Report by the Expert Committee on Desirable Market Economy System

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Expert Committee on Desirable Market Economy System

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Introduction

As Japan and the world face various changes and constraints, it is required to create a market economy system that ensures the sustainability of the economic society in order to achieve sustainable growth. After the Lehman Shock, other countries are also seeking a desirable market economy system.

The Expert Committee on Desirable Market Economy System was established under the Council on Economic and Fiscal Policy and has held discussions in order to study the shape of a market economy system under which sustainable growth can be achieved not by resorting to short-term speculation but by prioritizing medium- and long-term investments and to disseminate it to the world. This report summarizes the results of the discussions held so far.

1. Shape of Market Economy System

(1) Role of Market Economy System

A market economy system performs the functions as the basic infrastructure of economic society by maintaining the cycle of production, expenditure and income and achieving an efficient allocation of resources through the competition principle. At the same time, under a market economy system, companies try to increase productivity through innovation, seeking greater benefits, and to produce more attractive products, thereby fostering the dynamism that leads to reform of the economic society. Funds for creating innovation are provided to companies smoothly when they maintain liquidity in the financial market with the existence of diversified market participants and can fulfill their full functions. Expansion of fruits of innovations achieved by companies to society not only leads to growth of income but also enhances the welfare of the overall economic society in a broad range of fields, including the environment, safety and security.

In the process of maintaining the efficiency of the economic society as a whole and generating dynamism, a market economy system imposes discipline on market participants by creating both winners and losers and provides them with incentives by giving compensation. A market economy system shows its function more through the high degree of independence of the market participants.

Allowing a market economy system to fully perform such primary functions is generally expected in various capitalism societies, but it should be kept in mind that the actual institutional framework of the market economy system in each country has a different part, depending on such backgrounds as the history of economic development, legal system and employment practices.

(2) Problems Inherent in Market Economy System

In some cases, various problems occur due to factors inherent in a market economy system, preventing the system from performing its functions and inhibiting the sustainability of the economic society.

For example, due to asymmetry of information or the uncertainty of the future, medium- and long-term investments are not financed adequately, and, as a result, innovation may be stifled, or corporate activity based on market prices may put an excessive burden on the environment. Additionally, as human resource development in each company conducted under business decisions has externality, it may be below the desirable level for the economic society as a whole.

Moreover, it should be kept in mind that a market economy system may make a significant impact on the real economy in financial terms. Excessive financial volatility caused by a major financial crisis may have a significant negative impact on the real economy.

(3) Quest for Reform of Market Economy System

The concept of “sampo yoshi” (triple-win), which refers to the concept that a business that benefits all of the seller, buyer and society is good, has been traditionally cherished in Japan, which proves Japanese companies’ history of emphasizing links with various stakeholders.

The practice of long-term employment has contributed to human resource development, and in the past, the provision of medium- and long-term funds for growing sectors was ensured through traditional practices such as mutual shareholding and the main bank system. Such practices that have actually existed in the traditional Japanese style of business management may provide useful clues for exploring a desirable market economy system.

Transaction terms have become shortened in capital markets, where medium- and long-term funds should primarily be provided, and this has led companies to take short-sighted actions. In order to change such corporate actions as merely trying to reduce short-term costs and resulting in diminishing equilibrium, it is necessary to focus attention on the background thereof, i.e., the behavior of participants and mechanisms in capital markets.

After the emergence and collapse of the bubble economy, traditional Japanese practices have impeded the regeneration of industries in some cases. However, corporate actions with a medium- and long-term perspective, while prioritizing links with various stakeholders in order to ensure medium- and long-term investments, will surely create innovation and promote the regeneration of industries, instead of contributing to the protection of old businesses or inefficient ways of conducting business.

Now that corporate activities are globalized, stakeholders have spread all over the world. By advancing into emerging and developing countries, companies now serve as a bridge between them and developed countries.

Also in other countries, the quest is on to seek a new system to ensure investments from a medium- and long-term perspective, by overcoming such challenges as the increasing uncertainty due to technological innovations and globalization, the growing inclination toward short-termism in the financial market, and the need to reduce environmental burden. At the level of individual companies, there are also such growing efforts as to set sustainability as a business goal, and to place emphasis on pursuing medium- and long-term profits and contributing to various stakeholders, rather than merely maximizing short-term profits.

What we should aim to achieve is, by reconstructing our experiences, to create a sustainable "real economy driven" economic society, in which values are created continuously, without leaning excessively toward the speculation-driven "money game" that single-mindedly pursues unsubstantial short-term profits. We should also aim to ensure that the people share such a vision and are motivated to proactively participate in efforts to realize it. In other words, we must create a market economy system that accomplishes the following:

(i) promote medium- and long-term investments and active risk-taking that enable economic and social development and create new core industries through innovation;

(ii) maintain economic and social vitality by returning the values created to various stakeholders involved in companies;

(iii) enable personnel creating values within companies and in society to grow up;

(iv) accept countries and regions with various cultures and traditions and contribute to the economic development of the world, including developing countries, through free corporate activities; and

(v) co-exist with nature and the environment.

2. Stable Medium- and Long-term Funds for Achieving Sustainable Growth

(1) Necessity of Stable Medium- and Long-term Funds

Medium- and long-term funds refer to funds for innovation indispensable in increasing economic growth, competitiveness and employment through social infrastructure investments, corporate R&D activities and investments by venture companies, etc.[1]

[1] "The Role of Banks, Equity Markets and Institutional Investors in Long-Term Financing for Growth and Development" (2013), OECD

Although short-termism is prevailing in capital markets,[2] deals are reached under such circumstances and this does not directly suggest a decrease in medium- and long-term funds. However, the prevalence of short-termism has actually worked to discourage investors from holding shares in the medium and long term, which has made it difficult for companies to secure medium- and long-term funds stably.

As the shareholding period becomes shorter, companies are placed under strong pressure to improve business performance or carry out business restructuring from a short-term perspective, and corporate management based on medium- and long-term relationships of trust has become difficult for them. There is concern that such move may weaken companies' endurance capacity to consistently make efforts for innovation. How to have companies secure their medium- and long-term funds, while flexibly responding to changes in capital markets, is a significant challenge for Japan. We should overcome such challenge to achieve a new growth of Japan.

Corporate activities become possible with the involvement of various stakeholders, and prioritizing their interests results in boosting not only shareholder value but also the overall corporate value.[3] However, if investors make judgments on holding or disposal of shares based on current financial information only from the viewpoint of maximizing shareholder profits, this will make it difficult to maintain the overall corporate value and may even damage shareholder profits in some cases. If investors strengthen such tendency, corporate activities may further become myopic. The issues of reform of corporate governance and enhancement of communication by companies from this viewpoint will be discussed in 3. and 4. below.

(2) Current Status of Medium- and Long-term Funds

(i) Short-termism in Capital Markets

The average share holding period at the Tokyo Stock Exchange (TSE) was over five years in 1992, but has become shortened and is less than one year recently.

Amid globalization of financial markets and progress in technological innovations in finance, major stock exchanges in the world have introduced advanced systems that enable large amounts of trading speedily, and high-frequency trading prevails in markets, accompanying the sophistication of derivative trading and expansion of program trading.

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[2] Companies can raise funds from capital markets by means of liabilities (issuance of bonds, etc.), as well as by means of shares. However, this report covers the issue of the prevalence of short-term investments in capital markets with an eye on equity markets that involve diversified investors.

[3] See 3.(1) for the meaning of the overall corporate value.

Such changes concerning trading technologies have also opened the way for short-termism.

Regarding corporate disclosure rules, in light of the fact that nearly 90% of the listed companies on the TSE disclosed their quarterly financial reports in the third quarter of the business year ending in March 2005, the submission of quarterly financial reports became mandatory in FY2008, with the aim of informing investors of changes in corporate business performance during a business year as timely as possible. The submission of quarterly financial reports is considered to accelerate management’s decision-making, but on the other hand, it is criticized as making business operations from a medium- and long-term perspective difficult with too much emphasis placed on ensuring quarterly earnings.

Capital outflow from developed countries to emerging countries symbolizes moves focusing on differences in phases of economic conditions and policies and has been expanding, backed by structural changes emerging out of expectations of growth potential. Flow of risk-taking funds to emerging countries may have also exerted influence on provision of risk money in advanced countries.

(ii) Investor Behavior Causing Prevalence of Short-termism

Due to falls in the potential growth rates of advanced countries, investors face risks of suffering declines in their returns on investment. Insurance and pension systems are designed to ensure certain investment yields in order to perform payment obligations in the future, but it is becoming difficult to achieve prescribed investment yields due to declines in returns on investment with lower potential growth rates. Accordingly, in order to achieve prescribed yields, asset managers are apt to seek and accumulate short-term profit margins.

In Japanese equity markets, the trade share accounted for by overseas investors, who are characterized by a stronger preference for short-termism, is increasing, which is considered to be one of the factors that shorten the investment duration.[4]

Venture companies have stronger needs for R&D funds, but investments therein involve extremely large uncertainties and asymmetry of information and are apt to be made intensively at the stage when ventures are expected to take a company public. Recent investment behavior based on short-termism has worked to strengthen such intensive investments at the final stage and may force some of those ventures to sell their technology or business against their will.

The reasonable form of asset management according to individuals’ life stages is for young

[4] The average shareholding period in terms of the ratio of sales amount against the TSE’s total market capitalization has been 0.67 to 0.99 years since 2004. However, the average shareholding period for overseas investors has been below the average of the overall market, at 0.18 to 0.45 years, and the share accounted for by overseas investors among the total sales amount rose from 33% in 2003 to 54% in 2012. In the meantime, the average shareholding period for individual investors is below the average of the overall market, at 0.35 to 0.77 years, and the share accounted for by individual investors among the total sales amount has been unchanged at around 20%.

people to make investments involving certain risks to ensure returns and for aged people to make investments in risk-free assets to preserve the principal. Therefore, population aging in Japan and other advanced countries may strengthen people's preference for risk-free assets, such as sovereign bonds of highly rated advanced countries.

(iii) Short-termism in Business

Management's compensation also affects corporate actions. It is pointed out that Western companies have incentives in the remuneration practices for company executives under which management's compensation is linked to short-term business performance, and pressures from investors and markets work to accelerate managerial judgment. Also in Japan, though not so prevailing as in Western countries, a move to adopt remuneration practices linked to business performance came to be observed recently. Such practices are expected to be incentives for management to take actions to improve the overall corporate value, but it must be noted that adoption of incentives only prioritizing short-term business performance may encourage myopic behavior in business, such as stock buybacks or actions for mere cost reduction. In Western countries, a move to introduce incentives linked to medium-term business performance already emerged, reflecting on the experience of the Lehman Shock.

As short-termism has prevailed and attractive business chances have been decreasing in Japan, companies are apt to improve their composition of finances through cost reduction in order to record near-term profits, instead of trying to increase their earning capacity through medium- and long-term growth. Such negative responses will dampen the future economic vitality in such forms as a decline in productivity and curtailment of new business due to shortage in medium- and long-term investments.

(3) Challenges and Future Direction

Relations of trust between companies and investors are built while companies try to improve their value and communicate their visions and investors deepen understanding of companies' business operations from a medium- and long-term perspective. It is necessary to consider means to appropriately align incentives for medium- and long-term investments, along with means to increase medium- and long-term funds. Companies must make efforts not only to achieve value improvement but also to actively communicate their visions therefor to various stakeholders. In the meantime, enhancement of financial literacy and increase of the participation of individual investors will swell the base of medium- and long-term investments. It is also required to ensure appropriate provision of liquidity to investors in capital markets and to constantly check and review desirable regulations for performance evaluation and disclosure.

(i) Improvement of Overall Value and Communication by Companies

If companies seek supply of medium- and long-term funds from the market, it is indispensable for them to improve their overall corporate value and clearly communicate their visions and concrete measures to the market, because capital supply involving risks is limited and investors generally make investments focusing on companies' growth potential.

Companies' intentions are not always shared and companies may fail in securing an optimal investment size. Active communication efforts on the part of companies will eliminate asymmetry of information between fund providers and receivers and will help companies secure access to funds.

Based on the lessons from the Lehman Shock, companies are now trying to review their way of transmitting information with the aim of encouraging investments not from a short-term perspective but from a medium- and long-term perspective. In foreign countries, some companies have stopped disclosing their quarterly business prospects, which are thought to prompt short-term decision making. Also in Japan, medium- and long-term business visions have started to be presented. The number of companies that actively communicate their medium-term management plan with earnings goals for around three years is increasing rapidly, and some companies publicize their five-year or longer term visions without sticking to a form of medium-term management plan.

(ii) Improvement of Investors' Understanding and Increase of the Participation of Individual Investors

If investors do not fully understand how their investments affect the economy, this may encourage them to seek only short-sighted profits as a result. While enhancing financial literacy, private investors should deepen understanding that medium- and long-term investments function to foster companies and industries, and confirm the significance of their investments. Such process will be effective in improving the current situation where short-term investments are prevailing. Providers of hedge funds that repeat very short-term investments are individual investors after all. It is important to disseminate knowledge on roles that continuous fund supply play in growth fields to the individual investor level. Learning how to build assets in what composition at each life stage based on individuals' life plans is the basis for enhancing financial literacy.

Increase of the participation of individual investors, coupled with enhancement of financial literacy, will swell the base of medium- and long-term investments through the diversification of investors and vitalization of markets. Therefore, efforts should be continued into the future. The Nippon Individual Savings Account (NISA) system is expected to increase the participation of individual investors and provide individual investors with opportunities to learn the significance of investments. The effect of this system should be verified in the future.

There is a move on the part of investors to increase involvement in business conditions through giving advice or exercising their voting rights, instead of leaning excessively toward the speculation-driven money game. The move to consider medium- and long-term business trends when making investment judgments will surely spread in the future.

With regard to venture investments, shortage of discerning experts, as well as of funds, has been a problem. However, in recent years, some corporate managers who have succeeded in venture business started to make venture investments proactively and those with discerning eyes are increasing also in Japan. An increase in investors well-versed in business models of investment destinations will be a key to overcoming asymmetry of information in making investments.

In Japan, institutional investors have not actively had engagement with companies through the exercise of their voting rights, and it is pointed out that this is one of the causes to have undermined corporate governance. However, growing calls for institutional investors to assume greater responsibilities in strengthening corporate governance have prompted investment advisory companies and investment trust management companies, etc. to actively exercise their voting rights by establishing an independent committee to make judgments on the exercise of voting rights. Thus, institutional investors are now more strongly required to fulfill fiduciary responsibility.

Financial intermediates play significant roles to appropriately and efficiently effect transactions in markets, but their business models, which are defined by the frequency and amounts of transactions, may affect the behavior of fund providers. After the latest financial crisis, institutional investors have come to take into account investment managers' long-term investment performance in evaluating their annual performance. In order to effectively have fund providers make medium- and long-term investments, functions of the entities intermediating fund providers and receivers need to be properly fulfilled.

The Government Pension Investment Fund (GPIF) invests around 60% of its operating assets in government bonds and its asset structure is completely different from that of overseas pension funds. If the GPIF increases investments in risk assets by promoting portfolio diversification, this will exert significant influence on other institutional investors and will boost the expansion of the supply of risk money.

(iii) Appropriate Alignment of Incentives for Medium- and Long-term Investments throughout the Equity Investment Chain

For securing stable provision of medium- and long-term funds, companies need to appropriately transmit information on their needs for funds and investors need to have awareness and understanding concerning the provision of funds involving risks. How to spread market information is the key to link both sides. It is important to constantly check and review business performance evaluation and disclosure systems, which affect the behavior of investors and companies, as well as accounting standards, which serve as the basis for the former, in order to ensure appropriate alignment of incentives throughout the equity investment chain.[5]

It is indispensable that liquidity in transactions[6] is maintained and prices are formed properly in capital markets, and that the diversity of investment behavior is fully guaranteed for that purpose. Liquidity of long-term assets is also to be guaranteed by allowing freedom of short-term transactions thereof.[7] The diversity of investment behavior and liquidity provided thereby are essential factors for smooth transactions of medium- and long-term funds.

On the other hand, as short-sighted transactions are conducted generally based on daily bargaining tools and price trends, the underlying value of financial assets may not be fully taken into account. Accordingly, when prices are biased due to overheated short-termism, price formation in transactions may be distorted, which may hinder stable transactions of medium- and long-term funds. The prevalence of short-termism has encouraged excessive financial volatility in part. It is indispensable to properly maintain liquidity in order to ensure that medium- and long-term fund transactions are conducted smoothly in capital markets.

3. Efforts for Achieving Corporate Governance to Improve Overall Corporate Value from a Medium- and Long-term Perspective

(1) Necessity to Prioritize Coordination of Various Stakeholders in Corporate Governance

As seen in the concept of “sampo yoshi” (triple-win), Japanese companies have improved their overall value by placing importance on various stakeholders, including shareholders, employees, customers, business partners and local people.[8] The overall corporate value is a broad concept that does not merely refer to ordinary monetary value (so-called shareholder value) but also includes elements difficult to measure in numerical terms, such as value

[5] The fact that communication to various stakeholders changes the behavior of investors and shareholders will be explained in 4. below.

[6] Liquidity refers to the market profoundness, meaning the degree to which free transactions are guaranteed and smooth transactions are ensured.

[7] In this sense, short-term traders who solely engage in arbitrage transactions are also recognized as contributing to facilitating long-term transactions.

[8] Japanese companies place importance on various stakeholders, and those emphasizing balance among stakeholders generally enjoy higher growth (“Survey on IR/Communication Strategy for Sustainable Creation of Corporate Value” (2013), Task Force on IR/Corporate Value, Ministry of Economy, Trade and Industry)

arising from external economies and diseconomies whose monetary value cannot be evaluated immediately (reduction of environmental burden, etc.) and value relating to uncertain future sustainability (measures concerning exhaustible resources, etc.).[9] If a company can contribute to society, while adjusting the interests of various stakeholders,[10] and can create value that can be shared socially, its overall value will be improved as a result.[11] Improving the overall value of a company leads to increasing its aggregate market price (monetary value) and maximizing shareholder value in the end.[12] Corporate governance prioritizing coordination of various stakeholders[13] will result in benefitting investors who provide medium- and long-term funds and family finances that are the very sources of funds.

Employees in particular, out of various stakeholders, play core roles in corporate activities, and how to develop and utilize human resources through mutual efforts of a company and its employees is the key to improve the overall corporate value.

A move to place importance on relationships with various stakeholders has become an international trend.[14] Creation of value that can be shared socially, for which a number of companies are making efforts, overlaps with the concept of "sampo yoshi" (triple-win) in many parts. Emphasizing coordination of various stakeholders can be a guideline in pursuing corporate governance to improve value from a medium- and long-term perspective.

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9 In "*Chikyu to Kyozon suru Keiei – MOS Kaikaku Sengen* (Management for Coexistence with the Earth – MOS Reform Declaration) (2011)," Yoshimitsu Kobayashi advocates *KAITEKI* management to grasp the entirety of corporate management of chemical manufacturers by three axes: the axis of Management of Economics (the MOE axis) to measure progress in improvement of economic value; the axis of Management of Technology (the MOT axis) to ascertain how technology management for innovation has been deepened; and the axis of Management of Sustainability (the MOS axis) to promote efforts for the global environment and public interests.

10 In "*21-seiki no Kokufuron* (Wealth of Nations for the 21st Century) (enlarged edition) (2013)," George Hara advocates "Public Interest Capitalism." Companies are not solely for shareholders but for various stakeholders, including management, employees, customers, suppliers, local communities, and the earth as a whole. When companies act prioritizing contribution to all stakeholders and local communities, instead of only pursuing the interests of shareholders, a larger number of people can be happy and sustainable growth of the overall economy can be achieved. He explains that Public Interest Capitalism is a mechanism that enables business operation and investments from a medium- and long-term perspective and that it is the ideal form of capitalism.

11 In "Creating Shared Value (2011)," Michael E. Porter advocates "Creating Shared Value (CSV)" as a new concept replacing CSR. He defines CSV as efforts to balance activities for solving social problems with those for improving corporate earnings, and positions it as being indispensable for maximizing corporate interests.

12 In "How Great Companies Think Differently (2011)," Rosabeth M. Kanter introduces various cases and explains that companies whose business goal is not maximization of shareholder value can maximize shareholder value in the long run, and clarifies six factors common to those cases: a common purpose; a long-term focus; emotional engagement; partnering with the public; innovation; and self-organization.

13 Corporate governance is narrowly understood as a mechanism to discipline management for the purpose of maximizing the interests of shareholders. In this report, the term is used in a broader sense, basically meaning a mechanism to discipline management for the purpose of promoting the welfare of all stakeholders.

14 In "Corporate Governance (2001)," Jean Tirole defines corporate governance as institutional design to discipline management for the purpose of maximizing the total surplus of various stakeholders as a whole, and emphasizes the importance of considering corporate governance in that manner despite the difficulty in actualizing Multi-Stakeholderism in Western countries.

When investors recognize that a company has been increasing its overall value and shareholder value through business operations prioritizing coordination of various stakeholders, their investment behavior is expected to change.

After the emergence and collapse of the bubble economy, traditional Japanese practices of placing importance on the interests of various stakeholders have made business operators hesitate to venture into new fields and have protected old-fashioned inefficient management styles, thereby impeding the regeneration of industries in some cases. Therefore, it should be noted that companies need to promote the regeneration of business, investments in innovative technologies, and re-alignment of personnel to new business, etc. and that such corporate governance is indispensable for overcoming medium- and long-term uncertainties.

(2) Current Status of Corporate Governance in Japan

The financial crisis from the 1990s to early the 2000s triggered rapid unwinding of mutual shareholdings with banks and not a few companies saw a change in their share ownership structure to that mainly consisting of institutional investors, as in the case of other developed countries. As a result, corporate governance has been diversifying in Japan.

Under a mutual shareholding system, based on long-term ongoing transactional relationships with companies and financial institutions, it was possible to supervise corporate management. However, as institutional investors, whose presence increased along with the unwinding of mutual shareholdings, have not been actively involved in developing discipline in corporate management, it is pointed out that this has created a vacuum in corporate governance in companies with a share ownership structure dominated by institutional investors.

The TSE requires listed companies to have one or more independent member(s) of the board (outside director or outside auditor with no risk of causing conflicts of interest with general shareholders), and the percentage of companies whose shares are listed in the first section of the TSE that have appointed outside directors increased from 30% in 2004 to 62% in 2013. Furthermore, the Japan Revitalization Strategy states that the Draft Revision of the Companies Act, with the aim of promoting the introduction of highly-independent outside directors, will be submitted to the Diet at an early stage.[15]

In Japan, the practice of long-term employment has worked to provide employees with stable employment and has thus contributed to the development of human resources significantly. Companies have had a system under which a stable human network is formed and this has made communications among employees more efficient and has promoted

[15] "Japan Revitalization Strategy – Japan is Back (2013)," Headquarters for Japan's Economic Revitalization

accumulation of knowledge.

(3) Challenges and Future Direction

Amid diversification of corporate competitiveness and the competitive environment, there is no optimal solution for improving corporate governance. Individual companies need to voluntarily make reforms in accordance with their respective conditions. To improve the overall corporate value from a medium- and long-term perspective is to pursue corporate governance prioritizing adjustments of the interests of various stakeholders. From such viewpoint, it is necessary for companies to introduce independent outside directors to encourage the board of directors to make reasonable judgments, and to develop and utilize human resources while promoting regeneration, and for institutional investors to fulfill fiduciary responsibility by taking into account improvement of the overall corporate value in the medium and long terms, instead of leaning excessively toward maximization of short-term shareholder returns.

(i) Corporate Governance Prioritizing Adjustments of Interests of Various Stakeholders

A board of directors is expected to function as an organ to decide concrete corporate actions based on the adjusted interests of various stakeholders. In Europe, a board of directors generally functions to adjust the interests of stakeholders, as some countries have a system to include representatives of employees in a board of directors. In Japan, an increasing number of companies started to introduce outside directors,[16] and thus changes have come to be observed in members of boards of directors, which have consisted only of internal directors so far.

When appointing outside directors, great importance is to be placed on independence.[17] Outside directors, who are free from constraints unlike internal directors, can play significant roles in making reasonable judgments in order to improve the overall corporate value, while balancing the interests of various stakeholders, without being caught up in existing management policies or vested interests.

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16 Outside director means a director of any stock company who is neither an executive director 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. (Article 2, paragraph (1), item (xv) of the Companies Act)

17 The Outline of the Revision of the Companies Act adds the following requirements for outside directors: (i) an outside director is neither a parent company, etc. of a stock company nor a director, executive officer, manager or other employee thereof; (ii) an outside director is not an executive director, executive officer, manager or other employee of a subsidiary, etc. of a parent company, etc. of a stock company; (iii) an outside director is neither a spouse or relative within the second degree of kinship of a director, executive officer, manager or other major employee of a stock company or of a parent company, etc. ("Outline concerning Legislative Review of the Companies Act (2012)," Legislative Council of the Ministry of Justice)

(ii) Corporate Governance Enabling Development and Utilization of Human Resources while Promoting Regeneration

Employees play central roles in creating corporate value and are important in making innovation on an ongoing basis. Companies need to accumulate human resources appropriately and pursue corporate governance that enables individuals working for companies to actively develop and utilize their own resources.

Under the conventional Japanese system for human resource development and utilization, an individual worker is considered as the main character within a stable network, which gives him/her incentives to make efforts for the growth of the company as a whole from a long-term perspective.[18] The conventional Japanese system is effective in terms of developing human resources to be engaged in long-term investments, although attention should be paid to the possibility that the practice of long-term employment may make people's work styles inflexible.

In order to ensure that Japan achieves sustainable growth amid changes in the socioeconomic structure accompanying globalization, the key is to overcome externality of corporate human resource development and improve the environment for properly developing and utilizing human resources who can adapt to such changes. For that purpose, it is important to prepare a working environment where employees can continue playing roles in diversified value creation even if the content or style of their jobs changes on their own will or depending on their company's business cycles. Flexibility should be guaranteed so that individuals can fully utilize their own experience and ability to select workplaces. Specifically, individuals should have chances to effectively learn new technologies and skills in response to changes and young people and women should be provided with good education and training opportunities for their social participation.[19] It should be noted that in order to prepare a working environment where diversified working styles are encouraged, the society as a whole needs to make efforts, not merely counting on individual companies' efforts for better corporate governance.

If there is an increase in workers who can continue playing roles in value creation whether within a stable network or while experiencing changes in the content or style of their jobs, they will be the basis to further create innovation and to strongly support the economic cycle as consumers.

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[18] In "*Nihon-gata Kooporeeto Gabanansu* (Japanese-style Corporate Governance) (2000)," Hiroyuki Itami states that the Japanese corporate system is based on humanism where economic organizations are built upon human ties, and points out as advantages of humanism that people's skills and knowledge can be accumulated effectively and that the informational efficiency of communications among people is high.

[19] "Future Direction for Human Resource Utilization for Growth (2013)," Special Team for the Review of Human Resource Utilization for Growth, Working Group on Current Status of Japanese Economy and Desirable Policies, Expert Meeting on the Socioeconomic Structure

(iii) Improvement of Corporate Governance through Efforts by Institutional Investors

It is important for institutional investors to have constructive communications with companies in order to develop discipline in corporate management and encourage them to achieve sustainable growth by making medium- and long-term investments.[20] Through such efforts, they can fulfill their fiduciary responsibility. The content of communications includes corporate contribution to the environment and local communities, and their social contribution necessary for creating sustainable value.

One of the concrete measures therefor is the establishment of the Japanese Stewardship Code.[21] The Stewardship Code shows the desirable involvement of institutional investors in investment destinations. We hope that the Japanese Stewardship Code will be established depending on the circumstances in Japan, with focus placed on the achievement of sustainable growth of companies through constructive communications between institutional investors and companies, while referring to the Stewardship Code already established in the UK. It is expected that the establishment of the Code will enhance the quality of communications between institutional investors and companies and will significantly contribute to securing medium- and long-term funds.

4. Efforts for Improving Communications Including Disclosure of Non-financial Information

(1) Necessity of Communications in Appropriate Combination, Including Non-financial Information

In carrying out corporate activities, it has become important for companies to involve investors and other various stakeholders in value creation, in such aspects as accumulating intangible assets, addressing environmental problems, seeking coexistence with local communities, and ensuring safety and security. On the other hand, financial information, such as ROE, is limited in that it only covers corporate value as events presented as costs and revenues, or assets and liabilities. Information that analyzes investment targets from various aspects and accurately shows the overall corporate value resulting from multifaceted

[20] In addition to efforts made so far, a Corporate Reporting Lab was established to promote dialogues between companies and investors. A survey to ascertain common understanding was conducted and deliberations are being held concerning communication tools to help talks on corporate governance from a medium-and long-term perspective. A project to study means for achieving sustainable growth of Japanese companies and desirable capital markets helpful therefor started in July 2013.

[21] The “Japan Revitalization Strategy – Japan is Back (2013)” (Headquarters for Japan’s Economic Revitalization) suggests that the Japanese Stewardship Code should be established with the aim of having wide-ranging institutional investors have constructive communications with companies and properly fulfill their fiduciary responsibility, from the viewpoint of promoting the sustainable growth of companies.

corporate activities is indispensable for investors to make investments efficiently over a long period of time.[22]

Presenting the entirety of corporate activities to investors and other various stakeholders, by linking non-financial information, such as management philosophy, R&D activities, contributions to sustainability, and safety measures, with management strategy in an objective and foreseeable manner, is becoming more and more effective for companies.[23]

If investors become aware of the effectiveness of a wider range of indicators, including non-financial information, this will lead to changes in current market transactions excessively dependent on indicators showing short-term corporate profitability, such as ROE, and short-sighted corporate actions caused thereby.

(2) Current Status of Communications

The integrated reporting is prevailing as one of the means for better communications between companies and investors and other various stakeholders. The International Integrated Reporting Council (IIRC), which was established in 2010 for the purpose of building a framework for integrated reporting, consists of people from international organizations, such as the United Nations, World Bank, International Accounting Standards Board (IASB), International Organization of Securities Commissions (IOSCO), and companies, investors, NGOs, accounting firms of various countries. The first framework is scheduled to be publicized at the end of this year. Integrated reporting shows the future direction of business operations and investments, based on the idea that sustainability of both companies and the society as a whole is important, as the former is part of the latter and the both affect each other.

Regarding disclosure of non-financial information by Japanese companies, in FY2010, 1,068 companies (of which 579 were listed companies) prepared a CSR report or environmental report, and in FY2012, over 40 companies prepared a booklet incorporating an annual report and a CSR report.[24] However, only a limited percentage of them could successfully incorporate financial information and non-financial information to transmit the future direction of their business operations and investments logically in a simple, clear,

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[22] "Integrated Reporting" (2011), International Integrated Reporting Committee

[23] In "*Chikyu to Kyozon suru Keiei – MOS Kaikaku Sengen* (Management for Coexistence with the Earth – MOS Reform Declaration) (2011)," Yoshimitsu Kobayashi introduces the original index, the index of Management of Sustainability (MOS) to measure, visualize and quantify the progress of chemical manufacturers' efforts for achieving the sustainability of people, society and the global environment.

[24] "'*Togohokoku' wo Kataru Shiriizu* (Series on 'Incorporated Reporting')" (2013), Kiyoshi Ichimura
URL: http://www.shinnihon.or.jp/services/advisory/ir/column/index.html

persuasive manner.[25]

In Europe, the EU Accounts Modernisation Directive 2003 already required large and medium-sized companies to disclose non-financial information, as well as financial information, to the extent necessary for understanding their business performance and current status.[26] Furthermore, the Draft Revision of the EU Company Law Directive publicized in April 2013 shows a move to make it required to disclose non-financial information.[27] In the United States, the New York Stock Exchange announced its intention to endeavor to have companies disclose their non-financial information to investors in 2009, and so did NASDAQ in 2012.[28]

Non-financial information has already been used in socially responsible investment (SRI) and has been recognized as an important decision factor for medium- and long-term investments. When making socially responsible investments, investors decide investment destinations by evaluating companies' CSR activities, such as their eco-friendliness and social activities, and their sustainability, in addition to analyzing their financial conditions.[29] Some survey results show that shares related to SRI are highly stable, being less susceptible to past and present trends.[30] In Japan, the size of the SRI market is approximately 0.7 trillion yen, accounting for approximately 0.2% of the whole market (2009), which is much smaller compared to Europe (approximately 559 trillion yen and 39% (id.) in 2009) and the United States (approximately 258 trillion yen and 12% (id.) in 2010).[31]

(3) Challenges and Future Direction

Integrated reporting, including non-financial information as well as financial information, is effective in showing the entirety of corporate activities. Consideration of the combination of information, including non-financial information, to be disclosed can be recognized as part

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25 According to the "Results of the Questionnaire Survey to IR Staff of Japanese Companies (2011)" (Business Policy Forum, Japan), the percentage of companies that prepare integrated reporting of some sort at present is 62%. However, the largest number of such companies merely includes non-financial information together with financial information in their annual report (n=53; The survey covers leading companies in terms of information disclosure).

26 "Report of Studies on CSR Information Examination (Reference Material)" (2007), Ministry of the Environment

27 Draft Revision of the Company Law concerning Disclosure of Non-financial Information, European Commission (announced on April 16, 2013)
URL: http://ec.europa.eu/internal_market/accounting/non-financial_reporting/index_en.htm

28 "New Solution to Help NYSE-Listed Companies Enhance Corporate Governance and Transparency" (2009), New York Stock Exchange
URL: http://www.nyse.com/press/1242727551178.html,
"Exchanges Listing Over 4,600 Companies Commit to Promoting Sustainability" (2012), United Nations Global Compact
URL: http://www.unglobalcompact.org/news/244-06-18-2012

29 "*Esuaaruai no Gainen* (Concept of the SRI)," Japan Sustainable Investment Forum (SIF-Japan)
URL: http://www.sifjapan.org/sri/

30 "*Kigyo no Shakaitekisekinintooshi Fando no Shuuekisei ni tsuite* (Profitability of Companies' SRI Funds)" (2009), Yoko Shirasu, Financial Research Center, FSA Institute

31 "Recent Trends concerning CSR" (2012), Ministry of Economy, Trade and Industry

of companies' efforts to clarify their management strategy. In effectively making such efforts, it is important for companies to develop a system to link pieces of information necessary to show their entirety and secure and foster personnel who can have communications in a broad context.

(i) Communication of the Overall Corporate Value Including Non-financial Information through Integrated Reporting

Through integrated reporting, diversified information necessary for analyzing and evaluating companies is disclosed in a concise way. Such information includes a company's environmental activities and relationship with local communities, as well as its management strategy and medium-and long-term forecast, etc., in addition to financial information. Integrated reporting is thus effective in describing the entirety of the company's activities. If investors and other stakeholders come to fully understand the overall value to be created by the company as a result of its efforts for integrated reporting, etc., this will help the company's medium-and long-term growth.

Furthermore, it is pointed out that when investors make medium-and long-term investments, they should take in such indicators as companies' sustainability (safety, security and employee retention rates), fairness in distribution (toward various stakeholders), and capacity for reform and improvement (innovation) as substitutes for ROE or other financial indicators that are generally used at present.[32]

Further consideration should be given concerning proper evaluation of multifaceted corporate activities.

(ii) Communication of Information as Part of Efforts to Clarify Management Strategy

When communicating the overall corporate value, companies need to select the relevant data from diversified financial and non-financial information and decide how to provide it. This can be recognized as part of their efforts to clarify and communicate their management strategy.

Effective information and effective means for communication significantly differ depending on the messages that each company wants to transmit. Therefore, the originality and ingenuity of each company need to be respected. If disclosure of non-financial information is required uniformly, this may damage companies' discretion and independence and may cause the system to lose substance in the end. Instead, companies should be encouraged to make voluntary efforts to have communications with various stakeholders from a medium-and long-term perspective.

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[32] "*21-seiki no Kokufuron* (Wealth of Nations for the 21st Century) (enlarged edition)" (2013), George Hara, pp.292-297

When receivers broadly understand the significance of strategic communication of information, the quality of the communication will be further improved. We hope that public entities and mass media understand such significance and cover this topic more widely.

(iii) Development of a System to Communicate the Entire Picture of Corporate Activities

Companies must develop a system for strategic communication of information under strong leadership of management. When sectionalism prevails as a result of an organization becoming larger and sectionalized, it becomes difficult to have a company-wide point of view.[33] When disclosed information is inconsistent depending on the section, investors cannot correctly understand the overall policy of the company concerning its business operations and investments and may hesitate to make medium-and long-term investments in the company.

In order to ensure consistent communications to show the entire picture of a company, they need to eliminate sectionalism among related departments, such as the accounting/financial department, IR department, and CSR department, and improve cooperation within the company. It would also be effective to appoint a person in charge of external communications and concentrate the authority in that person. This will make it easy for a company to ascertain the entirety of its corporate activities and properly communicate information to investors and other various stakeholders.

Additionally, it has become more and more important to secure and foster highly skilled personnel who can make communications effectively from a broader point of view to ensure proper transmission of the entire picture of corporate activities. Required personnel are those who have capacity to communicate with the market to enhance appeal to investors, and can ascertain the situations of employees and trade partners properly and also pay attention to the influence of corporate activities on local communities and the environment. Such personnel can improve the company's communications and brand value, and enable the company to maintain competitive advantages even where there is no big difference in technologies or selling power.

5. Financial System that Supports the Growth of the Real Economy

(1) Necessity of the Financial System that Supports the Growth of the Real Economy

The financial system functions to back up the growth of the real economy by supporting

[33] "*'Jizokukanousei' wo Tsuikyuu suru Guroobaruna Kigyokyoso wo Kachinuku Keiei ni Mukete* (For Business Operations to Survive Global Corporate Competition Seeking 'Sustainability')" (2013), Yasuhito Hanado

daily transactions and investments toward the future through smoothly supplying necessary funds to economic agents and enabling appropriate dispersion of risks. However, when shareholders and investors lean excessively toward the so-called “money game,” merely pursuing short-term profits in financial markets, apart from the real economy, companies are apt to employ short-termism in business, and as a result, medium-and long-term investments, which serve as the basis of innovation, may not be made sufficiently. Furthermore, the prevalence of short-termism has encouraged excessive financial volatility in part.

Excessive financial volatility caused by a major financial crisis, etc. damages the functions of the financial system, which is supposed to work as the blood of the economy, and brings about a serious negative effect on the real economy. The stability of the financial system is the very premise of creating a sustainable “real economy driven” economic society.

(2) Reform of the Financial System

Based on lessons from the Lehman Shock, reform of the financial system should inevitably be discussed in order to prevent another large-scale financial crisis.

It is pointed out that the Lehman Shock was triggered by Western investors, who leaned excessively toward the “money game” of pursuing short-termism in financial markets amid housing market bubbles in the United States and expanding global imbalance that encouraged the former. Additionally, some say that one of the causes was the financial system under which financial institutions tried to maintain their risk-based capital adequacy ratios while expanding off-balance sheet assets. In response, under the G-20 framework, the governments of member countries have been strengthening financial regulation since the G-20 summit meeting held after the Lehman Shock in November 2008, such as by trying to ensure financial institutions’ capital adequacy, taking measures for systemically important financial institutions, and reforming over-the-counter derivatives markets. The government of Japan has presented its opinions on desirable financial regulation in international deliberations, while taking into consideration the current status of Japanese financial institutions and expected influences on the Japanese economy and the markets and economies of emerging countries.

As specific financial regulation, Basel III led by the Basel Committee on Banking Supervision presents a framework to strengthen capital adequacy requiring quantitative and qualitative improvement of equity capital with the aim of encouraging internationally active banks to control risks properly to ensure soundness. In Japan, new capital adequacy requirements have been applied to banks subject to international standards in a phased manner since March 2013.

At the time of the financial crisis, taxpayers’ money was used to rescue some of the major financial institutions. In order to address too-big-to-fail problems, discussions are being held with regard to global systemically important financial institutions, concerning such matters as a regulatory framework for preventing their failure, a framework for smooth resolution in the event of their failure, and enhancement of the effectiveness of supervision.

Financial regulation by advanced countries is now expanding its targets to include transaction regulations, in addition to conventional regulations on banks. Along with the strengthening of capital adequacy, as a means to reform over-the-counter derivatives markets, regulations have been tightened such as requiring transaction reports, and the transparency in transactions is thus improving. Although it is difficult to draw a line between speculation and real demand when regulating transactions, the regulation prohibiting short selling without arranging to borrow shares, which was introduced when the Lehman Shock occurred, is considered to have been effective in curbing excessive market volatility in respective countries.

If any international financial regulations do not reflect the reality, they may deprive financial institutions of freedom and hinder their efficient business operations. For example, respective countries have developed and enforced their own regulations on over-the-counter derivatives while no agreement has been reached concerning an international regulatory framework. As a result, such domestic regulations are applied externally and have caused redundancy with or violations of other countries' regulations and market participants are suffering complicated and excessive burdens, as pointed out by some of them. A financial system that has lost efficiency with excessively complicated regulations will face difficulty in supporting the growth of the real economy.

(3) Challenges and Future Direction

In order to create a sustainable "real economy driven" economic society, it is indispensable to establish a stable financial system and prevent major financial crises in advance. The government of Japan is also required to contribute to initiatives for international financial regulatory reforms and to continue to supervise financial systems through the macro-prudential policy.

(i) Contribution to Initiatives for International Financial Regulatory Reform

There still remain various problems concerning international financial regulatory reforms. The declaration announced at the G-20 Saint Petersburg Summit points out the necessity to address too-big-to-fail problems, and to solve problems concerning redundancy of cross-border regulatory frameworks on OTC derivatives and avoidance of regulations.

Taking into account such international deliberations, institutional designers and financial institutions in Japan should continue to actively participate in and contribute to various initiatives for international financial regulatory reforms, while discussing desirable financial regulation that balances its necessity with the expected influence on financial markets and market participants.

(ii) Effective Supervision of Financial Markets through Macro-prudential Policy

As we learned from the Lehman Shock, a major financial crisis causes disturbances in the real economy worldwide. Therefore, we need to consider a financial system that can prevent major financial crises in advance in order to create a desirable market economy system.

Financial agencies in Japan and other countries must continue effective supervision of financial systems through the macro-prudential policy, which is a framework for financial supervision to prevent any sign of deterioration in soundness observed in individual financial institutions or markets that comprise a financial system from spreading over to the entirety of the system.[34]

Conclusion

What we should aim to achieve is, by reconstructing our experiences, to create a sustainable "real economy driven" economic society in which values are created continuously, without leaning excessively toward the speculation-driven "money game" that single-mindedly pursues unsubstantial short-term profits.

In order to secure stable supply of medium-and long-term funds, companies must create their underlying value and communicate their visions first of all. This will deepen investors' understanding of companies' business from a medium-and long-term perspective and build a relationship of trust between them. Enhancement of financial literacy on the part of investors and increase of individual investors under the NISA system will swell the base of medium- and long-term investments. A mechanism to appropriately align incentives for medium- and long-term investments must also be prepared in the market, and means to evaluate and disclose individual companies' business performance should be checked and reviewed for that purpose.

Companies must pursue corporate governance prioritizing adjustments of the interests of various stakeholders with the aim of improving the overall corporate value from a medium-and long-term perspective. From that point of view, companies need to adopt a system of independent outside directors and develop and utilize human resources while

[34] Macro prudence means to ensure the soundness of a financial system as a whole by analyzing and evaluating the status of risks in the system and to design institutional arrangements and make policy responses based thereon. This is a concept in contrast with micro prudence, which means to ensure the soundness of individual financial institutions.

promoting regeneration, and in the meantime, institutional investors must fulfill their fiduciary responsibility. The establishment of the Japanese Stewardship Code will be helpful in that context. Additionally, companies should endeavor to communicate information, including non-financial information, by integrated reporting and to disclose information as part of their efforts to clarify their management strategy, so that various stakeholders understand the entire picture of their corporate activities. They also have to develop a system and secure and foster personnel for that purpose. Furthermore, it is also important for Japan to contribute to various initiatives for international financial regulatory reforms to prevent financial crises in advance and continue effective supervision of financial markets through the macro-prudential policy.

When all parties make these efforts, more and more companies will come to prioritize coordination of various stakeholders in corporate governance, without being overwhelmed by the prevalence of short-termism or excessive financial volatility, and they will improve communications by appropriately combining data including non-financial information. Then, relationships of trust will be built via the market between providers and receivers concerning the necessity of medium-and long-term funds.

This Expert Committee has presented challenges and the direction necessary for creating a desirable market economy system. A desirable market economy system will be created through addressing these challenges. In that process, we hope that companies will not take short-termism to merely try to reduce costs and result in diminishing equilibrium, but take actions to bring about expanding equilibrium, and that medium-and long-term investments and innovative activities will increase to achieve new growth that increases high-quality employment.

A desirable market economy system is a mechanism which people both in and outside of Japan would like to join, and Japan needs to disseminate it to the world.