financial information disclosure and intangible assets into investment' (29 May 2017), [https://www.meti.go.jp/english/press/2017/pdf/0529\\_004b.pdf](https://www.meti.go.jp/english/press/2017/pdf/0529_004b.pdf) (hereafter METI Guidance).

<sup>186</sup> METI, 'Kachi kyōsō no tame no sōgōteki kaiji/taiwa gaidansu – ESG/hizaimujōhō to mukei shisan tōshi' (2017); METI, 'Guidance for Integrated Corporate Disclosure and Company-Investor Dialogues for Collaborative Value Creation - ESG integration, non-financial information disclosure and intangible assets into investment', (2017) [https://www.meti.go.jp/english/press/2017/pdf/0529\\_004b.pdf](https://www.meti.go.jp/english/press/2017/pdf/0529_004b.pdf).

<sup>187</sup> *Ibid.*

<sup>188</sup> TCFD Final Report, *supra* note 11.

<sup>189</sup> TCFD, 'TCFD Supporters' (September 2020), <https://www.fsb-tcf.org/tcf-supporters/>.

<sup>190</sup> TCFD Consortium, Japan, 'Guidance on Climate-related Financial Disclosures 2.0', (July 2020) at 3, [https://tcf-consortium.jp/pdf/en/news/20081201/TCFD\\_Guidance\\_2\\_0-e.pdf](https://tcf-consortium.jp/pdf/en/news/20081201/TCFD_Guidance_2_0-e.pdf) (hereafter TCFD Consortium, 2.0 report).

<sup>191</sup> TCFD Consortium Japan, 'Guidance for Utilizing Climate-related Information to Promote Green Investment', [https://tcf-consortium.jp/en/news\\_detail/19100802](https://tcf-consortium.jp/en/news_detail/19100802) and <https://tcf-consortium.jp/en>. SASB has also published a TCFD Implementation Guide (<https://www.sasb.org/knowledge-hub/tcf-consortium-implementation-guide/>) in co-operation with the Climate Disclosure Standards Board, and has translated this guide into Japanese (<https://www.sasb.org/knowledge-hub/tcf-consortium-implementation-guide-japanese/>).

<sup>192</sup> UN PRI, *Final Report on Fiduciary Obligation in the 21<sup>st</sup> Century*, at 43, <https://www.unpri.org/download?ac=9792>.

utilizing climate-related information to promote green investment.<sup>193</sup> In July 2020, the TCFD Consortium released *Guidance on Climate-related Financial Disclosures 2.0*.<sup>194</sup>

The TCFD Consortium reports that the organizations that have become TCFD supporters are also playing a major role in reducing national GHG emissions. Pursuant to the *Act on Promotion of Warming Countermeasures*, companies whose GHG emissions are above a certain level are required to report the emissions through a Mandatory Greenhouse Gas Accounting and Reporting System (SHK system).<sup>195</sup> While only 3 per cent of the approximately 12,000 companies reporting to the SHK system have become TCFD supporters, their emissions account for more than 40 per cent of the emissions by all of the reporting companies, encouraging earlier emissions reductions in these companies.<sup>196</sup>

## 6.6 The Practical Handbook for ESG Disclosure

The Japan Exchange Group, Inc and Tokyo Stock Exchange, Inc in March 2020 published a 'Practical Handbook for ESG Disclosure', aimed at supporting listed companies in their efforts to improve ESG disclosure, recognizing that many of the global frameworks for sustainability disclosure have not been translated into Japanese.<sup>197</sup> 'Environmental' includes climate change, resource depletion, waste, pollution, and deforestation.<sup>198</sup> It draws on the work of the Sustainable Stock Exchanges (SSE) initiative, 'Model Guidance on Reporting ESG Information to Investors',<sup>199</sup> the METI's 'Guidance for Integrated Corporate Disclosure and Company-Investor Dialogues for Collaborative Value Creation - ESG integration, non-financial information disclosure and intangible assets into investment';<sup>200</sup> recommendations of the TCFD, and the SASB standards.<sup>201</sup> The Practical Handbook for ESG Disclosure proposes four steps:

### Step 1: ESG Issues and ESG Investment

Understand ESG issues and the current situation around ESG investment.

### Step 2: Connecting ESG Issues to Strategy

Decide on what ESG issues are material to your company's strategy.

### Step 3: Oversight and Implementation

Put in place an internal structure for oversight and implementation of ESG issues and set metrics/targets, to enable steady progress on ESG activities.

### Step 4: Information Disclosure and Engagement

Having linked ESG issues to corporate value, disclose ESG information so it can be used for investment decisions, aiming for mid- to long-term corporate value creation by actively seeking dialogue with investors and other stakeholders.<sup>202</sup>

<sup>193</sup> TCFD Consortium, 2.0 report, *supra* note 190; TCFD Consortium Japan, 'Guidance for Utilizing Climate-related Information to Promote Green Investment', *ibid*. Ministry of Economy, Trade and Industry's Guidance for Climate-related Financial Disclosures, [https://www.meti.go.jp/english/press/2018/1225\\_006.html](https://www.meti.go.jp/english/press/2018/1225_006.html).

<sup>194</sup> TCFD Consortium, 2.0, *supra*, note 190.

<sup>195</sup> *Ibid* at 3-4.

<sup>196</sup> *Ibid* at 3-4.

<sup>197</sup> Japan Exchange Group, Inc and Tokyo Stock Exchange, Inc published a *Practical Handbook for ESG Disclosure*, (31 March 2020), [English translation 25 May 2020], at 17, <https://www.jpex.co.jp/english/corporate/sustainability/esg-investment/handbook/index.html> (hereafter Practical Handbook for ESG Disclosure).

<sup>198</sup> *Ibid* at 9.

<sup>199</sup> Sustainable Stock Exchanges (SSE) Initiative, 'Model Guidance on Reporting ESG Information to Investors', <https://sseinitiative.org/wp-content/uploads/2017/06/SSE-Model-Guidance-on-Reporting-ESG.pdf> (hereafter SSE Model Guidance).

<sup>200</sup> METI Guidance, *supra* note 185.

<sup>201</sup> Practical Handbook for ESG Disclosure, *supra* note 197 at 5.

<sup>202</sup> *Ibid* at 7.

The Handbook recommends that identification and discussion of ESG issues should take place at the board of directors, given its oversight role, and should include outside directors.<sup>203</sup> It notes that the board of directors is responsible for oversight of whether the response to ESG issues is being suitably carried out and leading to corporate value creation; thus, there must be a process for reporting to the board. ESG issues should be included as part of discussions on strategy, risk management, and business planning, and the board should monitor and oversee progress towards targets related to ESG activities.<sup>204</sup> It also recommends that listed companies disclose and provide their ESG information in English so that overseas investors can easily access the information, taking into account what proportion of the company's investors are overseas.<sup>205</sup>

The Handbook recommends setting suitable metrics to measure progress on GHG emissions reductions, emissions intensity, energy usage, intensity and mix, water usage, environmental operations and oversight, and climate risk mitigation, in line with the company's strategy or ESG action plan.<sup>206</sup> Suitable metrics should be set based on where and in what way the chosen material issues will affect the company's business, recommending use of SASB and other metrics already established.<sup>207</sup> In terms of how to set specific targets, the Handbook recommends that each company should use a process suitable for their circumstances, but in general, they should calculate future predictions by looking at past achievements and set targets by looking to targets set by domestic or overseas organizations, 'backcast' as endorsed by the TCFD recommendations.<sup>208</sup>

The Handbook cites the International Accounting Standards Board (IASB) that 'Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.'<sup>209</sup>

The Handbook also commends the Guidance issued by the World Federation of Exchanges that there should be a board statement setting out material issues are identified and embedded in its strategy, and how the board reviews progress against targets. Boards should make clear how their selected ESG issues link to value creation/destruction; companies should explain to investors how they identify their material issues; and they should ensure that their reporting is accurate, timely, and follows one of the internationally recognized reporting standards.<sup>210</sup>

## 6.7 Disclosure by the Japan Government Pension Investment Fund

Japan's Government Pension Investment Fund (GPIF) has provided leadership in disclosure of climate-related financial risk.<sup>211</sup> All of its ¥151 trillion assets under management are now being tracked based

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<sup>203</sup> *Ibid* at 33.

<sup>204</sup> *Ibid* at 33.

<sup>205</sup> *Ibid* at 48.

<sup>206</sup> *Ibid* at 45.

<sup>207</sup> *Ibid* at 36. SASB has published standards for 77 industries, SASB Standards, <https://www.sasb.org/standards-overview/download-current-standards/>.

<sup>208</sup> Practical Handbook for ESG Disclosure, *supra* note 197 at 36.

<sup>209</sup> The Japanese Financial Services Agency (JFSA) writes that 'materiality of narrative information should be judged based on 18 IFRS, whether or not it is material to investors' investment decisions; Handbook at 19, citing Japan Financial Services Agency (2019) 'Principles Regarding the Disclosure of Narrative Information'.

<sup>210</sup> Practical Handbook for ESG Disclosure, *supra* note 197 at 67, citing WFE ESG Guidance and Metrics can be downloaded from the WFE website. <https://www.world-exchanges.org/news/articles/world-federation-exchanges-publishes-revised-esg-guidance-metrics>, and the Global Reporting Initiative Standards, <https://www.globalreporting.org/standards>. Japanese: <https://www.globalreporting.org/standards/gri-standards-translations/gri-standardsjapanese-translations-download-center/>.

<sup>211</sup> Japan Government Pension Investment Fund, 'GPIF Publishes the 'Analysis of Climate Change-Related Risks and Opportunities in the GPIF Portfolio'' (2 October 2020),

on ESG factors. Its assets under management tracking ESG indexes is ¥5.7 trillion, and its investment in green, social and sustainability bonds issued by multilateral development banks is approximately ¥440 billion.<sup>212</sup> It has an A+ rating from the UN PRI. In its FY2019 ESG Report released in August 2020, for the first time, GPIF has quantified the physical and transition risks and opportunities of climate change inherent in its portfolio in terms of the potential change in the value of these securities.<sup>213</sup>

GPIF expanded on the information it disclosed the previous year in line with the TCFD recommendations, now including a comprehensive assessment of climate change-related risks and opportunities across all major asset classes in the fund's portfolio.<sup>214</sup> It used three global climate change data and analytics firms to compile a climate change analysis that utilizes cutting-edge climate change assessment techniques. Given the space limitations in its ESG report, it issued a supplementary report in October 2020 on climate change specifically.<sup>215</sup>

The climate change report measures the carbon footprint and GHG emissions per unit of revenue (value added) for its investee companies, examining scope 1, 2 and 3 carbon emissions, setting out its methodology in great detail.<sup>216</sup> It measures carbon intensity of its portfolios by asset.<sup>217</sup> Compared to the prior fiscal year, GPIF reduced the carbon intensity and the carbon footprint of its portfolios by 15.3 percent.<sup>218</sup> GPIF reports that two main drivers affected its carbon footprint in the past year – changes in the quantity of GHG emissions by investee companies and changes in the types of investment held in investees.<sup>219</sup> It also discloses in detail the challenges due to inadequate reporting by investee companies of their carbon intensity, planning to accelerate its seeking accurate information.<sup>220</sup>

GPIF invested in the S&P/JPX Carbon Efficient Index. It conducted scenario testing under 1.5°C, 2°C, and 3°C scenarios, finding 1.5°C scenario had the highest positive effect on its equity portfolios.<sup>221</sup> Its fixed income portfolio had the opposite effect under the scenarios tested. It conducted a 'portfolio potential warming' analysis regarding the future potential contributions of investee companies to global warming, and potential fossil fuel exposure, as well as risks and opportunities in its government bonds portfolio.<sup>222</sup> It details the emissions in its sovereign bond investments, explaining its methodology for calculating carbon footprint.<sup>223</sup> It undertakes predictive analysis regarding investments in new technologies and potential value diminution in sectors with high traditional environmental impacts and energy needs. GPIF also introduced a 'transition pathway initiative management quality score' (developed by FTSE), which measures the extent to which investee companies manage GHG emissions and how they respond to risks and opportunities in the transition to a lower carbon economy.<sup>224</sup>

## 6.8 Conclusion - Director Liability and Disclosure of Material Climate-related Risks

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[https://www.gpif.go.jp/en/investment/esg/gpif\\_publishes\\_the\\_analysis\\_of\\_climatechange-related\\_risks\\_and\\_opportunitiesin\\_the\\_gpif\\_portfolio.html](https://www.gpif.go.jp/en/investment/esg/gpif_publishes_the_analysis_of_climatechange-related_risks_and_opportunitiesin_the_gpif_portfolio.html).

<sup>212</sup> *Ibid* at 4.

<sup>213</sup> Government Pension Investment Fund, 'For All Generations, ESG Report 2019', [https://www.gpif.go.jp/en/investment/GPIF\\_ESGREPORT\\_FY2019.pdf](https://www.gpif.go.jp/en/investment/GPIF_ESGREPORT_FY2019.pdf)

<sup>214</sup> Japan, 'Analysis of Climate Change-Related Risks and Opportunities in the GPIF Portfolio', Supplementary Guide to GPIF ESG 2019 Report', [https://www.gpif.go.jp/en/investment/GPIF\\_CLIMATE\\_REPORT\\_FY2019.pdf](https://www.gpif.go.jp/en/investment/GPIF_CLIMATE_REPORT_FY2019.pdf).

<sup>215</sup> *Ibid*.

<sup>216</sup> *Ibid* at 11 – 13.

<sup>217</sup> *Ibid* at 15.

<sup>218</sup> *Ibid* at 4.

<sup>219</sup> *Ibid* at 16.

<sup>220</sup> *Ibid* at 20-22.

<sup>221</sup> *Ibid* at 4.

<sup>222</sup> *Ibid* at 5.

<sup>223</sup> *Ibid* at

<sup>224</sup> *Ibid* at 5.

Climate change presents a foreseeable financial risk in the short, medium and long term. Financial disclosure is critically important for companies, investors, and regulators, and for effective functioning of capital markets, and directors and their corporate boards have a responsibility to disclose materials risks. For privately-held stock companies in Japan, that obligation is to shareholders in the form of reporting the financial statements to annual shareholder meetings.

For public companies in Japan, that disclosure requirement is both periodic and continuous pursuant to financial services law. Since it is directors that have the overall responsibility for ensuring the company's financial disclosures are accurate, they may be primarily liable for misleading disclosures made to the market.<sup>225</sup> Both companies and directors may be subject to sanctions under financial services legislation for failure to comply with disclosure requirements. Unlike general director duties under company law, disclosure pursuant to financial services law is not subject to the business judgment rule, as the requirements are clearly set out in law.

As has been observed for other countries:

Directors and fiduciaries must now approach their governance of climate change in the same way as they would any other financial matter. The only safeguard against liability exposure will be a proactive, dynamic and considered approach to the impact of climate change on strategy, risk management oversight and reporting.

...

There are a number of disclosure omissions that are amongst those most likely to present a risk of misleading disclosure in practice, particularly for companies in those sectors highly exposed to physical or economic transition risks associated with climate change within mainstream investment and planning horizons. These include:

- a failure to disclose material economic transition risks or physical risks to a company's financial prospects, especially in the narrative portions of the annual report...
- the denial or material understatement of risk exposure or material overstatement of strategic preparedness or risk management of relevant climate-related financial risks, as expectations of the content of disclosures increase to mirror the evolving standards of directors to identify, assess and manage climate related financial risks;
- ...
- an inconsistency between internal assessments on climate risk and external disclosures, such as where internal reports from management and experts indicate the impact on the business of a proposed regulation to implement the goals of the Paris Agreement would be severe, but disclosures deny that the company is able to assess those impacts; and
- a high-level boilerplate forward-looking risk statement about the predicted impacts (or lack of impacts) of climate change on the company's operations and assets, including a statement of opinion or belief, that is not supported on reasonable grounds or not accompanied by adequate, specific disclosures on the limitations or uncertainties that materially impact on the achievement of the statement.<sup>226</sup>

Disclosure of management of climate-related risks is likely to generate enhanced corporate governance as institutional investors increasingly insist that their investee companies report their management and metrics relating to decarbonization.

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<sup>225</sup> Janis Sarra, *Audit Committees and Effective Climate Governance, A Guide for Boards of Directors* (CCLI December 2020), <https://law-ccli-2019.sites.olt.ubc.ca/files/2020/12/CCLI-Guide-for-Audit-Committees-on-Effective-Climate-Governance.pdf>.

<sup>226</sup> Barker and Mulholland, *supra* note 123 at 6, 14-16.



Nikkei Business Newspaper has reported that disclosures related to climate change increased four-fold in the past year, companies reporting that the disclosure is in response to investor pressure.<sup>227</sup> Of 2,484 companies for which Takara Printing submitted securities reports for the fiscal year ended March 2020, 264 now disclose climate change and global warming as a risk to their businesses and financial performance, up from 71 companies the year prior. By sector, the largest increase in disclosure was in the banking and chemical sectors.<sup>228</sup>

## 7. LOOKING AHEAD

Awareness of climate-related financial risk as part of ESG governance is growing in Japan. The Government Pension Investment Fund signed the UN PRI in 2015 and the number of Japanese UN PRI signatories exceeded 80 in January 2020, where institutional investors acknowledge their duty to act in the best long term interests of beneficiaries and affirm their belief that ESG issues can affect the performance of investment portfolios.<sup>229</sup> The amount of Japanese assets allocated to ESG investment more than tripled between 2016 and 2018, from US\$ 0.5 trillion US\$ to 2.1 trillion.<sup>230</sup> A survey by the METI showed that of 97.9 per cent of investors surveyed who were practicing ESG investment aimed at reducing risks, 87.5 per cent adopted ESG to increase returns, and 83.3 per cent reported wanting to contribute to society.<sup>231</sup> A growing number of companies in Japan have recognized the seriousness of climate-related financial risk in their securities law annual reports.<sup>232</sup>

At the same time, the corporate culture in Japan is more one of relationship than litigation, and recent innovations in corporate and financial service law have not really changed that dynamic. Relationship and presenting one's best face may mean that it is difficult for outsiders to assess the dynamics of the board's oversight of climate risk, although all of the above-mentioned advances in corporate disclosure are likely to increase transparency.

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<sup>227</sup> Nikkei Business Newspaper, Nihon Keizai Simbun morning edition September 8, 2020 (in Japanese only), English translation of title: 'Climate change risk, disclosure 4 times, 264 companies in the previous term' (気候変動リスク、開示4倍 前期264社、環境規制言及、投資家の圧力強く。).

<sup>228</sup> *Ibid.* For example, Mitsubishi Chemical HD disclosed as a risk that 'if carbon taxes and climate change gas emission regulations are introduced in each country where we do business, it will affect our business performance.' Mitsubishi UFJ Financial Group said, 'If it is considered that we are not fulfilling our responsibilities to society due to insufficient efforts and information disclosure, it will lead to damage to corporate value' against the background of increasing investor pressure.

<sup>229</sup> Practical Handbook for ESG Disclosure, *supra* note 197 at 9-10.

<sup>230</sup> *Ibid* at 9.

<sup>231</sup> *Ibid* at 11.

<sup>232</sup> See for example, Ricoh Company, Ltd., Annual Securities Report, (The 120th Business Term) From April 1, 2019 to March 31, 2020, [https://www.ricoh.com/-/Media/Ricoh/Sites/com/IR/financial\\_data/securities\\_report/pdf/AnnualSecuritiesReport\\_120th.pdf](https://www.ricoh.com/-/Media/Ricoh/Sites/com/IR/financial_data/securities_report/pdf/AnnualSecuritiesReport_120th.pdf), which discusses the need to identify medium- to long-term sustainability risks and opportunities as well as material issues faced by the corporate group, including investment decisions on risks and opportunities related to climate change recommended by the TCFD; supervise and advice on sustainability strategies, material issues, and progress against ESG targets for each business division throughout the entire Group 4. Identify sustainability issues to be submitted for discussion at the Board of Directors and report them to the Board of Directors and the Head of the Sustainability Management Division; and reviewing its greenhouse gas reduction goals and stepping up efforts in that regard while sharing information better in keeping with the TCFD recommendations. See also Komatsu Ltd., Annual Securities Report From April 1, 2019 to March 31, 2020 (The 151st Fiscal Year), which observed: Komatsu is investing a significant proportion of its management resources, such as research and development expenditure, to comply with environmental and other related regulations and to respond to climate change issues. If Komatsu is required to incur additional expenses and make additional capital investments due to future revision of environmental regulations or future impacts of climate change, or if its development, production, sales and service operations are adversely affected by such revised regulations, Komatsu may experience an unfavorable impact on its business results, [https://home.komatsu/en/ir/library/annual-security-report/sir\\_info\\_02/\\_icsFiles/afieldfile/2020/07/06/151th\\_q4\\_houkokusyo\\_e.pdf](https://home.komatsu/en/ir/library/annual-security-report/sir_info_02/_icsFiles/afieldfile/2020/07/06/151th_q4_houkokusyo_e.pdf)

In Japan, over 100 companies, local governments, research institutions, and non-governmental organizations have established the Japan Climate Initiative, a network committed to strengthening communication and exchange of strategies and solutions among all actors that are implementing climate actions in Japan.<sup>233</sup>

In 2017, Japan Exchange Group (JPX) joined the Sustainable Stock Exchanges (SSE) Initiative, and in June 2019, it published a Japanese translation of the SSE Initiative's Model Guidance on Reporting ESG Information to Investors.<sup>234</sup>

Electric companies are now verifying their achievements in each fiscal year by referring to the CO<sub>2</sub> emission factor (CO<sub>2</sub> emissions per kWh of power consumption) that reflects their efforts.<sup>235</sup> As of July 2015, the Federation of Electric Power Companies of Japan, together with J-Power, JAPC and 23 power producers and suppliers, established a new voluntary framework for achieving a low carbon society, formulated the Action Plan for the Electricity Industry for Achieving a Low-Carbon Society, setting a CO<sub>2</sub> reduction target for the entire electricity industry for FY2030 and expanding use of non-fossil energy sources.<sup>236</sup>

Japanese companies are also looking at upside opportunities related to climate change. For example, MS&AD Insurance Group Holdings Co, Ltd and MS&AD InterRisk Research & Consulting, Inc, in collaboration with Jupiter Intelligence, have started providing a service known as 'Climate Change Impact Assessment Service for TCFD', having 'developed a next-generation climate risk analytics system for predicting multi-hazard risks such as floods and windstorms caused by climate change', the first Japanese insurance/financial group able to provide a global climate change impact assessment by simulating various catastrophe indicators and financial impacts for different climate scenarios, time axes, and return periods based on data from the latitude and longitude.<sup>237</sup>

Finally, Japan has embraced what is generally considered to be the next stage of decarbonization, the move to a circular economy, in which there are net-zero emissions or climate positive emissions. METI has released its 'Circular Economy Vision 2020' that urges a shift to new business models with higher circularity; is aimed at acquiring appropriate evaluation from the market and society; and that results in early establishment of a resilient resource circulation system to present Japan's basic policy directions for a circular economy.<sup>238</sup>

As all these developments unfold, corporate directors will be expected to stay current and exercise effective oversight of climate-related financial risks and opportunities.

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<sup>233</sup> Japan Climate Initiative (2019), <https://japanclimate.org/english/>.

<sup>234</sup> SSE Model Guidance, *supra* note 199 at 4.

<sup>235</sup> The Federation of Electric Power Companies of Japan, Efforts for Preventing Global Warming, [https://www.fepc.or.jp/english/environment/global\\_warming/index.html](https://www.fepc.or.jp/english/environment/global_warming/index.html).

<sup>236</sup> *Ibid.*

<sup>237</sup> MS&AD, 'Launching Climate Change Impact Assessment Service for TCFD with Jupiter Intelligence -Global impact assessment of natural catastrophe risk from climate change' (7 July 2020), <https://www.ms-ad-hd.com/en/news/irnews/irnews-5593844501232751076.html>.

<sup>238</sup> METI, 'Circular Economy Vision 2020', (22 May 2020), [https://www.meti.go.jp/english/press/2020/0522\\_003.html](https://www.meti.go.jp/english/press/2020/0522_003.html); in Japanese: 循環経済ビジョン 2020 (概要) <https://www.meti.go.jp/press/2020/05/20200522004/20200522004-1.pdf>.

## APPENDIX I

### THREE FORMS OF ORGANIZATION STRUCTURE UNDER THE COMPANIES ACT OF JAPAN

This appendix supplements the discussion in part 2 with additional details on Japanese corporate structures. As noted in part 2, effective May 2015, companies in Japan may choose one of three main forms of organizational structure under the *Companies Act*: a Company with *Kansayaku* Board (audit and supervisory board); a 'Company with Three Committees' – a nomination, audit, and remuneration committee;<sup>239</sup> or a 'Company with Supervisory Committee'.<sup>240</sup> The latter two forms of organizational structure under the *Companies Act* are similar to companies in other countries where committees are established under the board and assigned certain responsibilities with the aim of strengthening oversight and monitoring functions.<sup>241</sup>

For a Company with a *Kansayaku* Board, the *Companies Act* allocates specific governance functions to the board of directors, the *kansayaku* (auditor) and the *kansayaku* board.<sup>242</sup> Thus, under this governance model, listed companies are required to have two boards, a board of directors and a board of *kansayaku*. The *kansayaku* audit the performance of duties by directors and the management and have investigation powers by law.<sup>243</sup> In order to ensure both independence and high-level information gathering power, not less than half of *kansayaku*, as appointed at the general shareholder meeting, must be outside *kansayaku*, and at least one full-time *kansayaku* must also be appointed. Article 335(3) of the *Companies Act* specifies: 'A Company with Board of Company auditors shall have three or more company auditors, and the half or more of them shall be Outside Company Auditors.' Article 390(3) states: 'Board of company auditors shall appoint full-time company auditors from among the company auditors.' The *kansayaku* are allowed to exercise their power quite independently, compared with members of committees in a 'company with audit and supervisory committee'.

All stock companies can appoint *shikkoyaku* or *shikkoyakuin*, as discussed in part 2. Company with Three Committees must appoint one or more *shikkoyaku* (executive officers) from directors or non-directors, by a resolution of the board, and delegate business administration and certain kinds of business decisions to the *shikkoyaku*.<sup>244</sup> The board must appoint one or more representative executive officers from among the executive officers, and they are responsible for carrying out the decisions made by the board or the executive officers, and have authority to represent the company. The board can delegate substantial decision-making authority over the management of the company to the executive officers.<sup>245</sup> As of May 2020, only 76 of the approximately 3,700 listed companies on the Tokyo Stock Exchange had the three committees structure.<sup>246</sup>

A Company with Supervisory Committee has one board, but can create positions with the title of *shikkoyakuin* for persons who are delegated by the board to exercise a certain range of discretion regarding business administration.<sup>247</sup> If independent directors do not comprise a majority of the board, the Corporate Governance Code recommends, as best practice to strengthen the independence,

<sup>239</sup> Yamaguchi *et al*, *supra* note 70.

<sup>240</sup> Corporate Governance Code, *supra* note 64.

<sup>241</sup> *Ibid.* The Code's footnote states: 'There are cases where a Company with *Kansayaku* Board or a Company with Supervisory Committee creates positions with the title of "shikkoyakuin" for persons who are delegated by the board a certain range of discretion regarding business administration. Unlike *shikkoyaku* in companies with three committees (nomination, audit and remuneration), *shikkoyakuin* is not a statutory position', *ibid.*

<sup>242</sup> JPX's provisional English translation looks a bit confusing with comparison to the original Japanese version, which states "A Company with *kansayaku* Board is a system unique to Japan in which certain governance functions are assumed by the board, *kansayaku* and the *kansayaku* board", Corporate Governance Code, *supra* note 64 at 16-17, Notes to General Principle 4.

<sup>243</sup> *Ibid.*

<sup>244</sup> *Ibid.*

<sup>245</sup> Yamaguchi *et al*, *supra* note 70.

<sup>246</sup> *Ibid.*

<sup>247</sup> Corporate Governance Code, *supra* note 64 at 16.

objectivity and accountability of the board on the matters of nomination and remuneration of the senior management and directors, that the company seek appropriate involvement and advice from the independent directors; for example, by establishing an optional independent advisory committee under the board, in which independent directors approve remuneration and some executive hiring decisions.<sup>248</sup>

As noted in part 2, pursuant to the *Companies Act*, a company is defined as 'any Stock Company (*kabushiki kaisha*), General Partnership Company, Limited Partnership Company or Limited Liability Company' and a foreign company is defined as 'any juridical person incorporated under the law of a foreign country or such other foreign organization that is of the same kind as the Company or is similar to a Company.'<sup>249</sup> A public company means 'any Stock Company the articles of incorporation of which do not require, as a feature of all or part of its shares, the approval of the Stock Company for the acquisition of such shares by transfer'.<sup>250</sup>

The 2019 amendments to the *Companies Act* now require listed companies to have at least one 'outside director'.<sup>251</sup> Article 2 (xv) specifies:

Outside Director means a director of any Stock Company who is neither an Executive Director (hereinafter referring to a director of a Stock Company listed in any item of Article 363(1), and any other director who has executed operation of such Stock Company) nor an executive officer, nor an employee, including a manager, of such Stock Company or any of its Subsidiaries, and who has neither ever served in the past as an executive director nor executive officer, nor as an employee, including a manager, of such Stock Company or any of its Subsidiaries.

Outside director, in this context, does not mean 'independent' within the meaning of the Tokyo Stock Exchange rules. Listed companies that are not large companies defined by *Companies Act* article 2 (vi) are not required to have at least one outside director, but the number of such listed companies in Japan is small.<sup>252</sup> 'Large Company' means any stock company which satisfies any of the following requirements: (a) that the amount of the stated capital in the balance sheet as of the end of its most recent business year, referring to the balance sheet reported to the annual shareholders' meeting specifically 'referring to the balance sheet under Article 435(1) in cases where the first annual shareholders' meeting after the incorporation of the Stock Company has not yet been held) is 500,000,000 yen or more; or (b) that the total sum of the amounts in the liabilities section of the balance sheet as of the end of its Most Recent Business Year is 20,000,000,000 yen or more'.<sup>253</sup>

Article 2(15) of *Companies Act* defines the standard of 'outside' director, but makes no reference to independence. The TSE adds requirement of 'independent director', but does not make the criteria of independence clear in the Securities Listing Regulations. Listed companies set out their own criteria regarding the independence of directors and must disclose that criteria, but the TSE may publicly announce or impose a listing agreement violation penalty if a company's criteria does not satisfy TSE's requirements of independence in accordance with the TSE 'Guidelines concerning Listed Company Compliance', part III.<sup>254</sup> For example, III-5-(3)-2 of the TSE's Guidelines sets out a definition of independent director for purposes of exchange listing:

<sup>248</sup> *Ibid*, Supplementary Principle 4.10.1; this advice also applies to a Company with a *Kansayaku* Board.

<sup>249</sup> *Companies Act of Japan*, article 2. For example, Article 593(1) Partners who execute the business shall have the duty to perform their duties with due care of a prudent manager.

<sup>250</sup> *Ibid*.

<sup>251</sup> *Companies Act of Japan*, article 327-2.

<sup>252</sup> *Companies Act of Japan*, Article 2(vi).

<sup>253</sup> *Ibid*.

<sup>254</sup> TSE, 'Guidelines Concerning Listed Company Compliance', III. 'Examination Pertaining to Ensuring Effectiveness (Measures against Violation of Code of Corporate Conduct) 5. In the case of a violation by a listed company of the provisions of Chapter 4, Section 4, Sub-section 1 of the Regulations, a decision on public announcement pursuant to the provisions of Rule 508,

The status of a person(s) who is reported to the Exchange as being an independent director(s)/auditor(s) by the issuer of a listed domestic stock pursuant to the provisions of Rule 436-2 of the Enforcement Rules when such person falls under any of the following a. to d.;

a. A person for which said company is a major client or a person who executes business for such person, or a major client of said company or a person who executes business for such client;

b. A consultant, accounting professional or legal professional (in the case of a group such as a juridical person or association, including persons belonging to such group) who receives a large amount of money or other asset other than remuneration for directorship/auditorship from said company; or

c. A person who has recently fallen under any of the following (a) or (b);

c-2. A person who fallen under any of the following (a) or (b) at the time within ten years prior to assuming office;

(a) A person who executes business for a parent company of said company (including a director who does not execute business or an auditor in cases where said company designates its outside auditor as an independent director); or

(b) A person who executes business for a fellow subsidiary of said company.

d. A close relative of a person referred to in any of the following (a) to (f) (excluding those of insignificance);

(a) A person referred to in a. to the preceding c.;

(b) An accounting advisor of said company (limited to cases where the outside auditor thereof has been designated as an independent auditor. When said accounting advisor is a corporation, any member thereof who is in charge of such advisory affairs is included; the same shall apply hereinafter);

(c) A person who executes business for a subsidiary of said company (including a director who does not execute business or an accounting advisor in cases where said company designates its outside auditor as an independent auditor);

(d) A person who executes business for a parent company of said company (including a director who does not execute business or an auditor in cases where said company designates its outside auditor as an independent auditor);

(e) A person who executes business for a fellow subsidiary of said company; or

(f) A person who has recently fallen under (b) or (c), or a person who executed business for said company (in cases where an outside auditor is designated as an independent director, meaning a director who does not execute business).<sup>255</sup>

Rule 436-2(1) states that directors are independent if they are unlikely to have conflicts of interest with general investors. Securities Listing Regulations Rule 436-2 specifies:

Securing Independent Director(s)/Auditor(s): For the protection of general investors, an issuer of listed domestic stocks must secure at least one independent director/auditor (meaning an

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Paragraph 1 of the Regulations, as well as a decision on whether or not to impose the listing agreement violation penalty pursuant to the provisions of Rule 509 of the Regulations, shall be made in comprehensive consideration of (i) the matters prescribed in the classifications referred to in the following (1) to (8) and (ii) the details, the background, the cause, and the actual state of affairs relating to said violation, as well as the state of implementation of measures such as a regulatory action taken by the Exchange in response to said violation and any other circumstances'. [https://www.jpx.co.jp/english/rules-participants/rules/regulations/tvdivq0000001vyt-att/listed\\_company\\_compliance\\_guidelines\\_20150501.pdf](https://www.jpx.co.jp/english/rules-participants/rules/regulations/tvdivq0000001vyt-att/listed_company_compliance_guidelines_20150501.pdf)

<sup>255</sup> *Ibid.*

outside director (meaning an entity falling under an outside director prescribed in Article 2, Item (15) of the Companies Act who is an outside director/auditor prescribed in Article 2, Paragraph 3, Item (5) of the Ordinance for Enforcement of the Companies Act (the Ordinance of the Ministry of Justice No. 12 of 2006)) or outside auditor (meaning an entity falling under an outside auditor prescribed in Article 2, Item (16) of the Companies Act who is an outside director/auditor prescribed in Article 2, Paragraph 3, Item (5) of the Ordinance for Enforcement of the Companies Act) who is unlikely to have conflicts of interest with general investors; hereinafter the same.<sup>256</sup>

The Tokyo Stock Exchange may impose a listing agreement violation penalty on them. However, it is unclear whether the 'independent director' is likely to have conflicts of interest with general investors.

In case of failure to elect outside directors, the resolution of the board of directors risks being found to be void, because the board's structure and decision process would be in violation of the *Companies Act* and thus illegal. In contrast, where there has been a failure to elect independent directors, the resolutions of the board of directors be still valid (not void), because the election of independent directors is not required by *Companies Act* (statutory law), only requested by soft law, *eg*, the Tokyo Stock Exchange. The 2019 amendment comes into force on 1 March 2021.

In companies with a *Kansayaku* board (audit and supervisory board) and companies with a supervisory committee, directors' compensation is fixed by a resolution at a shareholders meeting if such matters are not prescribed in the articles of incorporation.<sup>257</sup> In companies with three committees, the remuneration committee sets directors' compensation in accordance with the regulation on Compensation Policies for Directors.<sup>258</sup> Therefore, making ESG factors indicators of directors' performance-linked compensation means that shareholders have agreed that the company should promote climate change adaptation, and directors have the obligation to make effort to fulfill that obligation.

One example is the electrical components maker OMRON corporation, where compensation to directors is set based on medium-to-long-term performance, including return on investment and meeting sustainability objectives, the latter evaluated by a third-party organization and based on the Dow Jones Sustainability Indices (DJSI).<sup>259</sup> The DJSI are a series of ESG indices that include companies evaluated and selected based on long-term shareholder value perspective, reflecting economic, environmental, and social factors comprehensively. Another example is Kao Corporation, a producer of human health care, skin care, cosmetics, and fabric and home care, where long-term incentive compensation is paid in accordance with several indicators including the World's Most Ethical Companies indicators evaluated by Ethisphere Institute.<sup>260</sup>

<sup>256</sup> Securities Listing Regulations Rule 436-2, [https://www.jpix.co.jp/english/rules-participants/rules/regulations/tvdivg0000001vvt-att/securities\\_listing\\_regs1-826\\_20190716.pdf](https://www.jpix.co.jp/english/rules-participants/rules/regulations/tvdivg0000001vvt-att/securities_listing_regs1-826_20190716.pdf).

<sup>257</sup> *Companies Act of Japan*, article 361.

<sup>258</sup> Compensation Policies for Directors, Regulation for Enforcement of the Companies Act, article 121.

<sup>259</sup> OMRON corporation, Business report for shareholders meeting, at 40-41, [https://www.omron.com/global/en/assets/file/ir/shareholder/convocation\\_notice\\_for\\_the\\_83rd\\_ordinary\\_general\\_meeting\\_of\\_shareholders.pdf](https://www.omron.com/global/en/assets/file/ir/shareholder/convocation_notice_for_the_83rd_ordinary_general_meeting_of_shareholders.pdf).

<sup>260</sup> Kao Corporation, Integrated Report 2020 at 79, <https://www.kao.com/content/dam/sites/kao/www-kao-com/global/en/investor-relations/pdf/reports-fy2020e-all-008.pdf>. See also Kirin Holdings Company, Limited, in which long-term incentive compensation is calculated by financial evaluation and non-financial evaluation, the latter including progress and achievement in four key areas including the environment, <https://www.kirinholdings.co.jp/english/ir/governance/compensation.html>.



One reason few companies have medium-to-long-term performance-linked compensation to directors evaluated by ESG indicators is the *Corporation Tax Act of Japan*.<sup>261</sup> Costs of payments of performance-linked compensation to directors evaluated by ESG indicators are excluded from deductible expenses, when calculating the amount of income of the domestic corporation for each business year. Only payments of performance-linked compensation to directors evaluated by the market price of the shares or indicators of company profit, including the amount of sales, are included deductible expenses.<sup>262</sup> If the *Corporation Tax Act* were reformed, many more companies would have performance-linked compensation to directors evaluated by ESG indicators.

Shareholder proposals, if approved by the requisite majority of votes, are binding on the corporate directors and officers. In Japan, a shareholder proposal that receives a majority of two-thirds or more of the votes of the shareholders present at the meeting is binding on directors.<sup>263</sup> Note that it is vote exercised by shareholders present and voting at the meeting; it does not include any unexercised votes. To amend the articles of incorporation, a special resolution by shareholders' meeting is necessary, which can be approved by the same majority, or the corporate articles can specify a higher threshold of votes required before the corporate articles can be revised.<sup>264</sup>

As discussed in part 5, amendments to the *Companies Act of Japan* were promulgated on 11 December 2019, including changes to the rules governing shareholders' meetings, virtual provision of meeting materials, and a restriction on the number of shareholder proposals. Only shareholders that hold at least 1 per cent of total votes (usually one unit of 100 shares) or 300 votes can make a shareholder proposal.<sup>265</sup> Pursuant to the amendments, they are now limited in the number of proposals that they can make each year.

Prior to the 2019 amendments, there had been instances of a single shareholder submitting more than 100 proposals, and the amendment is aimed at making governance more manageable. For example, in 2012, Nomura HD received over 100 proposals from one shareholder, and the other several companies have faced the same issues over the past 10 years.<sup>266</sup> It should not affect the ability to make a shareholder proposal related to managing climate-related risks, although the 1 per cent vote or 300 vote threshold can pose a barrier to shareholders with smaller investments to bring climate-related issues to the attention of the corporate board. The amendments will come into effect 1 March 2021, with some portions, such as providing shareholder meeting materials through the internet, coming into effect by June 2023.<sup>267</sup>

#### Shareholders' Right to Propose

Article 303 (1) Shareholders may demand that the directors include certain matters (limited to the matters on which such shareholders may exercise their votes. The same shall apply in the following paragraph) in the purpose of the shareholders meeting.

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<sup>261</sup> *Corporation Tax Act*, Act No 34 of March 31, 1965, 法人税法 昭和 40 年 3 月 31 日法律第 34 号 amended by No 4 of March 31, 2017. English translation of Amendment of Act No. 23 of 2008 prior to the amendment by No 4 of March 31, 2017 is available at [http://www.japaneselawtranslation.go.jp/law/detail\\_main?re=&vm=2&id=53](http://www.japaneselawtranslation.go.jp/law/detail_main?re=&vm=2&id=53). English translation of this paper is revised referring English translation of Amendment of Act No. 23 of 2008.

<sup>262</sup> *Corporation Tax Act*, article 34(3)(a).

<sup>263</sup> *Companies Act of Japan*, article 309 (2).

<sup>264</sup> *Ibid*, article 309 (2)(xi) and Chapter 5, article 466.

<sup>265</sup> *Ibid*, article 303(2). The shareholders have to have 1 per cent of votes or 300 votes. Usually one unit of 100 shares gives one vote to the shareholders, therefore the Act indicates number of votes (not number of shares). Listed companies are requested to make one unit by 100 shares by Tokyo Stock Exchange and/or other domestic stock exchanges. 'Standardization of Trading Unit', <https://www.jpx.co.jp/english/equities/improvements/unit/>.

<sup>266</sup> See 'Frustrated Shareholder Proposes Nomura 'Hunker Down'', *Wall Street Journal* ( 1 June 2012), <https://www.wsj.com/articles/BL-JRTB-12184>.

<sup>267</sup> Yamaguchi *et al*, *supra* note 70.



(2) Notwithstanding the provisions of the preceding paragraph, at a Company with Board of Directors, only shareholders having consecutively for the preceding six months or more (or, in cases where shorter period is prescribed in the articles of incorporation, such period or more) not less than one hundredth (1/100) (or, in cases where lesser proportion is prescribed in the articles of incorporation, such proportion) of the votes of all shareholders or not less than three hundred (or, in cases where lesser number is prescribed in the articles of incorporation, such number of) votes of all shareholders may demand the directors that the directors include certain matters in the purpose of the shareholders meeting. In such cases, that demand shall be submitted no later than eight weeks (or, in cases where shorter period is prescribed in the articles of incorporation, such period or more) prior to the day of the shareholders meeting.

## APPENDIX II

### RELEVANT PROVISIONS OF THE CORPORATE GOVERNANCE CODE

This appendix adds some detail to the discussion in part 4.3. Japan's Corporate Governance Code, published by Tokyo Stock Exchange in 2015, requires listed companies to address social, environmental and other sustainability issues positively and proactively.<sup>268</sup> The Corporate Governance Code is non-binding on companies, but it does strongly influence governance norms. Since climate-related financial risks and opportunities are part of the 'environmental' in ESG, the Code supports directors' efforts to effectively manage climate change impacts.

Principle 2.1 of the Code states that 'Guided by their position concerning social responsibility, companies should undertake their businesses in order to create value for all stakeholders while increasing corporate value over the mid- to long-term. To this end, companies should draft and maintain business principles that will become the basis for such activities.'<sup>269</sup> The board should view the establishment of corporate goals (business principles, etc) and the setting of strategic direction as one major aspect of its roles and responsibilities.<sup>270</sup>

Principle 4 of the Corporate Governance Code sets out the responsibilities of the Board:

4. Given its fiduciary responsibility and accountability to shareholders, in order to promote sustainable corporate growth and the increase of corporate value over the mid- to long-term and enhance earnings power and capital efficiency, the board should appropriately fulfill its roles and responsibilities, including:

- (1) setting the broad direction of corporate strategy;
- (2) establishing an environment where appropriate risk-taking by the senior management is supported; and
- (3) carrying out effective oversight of directors and the management (including *shikkoyaku* and so-called *shikkoyakuin*) from an independent and objective standpoint.

Such roles and responsibilities should be equally and appropriately fulfilled regardless of the form of corporate organization – i.e., Company with *Kansayaku* Board (where a part of these roles and responsibilities are performed by *kansayaku* and the *kansayaku* board), Company with Three Committees (Nomination, Audit and Remuneration), or Company with Supervisory Committee.

Principle 4.5 of the Corporate Governance Code specifies that the fiduciary responsibilities of directors and *kansayaku* requires that they 'secure the appropriate cooperation with stakeholders and act in the interest of the company and the common interests of its shareholders.'<sup>271</sup>

The Corporate Governance Code also contains principles for independent directors, notwithstanding they currently they are not the norm, linking their activities to sustainable growth. It recommends:

#### Principle 4.7 Roles and Responsibilities of Independent Directors

Companies should make effective use of independent directors, taking into consideration the expectations listed below with respect to their roles and responsibilities:

<sup>268</sup> Corporate Governance Code, *supra* note 64.

<sup>269</sup> *Ibid* at 10.

<sup>270</sup> *Ibid*, Principle 4.1.

<sup>271</sup> *Ibid*, Principle 4.5.

- i) provision of advice on business policies and business improvement based on their knowledge and experience with the aim to promote sustainable corporate growth and increase corporate value over the mid- to long-term;
- ii) monitoring of the management through important decision-making at the board including the appointment and dismissal of the senior management;
- iii) monitoring of conflicts of interest between the company and the management or controlling shareholders; and
- iv) appropriately representing the views of minority shareholders and other stakeholders in the boardroom from a standpoint independent of the management and controlling shareholders.

#### Principle 4.8 Effective Use of Independent Directors

Independent directors should fulfill their roles and responsibilities with the aim of contributing to sustainable growth of companies and increasing corporate value over the mid- to long-term. Companies should therefore appoint at least two independent directors that sufficiently have such qualities. Irrespective of the above, if a company believes it needs to appoint at least one-third of directors as independent directors based on a broad consideration of factors such as the industry, company size, business characteristics, organizational structure and circumstances surrounding the company, it should appoint a sufficient number of independent directors.

Since its early introduction, the Code has viewed directors as fiduciaries of shareholders and has been aimed at making directors' duty of care and duty of loyalty effective in practice by providing an important framework, as evidenced by the preamble of the 2009 Code. With respect to the Basic Principle 4, the current Corporate Governance Code states "...the reasonableness of the decision-making process at the time of decision is generally considered an important factor in determining whether or not the management and directors should owe personal liabilities for damages. The Code includes principles and practices that are expected to contribute to such a reasonable decision-making process..." The Code expects that it provides standards for a reasonable decision-making process in a lawsuit seeking a director's personal liabilities for damages.

The Corporate Governance Code has influenced the number of independent directors on publicly-listed company boards. Nicholas Benes has observed that the percentage of large Japanese corporations with independent director representation has expanded significantly since the Corporate Governance Code's launch, also reflecting pressure from external investors.<sup>272</sup> He reports that 80 per cent of companies listed on tier 1 level of the Tokyo Stock Exchange (TSE1) now have two or more independent directors on their boards, according to ascertainable criteria for 'independence', almost four times the percentage recorded prior to the Code.<sup>273</sup> Benes reports that for almost 23 per cent of TSE1-listed firms, independent directors make up one-third or more of the board.<sup>274</sup> However, he also points to continuing issues of the competence of boards, suggesting that investors will have to apply some pressure to have meaningful governance reform.<sup>275</sup>

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<sup>272</sup> Nick Benes, 'Corporate governance in Japan now' <https://ethicalboardroom.com/corporate-governance-in-japan-now/>.

<sup>273</sup> *Ibid.*

<sup>274</sup> *Ibid.*

<sup>275</sup> *Ibid.*

### APPENDIX III

#### DUTIES OF INSTITUTIONAL INVESTORS IN RESPECT OF CLIMATE-RELATED RISKS AND OPPORTUNITIES

The United Nations Principles for Responsible Investment (UN PRI) *Final Report on Fiduciary Obligation in the 21<sup>st</sup> Century* specifies that the fiduciary duties of investors require them to incorporate ESG issues into investment analysis and decision-making processes, consistent with their investment time horizons; to encourage high standards of ESG performance in the companies or other entities in which they invest; to understand and incorporate beneficiaries' and savers' sustainability-related preferences, regardless of whether these preferences are financially material; to support the stability and resilience of the financial system; and to report on how they have implemented these commitments.<sup>276</sup> Commitment to these UN PRI duties regarding responsible investment has grown to over 2,500 signatories, investing US\$ 90 trillion.<sup>277</sup>

The Japan Financial Services Agency is the financial regulation oversight agency, 'responsible for ensuring stability of Japan's financial system, protection of depositors, insurance policyholders and securities investors, and smooth finance through such measures as planning and policymaking concerning the financial system, inspection and supervision of private sector financial institutions, and surveillance'.<sup>278</sup> The FSA has specified that fiduciary duties include the duties of prudence and loyalty, requiring institutional investors to avoid conflicts of interest and provide services and advice in the best interests of their beneficiaries.<sup>279</sup> Institutional investors need to consider the intergenerational impact of their investment decisions.<sup>280</sup>

Japan's 'Principles for Responsible Institutional Investors Stewardship Code' was revised effective 24 March 2020, setting out principles for best practice for institutional investors in fulfilling their stewardship responsibilities with regard for their clients, beneficiaries, and investee companies.<sup>281</sup> The amendment to the Stewardship Code emphasizes promoting sustainable growth and consideration of ESG factors when making investment decisions.<sup>282</sup>

The Stewardship Code emphasizes the need to monitor investee companies' governance, strategy, performance, capital structure, business risks, and opportunities, including arising from climate change, and to monitor and assess how the companies address them.<sup>283</sup> The Code specifies that a part of stewardship responsibility is purposeful dialogue with companies based on in-depth knowledge of companies, and consideration of medium- to long-term sustainability, including ESG factors consistent with their investment management strategies.

As of 30 April 2020, approximately 280 institutional investors have endorsed the Stewardship Code; and many institutional investors are now actively monitoring corporate governance.<sup>284</sup> A growing number are publishing their principles of corporate governance. While prior to 2017, engagement with

<sup>276</sup> UN PRI, *Final Report on Fiduciary Obligation in the 21<sup>st</sup> Century*, <https://www.unpri.org/download?ac=9792>.

<sup>277</sup> UN PRI, 'ESG incorporation is an investment norm', (2020), <https://www.unpri.org/pri/fiduciary-duty-in-the-21st-century-final-report/4998.article>.

<sup>278</sup> Japan Financial Services Agency, 'The Role of the FSA' (2020), [https://www.fsa.go.jp/en/about/pamphlet\\_e.pdf](https://www.fsa.go.jp/en/about/pamphlet_e.pdf).

<sup>279</sup> UN PRI and Baker Mackenzie, 'Recommendations of Task Force on Climate-related Financial Disclosures', review of local relevance JAPAN' at 7, <https://www.unpri.org/download?ac=1406>.

<sup>280</sup> Mizuno *et al*, *supra* note 36 at 1.

<sup>281</sup> Council of Experts on Japan's Stewardship Code, Principles for Responsible Institutional Investors <<Japan's Stewardship Code>> (24 March 2020), <https://www.fsa.go.jp/en/refer/councils/stewardship/20200324/01.pdf>.

<sup>282</sup> *Ibid*. It also and establishes a new principle regarding the provision of appropriate services to institutional investors by service providers, such as proxy voting advisors and investment consultants.

<sup>283</sup> *Ibid* at 10.

<sup>284</sup> *Ibid*.

investee companies tended to be conducted primarily by overseas investors (in 2017 around 30 per cent of tier one JPX equities were internationally owned), in the past three years Japanese asset managers have been building their stewardship capacity and commencing engagement with investee companies on climate and other ESG issues.<sup>285</sup>

The UN PRI observes that a growing number of Japanese institutional investors now view consideration of ESG factors when making investment decisions as an important part of fulfilling their fiduciary duty and accountability as investors.<sup>286</sup> They also understand the importance of reporting this process and its results to beneficiaries.<sup>287</sup> The UN PRI report on Japan notes that institutional investors in Japan are increasingly understanding and creating capacity to act upon the stewardship responsibilities within their fiduciary duties.<sup>288</sup> However, it also highlighted an important aspect of Japan's corporate governance:

Central to engagement with Japanese corporations was an understanding of the culture and history of each corporation and taking the time to build the trust upon which effective engagement depended – an expectation highlighted in Principle 7 of the Stewardship Code.<sup>289</sup>

...

Our stakeholders consistently raised cross-shareholding or “allegiance shareholdings” as a critical issue in Japanese corporate governance, which could erode shareholders’ ability to engage with corporations on ESG issues. Japanese corporations often view such arrangements as a natural and expected feature of the business environment. However, they result in very different accountability dynamics for Japanese corporations as these shareholdings can account for a significant slice of a corporation’s shareholder base, though divided among many small holdings by corporations. Investors have several concerns about cross-shareholdings:

- lack of transparency on the rationale for such holdings;
- their effect on capital efficiency;
- conflicts of interest;
- dangers for “pure” minority shareholders;
- anti-takeover effects;
- emerging evidence that the size of cross-shareholding is negatively correlated with corporate performance.<sup>290</sup>

Thus the growing recognition by institutional investors globally that their fiduciary obligation includes considering how their portfolio investing is addressing climate-related financial risk is likely to result in an increasing number of Japanese institutional investors becoming active in oversight of how their investments are reducing their carbon footprint or carbon intensity or both. Many global investors now use ESG factors in financial reporting, as part of the financial statements and the management discussion and analysis (MD&A).

Effective climate governance is likely to increase as institutional investors press investee companies to decarbonize and develop sustainable business strategies.

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<sup>285</sup> UN PRI, *supra* note 276 at 9-10.

<sup>286</sup> *Ibid* at 10.

<sup>287</sup> *Ibid* at 10.

<sup>288</sup> *Ibid* at 8.

<sup>289</sup> *Ibid* at 10.

<sup>290</sup> *Ibid* at 12.