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Global and Japanese ESG Market and Regulatory Trends in Respect of ESG Risk, Impact and Opportunity Management: Sifting Signal From Noise

By Ruth Knox & Stephanie Leslie

Climate change disclosures have recently become mandatory in Japan, following amendments to the Financial Instruments Exchange Act (FIEA) and the Cabinet Office Order on Disclosure on Corporate Affairs. These require companies making public offerings to include ESG-specific information, aligning sustainability with management strategies. With Japan's regulatory approaches often being influenced by those adopted by the United States and Europe, the lack of alignment between the latter two jurisdictions has created uncertainty for the Japanese market. Here, we set out a comparison of the approaches taken by the market and regulators to ESG matters in the U.S. and Europe and the implications for Japanese companies and multinational companies with a presence in Japan.

ESG in the U.S.: Polarization Dominates

Reflective of the broader political climate in the U.S., approaches to managing ESG risks, impacts, and opportunities vary dramatically.

At the federal level, the SEC's proposed Climate Disclosure Rules signal a significant move towards mandatory ESG reporting. These rules aim to require public companies to report Scope 1 and Scope 2 emissions, and Scope 3 if deemed material, although the SEC has temporarily stayed the Climate Disclosure Rules pending the completion of certain legal proceedings. Whilst the SEC's Enforcement Division has disbanded its Climate and ESG Task Force, this should not be read as a renunciation of oversight of ESG-related claims by the SEC, who issued a statement confirming that the Task Force had been disbanded as its expertise was now successfully embedded throughout the Division.

Additionally, the Inflation Reduction Act of 2022 allocated $369 billion towards climate and clean energy initiatives, marking one of the most substantial federal investments in climate action.

At the state level, California's Climate Disclosure Regimes were signed into law in 2023, requiring businesses "doing business" in California and with over $1 billion in revenue to disclose their GHG emissions (Scope 1, 2, and 3) and assess climate-related financial risks.

At the other end of the spectrum, Texas has passed state-level anti-ESG measures prohibiting state agencies from investing in firms that "boycott" fossil fuels or are seen to discriminate against the firearms industry. Florida has also passed measures banning the consideration of ESG factors in state pension investments. Many other states have passed similar anti-ESG measures, some of which are now the subject of retaliatory contentious actions.[1]

Equally, at COP 26 in November 2021, the trustees of the IFRS Foundation announced the formation of the International Sustainability Standards Board (ISSB), which has published two draft disclosure standards—IFRS S1 (General Requirements for Disclosure of Sustainability-related Financial Information) and IFRS S2 (Climate-related Disclosures). These standards aim to provide a global baseline for sustainability reporting. Although ISSB standards are voluntary, they are intended to harmonise sustainability disclosures internationally, including in the U.S., where they can complement existing frameworks.

ESG in the U.K. & EU: A More Consistent Approach (mostly…)

The EU and U.K. have introduced several ESG-focused regulations impacting regulated financial institutions, listed companies, and large private companies:

Sustainable Finance Disclosure Regulation (SFDR): Aims to establish a framework to facilitate sustainable investments by creating a series of designations for in-scope financial products such as funds or pension products. The designations distinguish between products that promote environmental or social characteristics and those that actively make sustainable investments. SFDR also obligates financial market participants, such as asset managers, investment firms, and pension providers, to disclose how ESG factors are integrated into investment decisions and their impact on returns, increasing transparency for investors and creating pressure on companies to improve ESG risk and impact management and reporting.

EU Taxonomy: A classification system establishing a list of environmentally sustainable economic activities. It helps companies, investors, and policymakers identify which activities are aligned with the EU's climate and environmental objectives and which qualify as sustainable, based on specified technical criteria.

Corporate Sustainability Reporting Directive (CSRD): Expands mandatory sustainability reporting requirements for large companies and listed small- and medium-sized entities (SMEs) operating or listed in the EU, requiring disclosures on environmental, social, and governance risk and impact management from 2024 onwards. The European Commission has developed specific reporting standards (the "European Sustainability Reporting Standards" or "ESRS") against which companies subject to the CSRD must report. The EU maintains that the ESRS have been designed to be interoperable with the ISSB's IFRS S1 and S2 disclosure standards.

In an interesting potential example of anti-ESG rebellion amongst EU Member States, 17 out of the 27 Member States failed to transpose CSRD into their national law by the 6 July 2024 deadline. The European Commission has issued letters warning of infringement proceedings if transposition does not occur by the end of 2024.

Corporate Sustainability Due Diligence Directive (CSDDD): In-scope companies will be required to conduct due diligence covering their entire chain of activities, including their own operations, their subsidiaries, and their business partners to identify actual and potential adverse impacts. Unlike CSRD, which is a pure disclosure regime, CSDDD requires in-scope companies to take positive action to mitigate, remediate, or end adverse impacts caused by the company itself or its chain of activities. Companies will also be required to put in place a transition plan for climate change mitigation.

Carbon Border Adjustment Mechanism (CBAM): Introduces a carbon pricing mechanism on goods imported from outside the EU, targeting sectors with high emissions to prevent carbon leakage (in which companies based in the EU move carbon-intensive production abroad to take advantage of laxer standards, or replace EU-manufactured materials or products with more carbon-intensive imports).

EU Emission Trading System (EU ETS): A cap-and-trade system where companies must surrender EU-certified carbon credits (called EU allowances) for each ton of CO_2 emitted, with the cap reducing over time.

U.K. Sustainable Disclosure Requirements Regime (SDR) & Anti-Greenwashing Rule: The U.K. FCA has introduced rules and guidance to help consumers navigate the market for sustainable investment products:

- An anti-greenwashing rule that applies to all regulated firms making sustainability-related claims about financial products and services.
- Investment labels that apply to U.K. asset managers offering products that meet certain sustainability criteria.
- Rules for disclosure, naming, and marketing that specifically apply to U.K. asset managers offering products to retail investors.
- Targeted rules for distributors of investment products to retail investors in the U.K.

The U.K. Government plans to introduce economy-wide U.K. Sustainability Reporting Standards (U.K. SRS) by evaluating and endorsing the ISSB's IFRS S1 and S2 standards. This process involves assessing these standards for their suitability in the U.K. context, focusing on their relevance and impact on U.K. companies. The Government expects to make a final endorsement decision by Q1 2025. If endorsed, these standards will form part of a broader U.K. framework for sustainability disclosures, aligning U.K. reporting with international standards while considering national priorities.[2]

TCFD-Aligned Reporting Requirements: The FCA requires certain regulated U.K. asset managers and investment firms to prepare and publish entity- and product-level reports aligned with the Task Force on Climate-Related Financial Disclosure (TCFD)'s four recommendations and eleven recommended disclosures, covering the pillars of governance, strategy, risk management, and metrics and targets. TCFD disclosure requirements are also intended to be interoperable with the ISSB IFRS S1 and S2 standards. Listed and large private companies and partnerships are also required to publish climate-related financial disclosures aligned with the TCFD's recommendations.

U.K. Transition Plan Task Force (TPT): Establishes voluntary standards for U.K. companies to disclose their transition plans towards net zero, providing investors with insights into how businesses will adapt to a low-carbon economy.

Companies with U.K. operations or those seeking investment from U.K. investors should prepare to align with these requirements, as the TPT framework is expected to become mandatory for large businesses by 2024.

What Does This Mean for ESG in Japan?

There is a high level of interoperability and alignment between ESG regimes in Japan, the U.K., the EU, and pro-ESG U.S. states. Mandatory disclosure items under Japan's sustainability disclosure regimes mirror the four TCFD pillars, which align closely with the CSRD ESRS and the ISSB's IFRS S1 and S2 standards. Additionally, the Sustainability Standards Board of Japan (SSBJ) has confirmed that the ISSB standards will be fully integrated by March 31, 2025, further aligning Japan's disclosures with international sustainability standards.

As well as the interoperability of reporting standards, regulations and requirements introduced in the EU and U.S. could impact Japanese multinational companies in several ways:

- Japan's Green Growth Strategy and the emerging Japanese Green Taxonomy define green activities in key sectors, and as these frameworks develop, they are expected to align further with international taxonomies, such as the EU Taxonomy. Japanese businesses will need to navigate both the domestic and international taxonomies to access key markets like the EU.

- Japan's large multinational companies can expect to be captured by the CSRD reporting requirements if they have a European presence, requiring ever more detailed ESG-related disclosures (and ESG risk and impact management system development).

- The EU's CBAM means that Japanese businesses exporting to the EU should anticipate higher compliance costs if they do not meet emissions reduction targets.

- California's Climate Disclosure Regimes will impact some Japanese companies with a presence in California, requiring disclosures of GHG emissions and assessment of climate-related financial risks.

At the same time, Japanese companies are heavily invested in by U.S.-based shareholders that could hold anti-ESG views (or at least be subject to anti-ESG state restrictions), and Japanese companies will continue to find themselves caught in the crosshairs of these two views.

Please join us for a webinar exploring how Japanese multinational companies should position themselves in light of these issues and more on Wednesday, November 6, 2024 at 5:00 p.m.–6:15 p.m. (Tokyo time) (**REGISTER HERE**).

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 Texas is sued over anti-ESG law
Federal Court Rules That Missouri Anti-ESG Rules are Unconstitutional

2 Guidance U.K. Sustainability Reporting Standards, https://www.gov.uk/guidance/uk-sustainability-reporting-standards.

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