PRI RESPONSE

JAPAN FSA INVITATION FOR PUBLIC COMMENTS REGARDING REVISION PLANS TO THE CABINET OFFICE ORDINANCE ON DISCLOSURE OF CORPORATE AFFAIRS

7 December 2022

To inform this briefing, the following investor group has been consulted: PRI Regional Policy Reference Group for Japan. This consultation is not an endorsement or acknowledgement of the views expressed in this briefing.

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INTRODUCTION

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

The PRI develops policy analysis and recommendations based on signatory views and evidence-based policy research. The PRI welcomes the opportunity to respond to the Japanese Financial Services Agency (JFSA) call for feedback on its proposed revision plans to the Cabinet Office Ordinance on corporate reporting.

ABOUT THIS CONSULTATION

On 7 November 2022, JFSA's Corporate Accounting and Disclosure Division published its proposed plans on revisions to statutory corporate reporting rules. The plans were informed by deliberations of the Financial System Council's Working Group on Corporate Disclosure, who's report published in June 2022 provided the basis for the current proposed plans. The plans propose to cover the following points:

- A new sustainability information section in the annual securities report divided into four pillars covering: "governance", "risk management", "strategy", and "metrics and targets".
- Additional further reporting requirements on human capital and diversity within the existing annual securities reporting requirement on employee data, based on the minimum reporting requirement of the Act on the Promotion of Women's Active Engagement in Professional Life.
- A new principles-based guidance document outlining how companies ought to report on sustainability information, including in relation to climate change.

Requirements pertaining to the annual securities report will apply to reports covering financial years ending after 31 March 2023, effectively applying to most Japanese companies in the coming reporting cycle.

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KEY RECOMMENDATIONS

The PRI welcomes the opportunity to provide comments regarding the JFSA's proposals for the introduction of sustainability reporting requirements into the annual securities reporting framework and its aim to ensure that sustainability information is accounted for alongside financial information.

The JFSA's approach signals a movement toward providing a fair and level platform where companies are able to provide sustainability information under a common set of reporting pillars. The alignment of these four pillars with the frameworks adopted by the TCFD recommendations and the draft IFRS Sustainability Disclosure Standards also allows for efficiency among practitioners (especially for Prime Market listed companies now required to report in alignment with the TCFD recommendations as per the Corporate Governance Code). It can also provide a framework that can accommodate requirements of the IFRS Sustainability Disclosure Standards once finalized.

Alongside revisions to the cabinet office ordinance, the PRI also welcomes the opportunity to comment on the JFSA's guidelines and the principle-based guidelines that supplement the cabinet office ordinance. We note and appreciate that these supplementary documents aim to provide clarity and guidance for companies in implementing the newly introduced requirements.

However, we observe that overall, the JFSA's proposed revisions to the cabinet office ordinance and the supplementary guidance do not provide enough information about what is being required of companies in the new ruling. To support the JFSA's efforts to provide a better policy framework that aids companies in reporting decision-useful sustainability information alongside their annual financial reporting, the PRI's key recommendations are:

Revisions pertaining to requirements of the draft cabinet office ordinance regarding overall sustainability information

- The JFSA should consider making all four pillars of the general requirements mandatory for human capital reporting, climate reporting, and all other "material" sustainability issues
- The JFSA should rationalize its language of "important/importance" and "material/materiality" and preface the general requirements on the four pillars with an explanation that they apply to all material sustainability issues
- The JFSA should provide better clarity and definitions to what is meant by the four pillars of the general requirements
- The JFSA should require all companies to report on Scope 1, Scope 2 and where material[1], scope 3 GHG emissions data

[1] When considering whether to disclose Scope 3 GHG emissions, organizations should consider whether such emissions are a significant portion of their total GHG emissions. For example, see discussion of 40% threshold in the SBTi criteria and recommendations Version 4.2, April 2021, Section V, p. 10

Revisions pertaining to requirements of the draft cabinet office ordinance regarding human capital and diversity information

- The JFSA should require companies that don't report to the Promotion of Women's Active Engagement in Professional Life to explain why, require contextual information relating to the coverage of the data that is provided, and require the disclosure of disaggregated domestic and foreign data

Guidelines on disclosure of corporate affairs

- The JFSA should consider requiring all cross-referenced information to meet the same characteristics of quality as information included within the annual securities report

Principles regarding disclosure of detailed information (guidance on reporting sustainability-related information)

- The JFSA should better define key terms used in the guidance, including "materiality", "sustainability", and the four pillars of "governance", "risk management", "strategy" and "metrics and targets"
- The JFSA should require the disclosure of Scope 3 GHG emissions, where material and provide detailed guidance on how companies should report on Scope 1, Scope 2 and Scope 3 GHG emissions. Calculations should be required to be made using the GHG Protocol to support international consistency
- The JFSA should consider recommending that companies report on climate scenarios under the "strategy" pillar
- The JFSA should consider providing guidance on a wider range of metrics that can support companies in conveying their status quo and approach to human capital management
- The JFSA should consider requiring disclosure of information on governance, strategy and risk management for the consolidated group and individual companies
- The JFSA should consider specifying that reporting should cover the short-, medium- and long-term sustainability of the company
- The JFSA should consider requiring companies to specify which standards or parts of standards have been disclosed against, including what technical guidance has been applied

Points for further consideration

- Following the adoption of proposed reporting requirements, the JFSA should move at pace to align sustainability reporting requirements with IFRS Sustainability Disclosure Standards once these are finalised, and at this stage should encourage companies to consider international sustainability reporting standards in their identification of material risks and opportunities
- The JFSA should commit to conducting a comprehensive review of how companies respond to these new statutory reporting provisions and implement relevant updates prior to the next reporting cycle

DETAILED RESPONSE

SECTION 1: THE CABINET OFFICE ORDINANCE ON DISCLOSURE OF CORPORATE AFFAIRS

Relevant proposal documents: Supplement 1, Supplement 2, Supplement 3

PART 1: REVISIONS PERTAINING TO OVERALL SUSTAINABILITY INFORMATION

- **The JFSA should consider making all four pillars of the general requirements mandatory for human capital reporting, climate reporting, and all other "material" sustainability issues.** The JFSA's proposal only requires companies to report to the two of the pillars of the general requirements ("governance" and "risk management") and only requires the remaining two pillars ("strategy" and "metrics and targets") where the company deems it to be "material". This fragmented approach may fall short of providing investors with decision-useful information that is relevant[2], comparable[3] and verifiable[4].

  Making reporting against all four pillars mandatory, where 'material' would provide an effective balance between ensuring that companies provide the categories of information that investors expect on the key topics of human rights and climate change, while at the same time allowing companies flexibility to determine what form their disclosures under these pillars will take, and which other sustainability issues are material to their investors, based on their particular circumstances.

  In particular, we note that investor feedback has indicated that reporting on strategy is crucial to their decision-making and provides a complement to reporting on governance and risk management that is needed to achieve an appropriate level of connectivity. In relation to climate change, this would lead to an overreliance on static and backward-looking disclosures. However, from a scientific understanding and government policy it is apparent that the materiality of climate-related risks and opportunities will not be static, but rather grow over time.

  Hence, both static and strategic disclosures are needed by investors to inform stewardship and capital allocation decisions. In addition, the four pillars of the TCFD / ISSB are functionally inter-related. For instance, having metrics and targets would be essential to the effective management of risk and an organisation governance of a sustainability issue. Given Japan's role in promoting

[2] Relevant data must both inform the investment decision-making process (i.e. be investment relevant) and (where applicable) provide insights for (or enable) investors' decisions, reporting obligations and/or commitments on specific issues (i.e. be issue relevant).

[3] Comparable data must be consistent across investees, asset classes, sectors, geographies and timeframes to enable investors to identify and understand similarities/differences at the scale that suits their data needs.

[4] For data to be verifiable, investors should be able to corroborate the information/inputs used to derive the data.

the TCFD and the number of official Japanese TCFD "supporters", more than any other country[5], the PRI anticipates there would be Japanese market familiarity and a degree of readiness for reporting against the four pillar– governance, strategy, risk management & metrics – structure.

We believe that companies would have better clarity over their reporting duties and ultimately investors will have better access to decision-useful information if the JFSA makes it a mandatory requirement to report on all four pillars for human capital, climate change, and any other sustainability issues that are "material" to the company.

- **The JFSA should rationalize its usage of the terms "important/importance" and "material/materiality" and preface the general requirements on the four pillars with an explanation that they apply to all material sustainability issues.** The proposed rule as stated in the cabinet office ordinance only refers to the concept of "materiality" in relation to the two optional pillars – more specifically, it requires that companies report on the two optional pillars if they decide they are "material". The principles regarding disclosure of detailed information (guidance on reporting sustainability-related information), however, suggests that there are two tiers of materiality: one where companies need to initially identify "material" sustainability issues to report on based on the four pillars, and one where companies need to decide whether the two optional pillars are "material" to each sustainability issue being reported on. We support the notion conveyed by the principles regarding disclosure of detailed information, but recommend that this is made clear in the cabinet office ordinance as well.
- **The JFSA should provide better clarity and definitions to what is meant by the four pillars of the general requirements.** The JFSA's proposal provides a high-level explanation of what each of the four pillars means, but the provided definition lacks detail and clarity. While the definitions provided align with the lead sentence provided in the definitions of the ISSB Exposure Draft IFRS S1, without examples of specific reporting items that come under each pillar, companies especially inexperienced in sustainability reporting may lack the necessary guidance to be able to provide decision-useful information. For example, providing further detail and clarity can help companies differentiate between the similar definitions currently provided for "governance" and "risk management".
- **The JFSA should require all companies to report on Scope 1, Scope 2 and, where material, Scope 3[6] GHG emissions data.** Currently, Scope 1 and Scope 2 GHG emissions data is referred to in the principles-based guidance as an optional but encouraged item of disclosure. However, given the pertinence of climate-related data and the global shift toward policy interventions to increase the availability of it, we recommend that at minimum, Scope 1, Scope 2 and, where material, Scope 3 data be required of all companies alongside the three human capital metrics.

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[5] Source TCFD Status Report to the Financial Stability Board 2022

[6] When considering whether to disclose Scope 3 GHG emissions, organizations should consider whether such emissions are a significant portion of their total GHG emissions. For example, see discussion of 40% threshold in the SBTi criteria and recommendations Version 4.2, April 2021, Section V, p. 10

PART 2: REVISIONS PERTAINING TO HUMAN CAPITAL AND DIVERSITY INFORMATION

- **The JFSA should require companies that don't report to the Promotion of Women's Active Engagement in Professional Life to explain why.** The proposed wording gives the impression that companies not actively compliant to the reporting requirements of the Act on the Promotion of Women's Active Engagement in Professional Life are not required to report this data in their annual securities report. However, companies that do not report on these metrics in their annual securities report should be required to explain why they are not doing so in a manner consistent with why they do not report to the relevant Act itself.
- **The JFSA should require contextual information relating to the coverage of the data they provide for the three diversity metrics.** Given that publicly listed subsidiaries still exist in Japan, confusion persists on the aggregation of information by parent companies. Furthermore, many companies manage their employee data at the corporate or jurisdictional level as employee data requirements vary by jurisdiction or whether you are a parent company or subsidiary. Given that the Act was developed with the aim to support the vocational market and not investors, the level of scrutiny for the consistency and accuracy in data reporting may not be in line with what is expected at the financial reporting level. Where a company decides to report on these three metrics but has limitations or caveats to their data, such as using proxy data or estimations, they should be required to note this kind of information explicitly.
- **The JFSA should require disaggregated domestic and foreign data for the diversity metrics.** Given that the baseline requirement is to report on diversity metrics at the globally consolidated level, the diversity data of companies with subsidiaries in foreign jurisdictions will be exposed to different implications as those operating solely domestically. For example, depending on how a jurisdiction defines parental leave or if the management level is defined differently according to jurisdiction, consolidated data may be skewed from reality. At minimum, comparability would be better ensured if companies are required to report on these metrics at the domestic and foreign level. Where foreign data is difficult to obtain due to operational challenges, companies should be required to provide a timeline on their plans to make this information available.

SECTION 2: GUIDELINES ON DISCLOSURE OF CORPORATE AFFAIRS

Relevant proposal documents: Supplement 4

- **The JFSA should consider requiring all cross-referenced information to meet the same characteristics of quality as information included within the annual securities report.** This would help to ensure the relevance, comparability and verifiability of all reported information, as the proposals currently allow for incorporation of information by reference to "voluntary disclosure documents". It would also be consistent with the approach of international standards [c.f. ISSB Exposure Draft IFRS S1, paragraph 76].

SECTION 3: PRINCIPLES REGARDING DISCLOSURE OF DETAILED INFORMATION (GUIDANCE ON REPORTING SUSTAINABILITY-RELATED INFORMATION)

Relevant proposal document: Supplement 5

DEFINING KEY TERMS AND CONCEPTS

- **The JFSA should provide a definition and guidance on "materiality", as this forms the basis of what information a company will disclose.** Otherwise, there may be inconsistency in the materiality assessment implementation across companies, risking comparability of reporting. The JFSA should consider adopting the definition of materiality laid out within the IASB's Conceptual Framework, in line with existing precedent in financial reporting and recent ISSB decisions as it finalises IFRS Sustainability Disclosure Standards. This would help to ensure that relevant information is reported to investors and promote comparability across companies. Should the JFSA choose to do so, our response to the ISSB's consultation on Exposure Draft IFRS S1 contains proposed guidance on how companies could implement the materiality assessment, based on the reporting requirements within this exposure draft. Note that we strongly support the JFSA's proposal to require reporting on materiality judgments, and on the basis for these judgments – this would improve verifiability of reporting by providing investors with a needed level of transparency on the materiality assessment.
- **The JFSA should provide a definition and guidance on "sustainability", as without a concrete and shared baseline of understanding, the comparability of this information may not be maintained.** The concept of "sustainability" is not defined clearly enough for companies to be able to practically consider the materiality of relevant information. The referenced codes and reports provide disaggregated and fragmented interpretations of key concepts such as "sustainability" and "long-term" and therefore the JFSA should consider providing better clarity and granularity to the definition they provide here for sustainability. In providing a clearer definition, the JFSA can consider the approach that the ISSB Exposure Draft IFRS S1 takes in the Introduction, defining sustainability-related risks and opportunities through a company's dependencies on economic externalities, including both positive and negative influences the company is subject to in those relationships.
- **The JFSA should provide a more detailed definition and guidance on the four pillars.** The four pillars of 'governance', 'strategy', 'risk management' and 'metrics and targets' are defined vaguely and briefly in the Cabinet Office Ordinance, but this will be insufficient in supporting practitioners. The JFSA should consider providing a guidance broken down by the objective of the pillar, key components of information that should constitute the pillar, and examples of information that support the key components. This can take a similar approach to the ISSB's Exposure Draft IFRS S1 standard and should commit to adapting it accordingly once the standards are finalized.
- **The JFSA should consider requiring disclosure of information on governance, strategy and risk management for the consolidated group and individual companies**, where there is a material difference in arrangements between the consolidated group and individual companies.

Under the current proposal this principle is applied to metrics, but should be extended to all reporting pillars to capture material divergences at the company-level.

- **The JFSA should consider specifying that reporting should cover the short-, medium- and long-term sustainability of the company.** The current proposal would capture reporting on the medium- and long-term sustainability of the company, however sustainability information relevant to the short-term can also be material. This change would help to ensure that all relevant information is captured in reporting, and would improve alignment with TCFD recommendations and international standards.
- **The JFSA should consider requiring companies to specify which standards or parts of standards have been disclosed against, including what technical guidance has been applied.** Under the current proposal companies would have the option to do this. However, this specification should be mandatory as it would allow investors to verify the completeness and basis of reporting.

CLIMATE REPORTING

- **The JFSA should provide detailed guidance on how companies should report on Scope 1, Scope 2 and where material, Scope 3 GHG emissions.** As above, we welcome JFSA's reference to the Financial System Council's Working Group on Corporate Disclosure's Report on the expectation that companies should proactively report on Scope 1 and Scope 2 emissions data. Scope 3 reporting should be made in reference to the relevant categories of the scope 3 reporting in the GHG Protocol. However, in disclosing GHG emissions, entities should also be recommended to disclose the material inputs and assumptions used to calculate these, and a description of the calculation methodology – including organisational scope, emissions factors used and other information on the calculation approach. This would help investors verify reported GHG emissions, particularly if these have not been subject to third-party verification. Furthermore, it would allow for better global alignment as this approach has also been suggested in both the US Securities and Exchange Commission's Proposed Rule on climate-related disclosures [page 471] and EFRAG Exposure Draft ESRS E1 on Climate change [page 31].
- **The JFSA should include Scope 3 emissions in the principles as a key climate-related metric that should be proactively reported on my companies.** We recommend that the disclosure of Scope 3 GHG emissions be required, where material [7]. While Scope 3 GHG emissions are often more difficult to report, these are the largest source of emissions in some industries. Leaving them out could mean that a large share of actual emissions, where material, are not reported. In addition, Scope 3 disclosures should be accompanied by robust methodological explanations of the underlying inputs, assumptions, calculation methodologies used, and categories included in (and excluded from) the reported figure.

[7] When considering whether to disclose Scope 3 GHG emissions, organizations should consider whether such emissions are a significant portion of their total GHG emissions. For example, see discussion of 40% threshold in the Science Based Targets initiative's (SBTi's) paper SBTi Criteria and Recommendations, Version 4.2, April 2021, Section V, p. 10.

- **The JFSA should provide guidance on methodologies to calculate GHG emissions data.** We recommend that GHG emissions should be calculated in line with the GHG Protocol methodology, the most widely used and recognised international standard for calculating GHG emissions. While we recognise outstanding methodological issues, this would allow for a standardisation of emissions data across jurisdictions, increasing comparability and facilitating aggregation for investors. Where different jurisdictional methodology for calculating GHG emissions exist, such as in Japan, we still recommend using GHG Protocol methodology and if necessary, outlining the differences in methodology to ensure comparability.
- **The JFSA should consider providing guidance on material cross-industry metrics.** We recommend that disclosure of other cross-industry climate-related metrics within the TCFD recommendations and the final IFRS Sustainability Disclosure Standard on climate reporting be required, where material. Investors need this information to assess a company's exposure to climate-related risks and opportunities.
- **The JFSA should consider recommending that companies report on climate scenarios under the "strategy" pillar.** We recommend that disclosure regarding the climate resilience of a corporation's strategy be required, as is recognised in IFRS S2 standard. As per the TCFD recommendations, we recommend using climate-scenario analysis disclosure to do so. Disclosure on climate scenarios is important to investment and voting decisions as it demonstrates the degree of attention by companies to the issue and an understanding that the importance of climate change will not be static. Static disclosures, such as GHG emissions, should be complemented with forward looking disclosure, such as climate scenarios. At a minimum, this should include:
    - how a company assessed its potential climate-related future(s) and the insights it gleaned from scenario
    - what changes, if any, the company may be considering to its business model in response to its scenario analysis
    - how resilient management believes the company's strategy is to various future climate states; and
    - where the uncertainties are regarding the company's strategy and its resilience to climate-related risks and opportunities[8].

HUMAN CAPITAL AND DIVERSITY METRICS

- **The JFSA should consider providing guidance on a wider range of metrics that can support companies in conveying their status quo and approach to human capital management.** We note that the Cabinet Secretariat has published the Guidelines for Visualizing

[8] TCFD (October 2020), TCFD Guidance on Climate Scenario Analysis for non-Financial Companies, available at: https://assets.bbhub.io/company/sites/60/2020/09/2020-TCFD_Guidance-Scenario-Analysis-Guidance.pdf

Human Capital, which covers a range of human capital metrics. While the guidance and the covered examples of metrics are relevant at the domestic level, companies should be encouraged to consider a wide range of diversity metrics to provide investors with necessary data to consider the holistic risks and opportunities associated with diversity, equity and inclusion. For example, the Guidelines and the JFSA's proposal can additionally encourage companies to report on diversity metrics such as managerial diversity and pay gap by including other characteristics beyond gender, such as age, disability, sexual orientation, religion, nationality, etc., and for all levels of seniority and not just managers or board members. It would be beneficial to emphasize the importance of using 'inclusion metrics', which go beyond workforce composition data and instead look at the treatment of staff across the recruitment, retention and promotion employee lifecycle, and how this is broken down across different characteristics and identities.

- **The JFSA should expand the disclosure guidance on pay gap.** The PRI supports the inclusion of the metrics on wage gap between men and women, however it would be beneficial to include disclosure around other issues related to pay. The importance of salary transparency for current and potential employees should not be underestimated, since it often reinforces pay gaps, such as the gender[9] and racial pay gap[10]. This may include listing the salary of a job in a job advert. It also may include ensuring pay bands and criteria for how people are paid is completely transparent within the business. Pay rises and other rewards, such as bonuses, are also important rewards that should be assessed for fairness, which we recommend including in the calculation of wage gaps.

SECTION 4: POINTS FOR FURTHER CONSIDERATION (ROADMAP, ALIGNMENT WITH THE ISSB AND THIRD-PARTY ASSURANCE)

- **Following the adoption of proposed reporting requirements, the JFSA should move at pace to align sustainability reporting requirements with IFRS Sustainability Disclosure Standards once these are finalised.** The PRI strongly supports the ISSB's mission to deliver a high-quality global baseline of sustainability-related financial disclosures. This reflects investor demand for consistent and reliable sustainability information that enables them to fully understand related risks and opportunities, and to take investment and stewardship decisions aligned with their long-term investment goals.
- **The JFSA should consider encouraging companies to consider external sources in their identification of material risks and opportunities.** These should include the IFRS Sustainability Disclosure Standards, SASB Standards, the CDSB Framework, and the most recent pronouncements of other standard-setting bodies (where requirements are designed to meet the needs of users of general purpose financial reporting) – in line with the approach outlined in the ISSB's Exposure Draft IFRS S1 [c.f. paragraph 51]. This would help to ensure that all relevant information is reported, enhance alignment with (and market preparedness for) IFRS

[9] https://www.forbes.com/sites/adigaskell/2021/03/08/transparency-is-key-to-removing-the-gender-pay-gap/?sh=7126f11266c3

[10] https://www.payscale.com/data/racial-wage-gap

Sustainability Disclosure Standards, and allow for greater comparability of reporting across companies.

- **The JFSA should consider encouraging the attainment of third-party verification/certification/assurance for information provided under "metrics and targets".** Although a legal safe harbour is effective in the early stages of introducing mandatory sustainability reporting, companies should be prompted to consider how best to ensure that the data is reliable and trustworthy.
- **The JFSA should commit to conducting a comprehensive review of how companies respond to these new statutory reporting provisions and implement relevant updates prior to the next reporting cycle.** The proposed introduction of sustainability reporting requirements are currently retained to high-level instructions, leaving ample room for companies to interpret how best to follow these rules. To understand where clearer signalling and granular guidance is required, the JFSA should commit to comprehensively reviewing the annual securities reports filed immediately after the rule takes effect, and alongside its decision-making on how to introduce the ISSB standards (once finalized) into the Japan market, consider how best to amend the cabinet office ordinance and respective guidance for next year.

The PRI has experience of contributing to public policy on sustainable finance and responsible investment across multiple markets and stands ready to support the work of the JFSA further to embed sustainability information into statutory reporting requirements in Japan.

Please send any questions or comments to policy@unpri.org.

More information on www.unpri.org