Corporate Sustainability Due Diligence and Sustainable Investments

Companies at the intersection of two mechanisms to address sustainability issues

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Agenda

1. Corporate Sustainability Due Diligence (CSDD) and the Duty of Directors

2. Sustainable Investment

1 CSDD and the Duty of Directors
1.1 EU CSDD Directive

Proposal of the European Commission (23/2/2022)
Article 25 Directors' duty of care
1 Member States shall ensure that, when fulfilling their duty to act in the best interest of the company, directors of companies referred to in Article 2(1) take into account the consequences of their decisions for sustainability matters, including, where applicable, human rights, climate change and environmental consequences, including in the short, medium and long term.
2 Member States shall ensure that their laws, regulations and administrative provisions providing for a breach of directors' duties apply also to the provisions of this Article.

European Council (22/12/2022)
Article 25 [deleted].

European Parliament (1/6/2023)
Article 25 [No modification].

1.1 EU CSDD Directive

Proposal of the European Commission (23/2/2022)
Article 26 Setting up and overseeing due diligence

1 Member States shall ensure that directors of companies referred to in Article 2(1) are responsible for putting in place and overseeing the due diligence actions referred to in Article 4 and in particular the due diligence policy referred to in Article 5, with due consideration for relevant input from stakeholders and civil society organisations. The directors shall report to the board of directors in that respect.

2 Member States shall ensure that directors take steps to adapt the corporate strategy to take into account the actual and potential adverse impacts identified pursuant to Article 6 and any measures taken pursuant to Articles 7 to 9.

European Council (22/12/2022)
Article 26 [deleted]

European Parliament (1/6/2023)
Article 26 [deleted].

1.2 The Duty of Directors from a Company Law Perspective

Shareholder Primacy Theory

- Director’s duty is to maximise corporate value (=shareholders’ value).
- Based on the logic that the rights of shareholders are subordinate to all creditors. Maximising the shareholders’ interest would increase the company's value and, thus, society's wealth.
- Externalities should be regulated by individual laws and regulations.
- Suitable for directors’ discipline.
- Directors may consider other stakeholders’ interests if they serve the company’s long-term interests.
- Philanthropic and social contribution activities are allowed to a reasonable extent.

1.2 The Duty of Directors from a Company Law Perspective

Enlightened Shareholder Value Theory

- Directors must act in the way they consider, in good faith, most likely to promote the success of the company for the benefit of shareholders as a whole, and in doing so, have regard for the interests of employees, the need to foster business relationships with suppliers or customers, and the impact of their operations on the community and environment, etc. (cf. UK Companies Act s. 172)
- Clarify that other stakeholders' interests can be considered, though the ultimate aim is to maximise shareholders' interest.
- No much difference from the Shareholder Primacy Theory.

1.2 The Duty of Directors from a Company Law Perspective

Stakeholder Theory

- Shareholder Primacy Theory is not valid.
  - It's hard to incorporate the interests of other stakeholders.
  - Not all externalities can be regulated by other laws and regulations.
- Directors should be able to consider the interests of other stakeholders.
- Criticisms of Stakeholder Theory
  - Difficult to determine what to prioritise among various interests.
  - Giving broad discretion would result in insufficient disciplining of directors.

1.3 Discussion

Question of “may” or “should”

- Company law debate is concerned with the question of “may”.
- CSDD is concerned with the question of “should”.

Different natures of issues concerned

- Company law: philanthropic and social contribution activities?
- CSDD: adverse impacts on human rights and the environment, particularly when a governance gap exists.
- Climate Change: The causal relationship or the extent of the company’s contribution is unclear.

1.3 Discussion

Suggested idea

1. Director “should” address the adverse impact identified in the CSDD. Prioritise according to the severity and the company’s circumstances.
2. Director “may” consider other interests if it would lead to maximising long-term shareholder value.
3. Director “may” consider philanthropic and social contribution activities to a reasonable extent.

Directive may help overcome the company law problems

- Breach of the duty to comply with laws and regulations makes the director liable. They must prove non-negligence.

2. Sustainable Investment
2.1 What is the Sustainable Investment?

Sustainable Investment

- an investment that takes into account E (environment), S (society) and G (governance) factors.
- In 2020
  - Sustainable investments accounted for 35%.
  - Of which, Europe (34%), the US (48%), and Japan (8%) .
- Methods include:
  - Negative screening
  - ESG integration
  - Engagement

2.2 Japan

For Issuing Company

- Disclosure standards: Recommendations of the Task Force on Climate-related Financial Disclosure (TCFD) are widely accepted.
- TCFD
  - Identify risks and opportunities for companies.
  - Disclosure recommendation in four segments.
    (governance, strategy, risk management, metrics/targets)
  - Single materiality approach.
- Corporate Governance Code
  - Companies are urged to address sustainability issues, but they are positioned as a part of the important management issues that create both risks and opportunities for the company.

2.2 Japan

For Institutional Investors

- Stewardship Code
  - The counterpart of the Corporate Governance Code.
  - Institutional investors should make clear how they consider sustainability issues.
  - Institutional investors owe a responsibility to their clients or beneficiaries to increase medium- and long-term investment returns by enhancing corporate value and promoting growth, and sustainability considerations are subordinate to this objective.
- Publication by the Financial Services Agency
  - Supervisory standards for ESG investment trust.
  - Supervisory guidance on climate-related risk management and client engagement.

2.3 EU

Taxonomy

- Definition of “Environmentally Sustainable Economic Activity”
- UNGPs serve as a minimum safeguard.

For Issuing Companies

- Disclosure obligation by the Corporate Sustainability Reporting Directive (double materiality approach).
- Taxonomy Regulation requires them to disclose the proportion of their turnover, capital and operating expenditure that corresponds to economically sustainable economic activity.

For Institutional Investors

- Disclosure obligation by the Sustainability Finance Disclosure Regulation at the entity level and financial product level.

2.4 Discussion

- Between 2014 and 2020, the Japanese market expanded dramatically, while the European market generally remained unchanged in volume.
- Several laws structure regulation in Europe and they are consistent with each other.
- Europe is more prone to the use of hard laws, whereas Japan seems to prefer a soft law approach.
- The EU adopts the double materiality approach, whereas Japan is based on the single materiality approach. The double materiality approach is consistent with the CSDD Directive.
- International convergence of non-financial disclosure standards is likely to be the main focus of the near future.

Concluding Remarks

- CSDD
  - Focus on adverse impacts on human rights and the environment.
  - Effectiveness of the enforcement is dependent.
  - Expecting to reach for SMEs and the entities along the value chain.
- Sustainable Investment
  - Focus includes various risks and opportunities for companies.
  - Powerful market force for the listed companies.
  - Limited reach for SMEs and the value chain.

- The governance of corporate sustainability endeavour is established through a combination of mechanisms with different characteristics.