

Legal Issues with regard to TCFD Recommendations

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Summary

- 1. The TCFD Recommendations are an initiative to facilitate a company's disclosure of the actual and potential financial impacts of climate-related risks and opportunities on the company, such as increases/decreases of costs, and increases/decreases of sales, in mainstream financial filings/reports, in order to protect investors.**
- 2. A "Common scenario" to identify and assess the potential financial impact of climate-related risks and opportunities on relevant companies is necessary, so that investors can financially compare them under the same assumptions.**
- 3. The Basic Energy Plan under the Basic Act of Energy Policy is appropriate for a "common scenario" to be used by all companies relating to Japanese energy policy and laws.**
- 4. ESG/SDGs focus on "what to do to tackle climate-related issues." On the other hand, TCFD Recommendation focuses on "what financial impacts of climate-related risks and opportunities are." The focus points are different.**
- 5. Some situations may lead to investors' misunderstanding that a company's more desirable activities, from the viewpoint of ESG/SDGs, will always have a positive financial impact on the company, and that the ESG rating of a company accurately reflects the financial rating of the company.**
- 6. Misleading disclosures and ratings may be in violation of investor protection laws, such as the Financial Instruments and Exchange Act of Japan. Applicable government initiatives are expected.**

Outline of TCFD Recommendations (1)

【Background】

Because the transition to a lower-carbon economy requires significant and, in some cases, disruptive changes across economic sectors and industries in the near term, financial policymakers are interested in the implications for the global financial system, especially in terms of avoiding financial dislocations and sudden losses in asset values. Given such concerns, and the potential impact on financial intermediaries and investors, the **G20 Finance Ministers and Central Bank Governors** asked the **Financial Stability Board** (the “**FSB**”) to review how the financial sector can take account of climate-related issues. As part of its review, the FSB identified the need for better information to support informed investment, lending, and insurance underwriting decisions, and improve understanding and analysis of climate-related risks and opportunities.

To help identify the information needed by investors, lenders, and insurance underwriters to appropriately assess and price climate-related risks and opportunities, the FSB established an industry-led task force: the **Task Force on Climate-related Financial Disclosures** (the “**TCFD**”), in December 2015. The TCFD was asked to develop voluntary, consistent climate-related financial disclosures that would be useful to investors, lenders, and insurance underwriters in understanding material risks.

Through the process to widely gather the public comments, the TCFD finalized its final report, titled, “**Recommendations of the Task Force on Climate-related Financial Disclosures**” (the “**TCFD Recommendations**”), which was presented in the G20 Hamburg summit held in June 2017.

【Link of TCFD Recommendation】

<https://www.fsb-tcfd.org/publications/final-recommendations-report/#>

Outline of TCFD Recommendations (2)

【Key Features of the TCFD Recommendations】

- Adoptable by all companies
- Included in **financial filings/reports**
- Designed to solicit decision-useful, forward-looking information on **actual and potential financial impacts on companies, such as increases/decreases of costs and increases/decreases of sales**
- Strong focus on **risks** and **opportunities** related to a transition to lower-carbon economy

【Core Elements of the TCFD Recommended Climate-Related Financial Disclosures】

- **Governance:** To disclose how the company governs the climate-related risks and opportunities, which have actual and potential financial impacts on the company, such as increases/decreases of costs and increases/decreases of sales.
- **Strategy:** To disclose the actual and potential financial impacts of climate-related risks and opportunities on the company's businesses, strategy, and financial planning.
- **Risk Management:** To disclose the processes used by the company to identify, assess, and manage climate-related risks on the company, which have actual and potential financial impacts on the company, such as the increase/decrease of costs and the increase/decrease of sales.
- **Metrics and Targets:** To disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities, which have actual and potential financial impacts on the company, such as the increase/decrease of costs and the increase/decrease of sales.

Outline of TCFD Recommendations (3)

【Examples of risks and the financial impacts】

Risks: Enhanced environmental obligations from changes of policy and laws.

Financial impact: Increased capital costs and/or operating costs.

Risks: Customers' leaving due to their preference.

Financial impact: Decreased sales.

Risks: Rising sea levels.

Financial impact: Increased insurance premiums, and damage to property and assets.

Risks: Enhanced disclosure obligations concerning climate-related information.

Financial impact: Increased costs to prepare for such disclosure.

【Examples of opportunities and the financial impact】

Opportunities: Increased needs for carbon capture, storage, and recycling technology.

Financial impact: Increased sales of such technology.

Opportunities: Public sector's financial support for carbon capture, storage, and recycling technology.

Financial impact: Decreased capital costs and/or operating costs.

Opportunities: Increased needs of high-efficiency technology in the energy sector

Financial impact: Increase sales of such technology.

Outline of TCFD Recommendations (4)

【Scenario Analysis】

- The **actual financial impact** of climate-related risks and opportunities on the company is identifiable and assessable.
- How should we identify and assess **the potential financial impact** of climate-related risks and opportunities on the company? We cannot predict which climate-related risks and opportunities will be realized in the future.
- The TCFD recommends using “**scenario analysis**,” in which **plausible future statuses are used as assumptions to identify and assess the potential financial impact of climate-related risks and opportunities on the company**.

【Importance of disclosure in mainstream financial filings/reports】

- The TCFD Recommendation states as follows:

“[P]ublication of climate-related financial information in mainstream annual financial filings will help ensure that appropriate controls govern the production and disclosure of the required information. More specifically, the Task Force expects that the governance processes for these disclosures would be similar to those used for existing public financial disclosures, and would likely involve review by the chief financial officer and audit committee, as appropriate.”

- **The TCFD expects that the actual and potential financial impacts of climate-related risks and opportunities on a company will be reviewed by the chief financial officer and audit committee of the company.**
- For example, the Corporate Act of Japan requires financial information (i) to be prepared by the Representative Director, (ii) to be reviewed and reported by the Auditor, (iii) to be approved by the Board of Directors, and (iv) to be submitted to shareholders. And the Financial Instruments and Exchange Act of Japan requires that the financial information in the Annual Securities Report be audited by a certified public accountant.

Necessity of a “Common Scenario”

【Issues in Scenario Analysis】

- To identify and assess the potential financial impact of climate-related risks and opportunities on a company, the TCFD recommends using “scenario analysis,” in which plausible future statuses are used as assumptions.
- The potential financial impacts of climate-related risks and opportunities on a company, such as increases/decreases of costs and increases/decreases of sales, differ by the scenarios used as assumptions.
- It is difficult, in practice, for an investor to financially compare companies, each of which uses different scenarios to identify and assess the potential financial impact of climate-related risks and opportunities on the company.
- Companies may tend to intentionally select scenarios which can lead to a more positive potential financial impact of climate-related risks and opportunities on them, so that they can obtain better assessments and/or better ratings from investors and or rating institutes.

【Necessity of a “Common Scenario”】

- Although companies should use a number of scenarios in their disclosures, pursuant to the TCFD Recommendations, at least one “common scenario” which all related companies use to identify and assess the potential financial impact of climate-related risks and opportunities on them should be included, so that investors can financially compare such companies based on the same assumption.

The Basic Energy Plan under the Basic Act of Energy Policy is appropriate for a “common scenario” to be used by all companies relating to Japanese energy policy and laws

【The Basic Energy Plan under the Basic Act of Energy Policy of Japan】

- The Basic Energy Plan should be formulated by the Japanese government, pursuant to the Basic Act of Energy Policy of Japan (the “Act”).
- Article 1 of the Act states “contributing to the preservation of the local and global environment and to the sustainable development of the Japanese and global economy and society“ as the purpose of the Act, and Article 3 of the Act requires that energy policy be environmentally suitable, stating that “With regard to energy supply and demand, measures shall be promoted to realize energy supply and demand that allow for the prevention of global warming and the preservation of the local environment, as well as to contribute to the formation of a recycling society by improving energy consumption efficiency, by such measures as promoting the conversion to non-fossil-fuel energy use, such as solar and wind power, and the efficient use of fossil fuels.” That is, **the Act requires the Basic Energy Plan to reflect climate-related issues.**
- Article 12 (3) of the Act requires procedures such as hearing the opinions of the heads of the relevant administrative organs, including the Ministry of Environment, in the process of formulating the draft of the Basic Energy Plan. That is, **procedures to secure the Basic Energy Plan reflect the climate-related issues are stipulated in the Act.**
- Article 12(5) of the Act states, “The government shall review the Basic Energy Plan at least once every three years, by taking into consideration the changes in the situation concerning energy, and based on an evaluation of the effects of measures concerning energy, and if it finds necessary, make changes to the plan.” That is, **structures by which the Basic Energy Plan can reflect changes in the situation related to climate-related issues are included in the Act.**

【Link of the current Basic Energy Plan of Japan】

https://www.meti.go.jp/english/press/2018/pdf/0703_002c.pdf

“Position” and “Policy Direction” of Coal in the Basic Energy Plan of Japan

【Page 20 of the Japanese version of the current Basic Energy Plan dated July 2018】

(i) Position

Although coal has a problem — it emits a large amount of greenhouse gas — it is currently evaluated as a fuel for an important base-load power supply, because it involves the lowest geopolitical risk and has the lowest price per unit of heat energy among fossil fuels, but it is expected that the need to adjust power output appropriately will grow as a consequence of the expansion of the introduction of renewable energy. Going forward, the GOJ will promote conversion to high-efficiency and next-generation coal thermal power generation, and utilize this energy source while focusing on reducing the environmental load in the long term, for example by making efforts to shift to the cleaner use of gas, and phase out inefficient coal use.

(ii) Policy Direction

In addition to speeding up the metabolism through the introduction of available leading-edge technology, the GOJ is further promoting the development of technologies to greatly improve power generation efficiency, and drastically reduce greenhouse gas emissions per unit of generated power, etc. (IGCC, CCUS, etc.).

In order to lead global decarbonization, taking into account the Paris Agreement, the GOJ proposes to the partner countries all options that contribute to CO₂ emissions reduction, including renewable energy and hydrogen, etc., based on the needs of the partner country, to actively promote “low-carbon infrastructure exports.” In this process, in the case where there is a request from a partner country for Japan’s high-efficiency coal thermal power generation, then only for those countries that are forced to choose coal as an energy source from the perspectives of energy security and economic viability, the GOJ supports the introduction of power generation equipment that is, in principle, at or above ultra-supercritical pressure (USC), the global state-of-the-art, taking into account OECD rules and in a form that is consistent with the energy policy and climate change measures of the partner country.

Correlation between ESG/SDGs and the TCFD Recommendations

【Correlation between ESG/SDGs and the TCFD Recommendations】

- Both ESG/SDGs, and the TCFD Recommendations, deal with climate-related issues.
- However, **the focus points are different.** ESG/SDGs focus on “what to do to tackle climate-related issues.” The TCFD Recommendations focus on “what financial impacts on each company the climate-related issues have.”

【Questions from the perspective of difference of focus points. 】

- Do a company’s more desirable activities, from the viewpoint of SDGs, always have a positive financial impact on the company, such as an increase in sales and decreases in costs?
- Do a company’s less desirable activities, from the viewpoint of SDGs, always have a negative financial impact on the company, such as decreases in sales and increases in costs?
- Are decision-makings of ESG investors based ONLY on the actual and potential financial impacts of climate-related risks and opportunities on target companies, such as increases/decreases of costs and increases/decreases of sales, or are they based on NON-Financial Factors related to ESG and SDGs as well?
- Are ESG ratings issued by ESG assessment institutes based ONLY on the actual and potential financial impact of climate-related risks and opportunities on target companies, such as increases/decreases of costs and increases/decreases of sales, or are they based on NON-Financial Factors related to ESG and SDGs too?
- Are ESG ratings issued by ESG assessment institutes based on assumptions concerning Japanese energy policy and laws, which are the same as those for the Basic Energy Policy under the Basic Act of Energy Policy?

Legal Risks arising from the Differences in Focus Points

【Current Situations】

- A company's more desirable activities, from the viewpoint of SDGs, don't seem to always have a positive financial impact on the company, such as increases in sales and decreases in costs.
- A company's less desirable activities, from the viewpoint of SDGs, don't seem to always have a negative financial impact on the company, such as decreases in sales and increases in costs.
- Decision-makings of ESG investors do not seem to be based ONLY on the actual and potential financial impact of climate-related risks and opportunities on target companies, such as increases/decreases in costs and increases/decreases in sales, and are also based on NON-Financial Factors related to ESG and SDGs as well.
- The ESG ratings issued by ESG assessment institutes do not seem to be based ONLY on the actual and potential financial impact of climate-related risks and opportunities on target companies, such as increases/decreases in costs and increases/decreases sales, and are based on NON-Financial Factors related to ESG and SDGs too.
- ESG ratings issued by ESG assessment institutes may be based on assumptions concerning Japanese energy policy and laws, which are different from the Basic Energy Policy under the Basic Act of Energy Policy.

【Risks of Misleading Disclosures and Ratings】

- To include a company's more desirable activities, from the viewpoint of ESG/SDGs, without referring to the actual and potential financial impact of the activities on the company in the disclosure based on the TCFD Recommendations, **may lead investors' misunderstanding** that the activities have a positive financial impact on the company.
- To include a company's ESG rating without referencing the fact that the ESG assessment institutes also assessed NON-Financial Factors in rating in the disclosure based on the TCFD Recommendations, **may lead investors' misunderstanding** that the ESG rating of a company shows the financial rating of the company.

Governmental Initiatives are expected

【Legal Risks】

- Misleading disclosures and ratings may be in violation of investor protection laws, such as the Financial Instruments and Exchange Act of Japan.
- For example, Article 158 of the Financial Instruments and Exchange Act of Japan states that “No person shall spread rumors for the purpose of carrying out sales and purchases or other transactions of securities.”

【Governmental Initiatives are expected】

- To avoid the legal risks related to misleading disclosures and ratings, governmental initiatives are expected; for example:
 - ✓ Initiatives to familiarize companies with the Basic Energy Plan under the Basic Act of Energy Policy, as a “common scenario” to identify and assess the potential financial impact of climate-related risks and opportunities on companies whose businesses are related to Japanese energy policy and laws.
 - ✓ A research project to see whether ESG ratings are based ONLY on the actual and potential financial impacts of climate-related risks and opportunities on target companies, such as increases/decreases in costs and increases/decreases in sales, or on Non-Financial Factors as well.
 - ✓ Initiatives to avoid investors’ misunderstanding, from the disclosure pursuant to the TCFD Recommendations, that a company’s more desirable activities, from the viewpoint of ESG/SDGs, always have a positive financial impact on the company.
- Such initiatives may make the quality of ESG/SDG ratings more scientific and logical.

Thank you for your attention.

If you have any further questions, please feel free to contact me.

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