

## **The "Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors" Project**

### **Main Issues and Call for Evidence and Information"**

In order to review the competitiveness of Japanese companies for sustainable growth and the function and ability of the capital markets to support those companies, the "Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors" Project (chaired by Professor Kunio Ito of Hitotsubashi University; secretariat: Ministry of Economy, Trade and Industry and Business Policy Forum, Japan,) has identified main issues to be discussed and is seeking a wide range of evidence and information on these issues from those involved both in Japan and overseas.

This project aims to address factors and incentive structures which hinder management and capital markets from enhancing long-term value creation, improving disclosure and engagement practices between companies and investors by gathering key players in and around the investment community, such as board members and senior executives of companies, institutional investors, and sell-side research analysts, etc.

After holding four meetings since its launch in July 2013, the project identified and summarised the main issues as attached below.

While seeking evidence and information from all over the world, the following three working groups will conduct in-depth discussion on each issue.

- <Working Group 1> WG on Corporate Value Creation
- <Working Group 2> WG on Investment Chain
- <Working Group 3> WG on Short-termism and Disclosure

Based on evidence and in-depth discussions, this project plans to publish an interim report early 2014, gather feedback once again, and draw up a final report by the end of March, 2014.

### **Project Background**

In response to the financial crisis, there are global debates concerning the following issues: overcoming short-termism among investors and companies, strengthening corporate governance, and dialogues and engagement between companies and investors and review of information disclosure and reporting.

In the UK, for instance, the “Kay Review” examined and made proposals concerning the roles of capital markets and investors in order to enhance the long-term performance of UK companies, which has had an impact on debates at the EU level.

In the US, there are also debates going on, where “activist funds” show strong presence. Issues of debate include: how companies carry out dialogues with shareholders and how to form long-term relationships with institutional investors such as pension funds.

In the field of corporate disclosure and reporting, new developments and initiatives have been seen recently. As for financial reporting, discussions are progressing on how to streamline and improve the disclosure content and methods, e.g. discussions on disclosure frameworks. Furthermore, reporting also on mid-to-long-term value creation of companies, including non-financial matters such as business strategies and risk information, are being discussed. "Integrated reporting," for which an international framework is being developed, is one example of such attempts.

In Japan, where a macro economy shows improvement, major challenges for future growth are to improve competitiveness of companies for mid-to-long-term value creation as well as encourage a virtuous cycle in which sustainable return can be expected in capital markets through investments in such companies.

From this viewpoint, the above mentioned issues that are being debated globally are also challenges for Japan and to be discussed in light of domestic and international circumstances of this country.

Recently, global investors have been showing increased interest in the Japanese market, gathering information and making evaluations of Japanese companies' potential for future growth.

In this context, it is important to discuss those issues, paying particular attention to and encouraging dialogues with international stakeholders including investors overseas during the process of this project.

With such a background of international debate and Japan's challenges, the "Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors" Project was launched in July 2013.

### **How to Provide Evidence and Information**

In order to carry out further reviews in the future, we are welcoming submissions of evidence as well as information that could be used as reference concerning the issues listed in the attached sheet.

- Deadline for submissions: December 10, 2013 (Tue)
  
- Please send us your submissions by mail, fax, or e-mail to the following:

The "Building Favorable Relationships between Companies and Investors" Project  
Corporate Accounting, Disclosure and CSR Policy Office, Economic and Industrial  
Policy Bureau, Ministry of Economy, Trade and Industry  
Mailing address: 1-3-1 Kasumigaseki, Chiyoda-ku, Tokyo, Japan  
100-8901

FAX: 03-3501-5478

E-mail address: [callforevidence@meti.go.jp](mailto:callforevidence@meti.go.jp)

Other instructions:

- Submissions are to be made in English or Japanese.
- Please print your name, organization, address and contact information (telephone number or e-mail address) in your submissions.
- We will assume that the evidence or information you submit can be published. If you wish to remain anonymous, or would not like the submitted information to be published, please indicate that in your submissions.
- Your address and contact information which you provide along with your submissions will be managed appropriately and will be used strictly for purposes of carrying out the project. For instance, we may contact you if we have any questions about the information you provided.

(Attached Sheet)

## Main Issues

～ Call for Evidence and Information～

October 16, 2013

In this project, we are reviewing the competitiveness of companies for sustainable growth and the function and ability of the capital markets to support those companies. Based on discussions up to this point, the following 14 issues have been identified.

Regarding these issues, we are seeking a wide range of evidence (e.g. factual data or examples) as well as information that could be used as reference from those involved both in Japan and overseas in order to understand actual situations, problems, factors and incentive structures.

### (1) Definition of Sustainable Growth

In light of the aims of this project, under what definition should "sustainable growth" and "competitiveness" of companies be used? How and on what criteria should “sustainable growth” and “competitiveness” be evaluated?

We would particularly welcome evidence on the following points:

1. How "sustainable growth" and "competitiveness" of companies are defined.
2. Criteria on which “sustainable growth” and “competitiveness” of companies are evaluated.

### (2) Companies Achieving Sustainable Growth

What are the characteristics of a company that has achieved sustainable growth? What do companies that have achieved sustainable growth have in common? What are the challenges of achieving sustainable growth?

We would particularly welcome evidence on the following points:

1. Examples of companies that have achieved sustainable growth
2. Things that companies achieving sustainable growth have in common.
3. How have Japanese companies achieved sustainable growth? What are the characteristics?

(\*"Japanese companies" in this document refers loosely to companies that are based in Japan and typically listed in the Japanese market.)

4. What are the challenges for companies and investors in achieving sustainable growth? What are the challenges in government policies for this end?
5. Characteristics and performance of M&A (mergers and acquisitions) of Japanese companies. (e.g. differences between projects in Japan and overseas, effectiveness and assessment of the projects, companies' expertise in M&A )

### (3) Incentives for Boards and Executives of Companies

What are the incentives for boards and executives of Japanese companies? Do those incentives encourage the sustainable growth of the companies?

We would particularly welcome evidence on the following points:

1. Financial rewards (Remuneration) of executives and board members of companies and whether they are consistent with evaluation by the companies. How are they evaluated by investors and market players?
2. Non-financial incentives which motivate executives and board members of companies and whether they are consistent with evaluation of the companies. How are they evaluated by investors and market players?

### (4) Capital Discipline

How Japanese companies recognize capital discipline in relation to sustainable growth of the companies and development of corporate value? Whether, and how management systems for Japanese companies are designed to contribute to sustainable growth of the companies.

We would particularly welcome evidence on the following points:

1. Recognition and importance of cost of capital and return on equity in managing and operating companies, in particular, in relation with capital discipline and development of corporate value.
2. Current conditions and appropriate levels of cash holdings
3. Whether, and how management systems for the company are functioning for management discipline and development of corporate value. (e.g. composition of boards, presence of outside/independent directors, and committee governance structure)
4. Current situation and evaluation of equity investment (e.g. cross-holdings and other

equity investments) of companies.

5. Impact of voting by institutional investors on management.

(5) Alignment of Interest, Incentives and Management Policies for Corporate Value Creation between Company Management and Investors

Whether the interests, incentives, and management policies of boards and executives of Japanese companies are aligned with the interests, incentives, and evaluations of investors in terms of creating corporate value.

(6) Incentives for Investors

What are the incentives (e.g. fee, pay structure and rewards) for investors (asset managers and asset owners)? Are they consistent with the evaluation by investing communities? Do they match the sustainable growth of companies as well as the mid-to-long-term profit of investors and underlying beneficiaries?

We would particularly welcome evidence on the following points:

1. The structure of incentives (e.g. rewards) and evaluation of asset owners; their relationship with asset managers, beneficiaries, companies, and other players of the capital market; and systems and practices underlying such structures and relationships.
2. The structure of incentives (e.g. rewards) and evaluation of asset managers; their relationship with asset owners, companies, and other players of the capital market; and systems and practices underlying such structures and relationships.

(\*"Investing communities" in this document refers to all market players including asset owners, asset managers, analysts and intermediaries. The focus of this project is (domestic and global) market players involved in investments in Japanese companies.)

(7) Challenges for Analysts

What are the roles of analysts and their motivation and incentives? How are they understood and evaluated? Whether and how are they contributing to the sustainable growth of the company as well as developing capital markets that support it? What are the challenges for analysts to fulfill their expected roles?

We would particularly welcome evidence on the following points:

1. The roles that analysts (sell-side analysts and buy-side analysts) fulfill and the roles

- they are expected from their clients and stakeholders.
2. The system of rewards (fee and pay structure) for analysts and other incentives
  3. Whether and how analysts are contributing to sustainable growth of the company as well as developing capital markets that support it.
  4. The current status and evaluation of activities of analysts; analyst reports, rating for the covered companies and valuation methods.

#### (8) Role and Organization of Institutional Asset Owners

What are the organization and expertise of institutional asset owners like? Whether and how they are contributing to sustainable growth of the company as well as mid-to-long-term profit for the underlying beneficiaries? What are the systems and practices underlying?

We would particularly welcome evidence on the following points:

1. Expertise of executives and employees in charge of operation at asset owner organizations.
2. Methods of evaluating asset managers by institutional asset owners.

#### (9) Promoting Mid-to-long-term Investments

What is the current status of the investors who are making mid-to-long-term investments in Japanese capital markets and how are they evaluated? Who can or should be the source of mid-to-long-term investments? What are the systems or practices that are hindering or expected to encourage mid-to-long-term investments?

We would particularly welcome evidence on the following points:

1. The current state and evaluation of the function and variety of Japanese capital markets and their players including mid-to-long-term investors.
2. The current status of individual investors in Japan who are making mid-to-long-term investments. Whether there is a need to increase such investors. Problems, challenges, as well as measures to implement to encourage such investments
3. The current status of concentrated mid-to-long-term investments by institutional investors in Japan. Whether there is a need to increase such investors. Problems, challenges, as well as measures to implement to encourage such investment
4. The current status of indexes and how new indexes should be developed for promoting mid-to-long-term investments.
5. Systems and practices that are incentives or counter-incentives for mid-to-long-term

investments.

#### (10) Conflicts of Interest

Current status of conflicts of interest by relevant parties (e.g. asset owners, asset managers and analysts), issues and challenges

What are the systems and practices underlying conflicts of interest?

How are they impacting mid-to-long-term investments and the sustainable growth of companies?

What measures are being taken to avoid problems caused by conflicts of interest?

#### (11) Short-termism (companies, investors, market players)

How should short-termism be understood? What are the problems, their causes and structures? Are the time horizon of companies and investors consistent with one another from the perspective of sustainable growth of the company as well as mid-to-long-term profit for investors and the beneficiaries?

We would particularly welcome evidence on the following points:

1. How is short-termism defined?
2. The current status of timescales used by market players (e.g. asset owners, asset managers, analysts).
3. The current status of timescale used by companies
4. Whether and to what extent each time horizon has been shortening. Systems, practices, and business environments which have caused that to happen. Impact of short-termism on corporate management and operations and interactions of short-termism of companies, asset managers, asset owners and analysts.

#### (12) Challenges concerning corporate disclosure and reporting

What are the current status and issues concerning the current disclosure of Japanese companies and the underlying systems and practices? What are the challenges and solutions to be considered?

We would particularly welcome evidence on the following points:

1. The current needs concerning corporate disclosure and reporting, the current status, and challenges. International comparison of disclosure and reporting in this regard.
2. The impact of quarterly reporting system on the management of companies as well as the evaluation process of investors, especially with regard to its influence on

short-termism.

3. Evaluation and challenges of the existing system for information disclosure and reporting from the perspective of users' needs and the sustainable growth of companies.

#### (13) Disclosure for Mid-to-long-term Dialogues

What kinds of explanations and information will be required for investment communities and companies to engage in mid-to-long-term dialogues? What are the systems and practices that are preventing that from happening and what are the challenges? What are the measures for improvement?

We would particularly welcome evidence on the following points:

1. The current attitude toward disclosure by companies and its evaluation.
2. Items, contents and ways of disclosure and reporting that are required by investors in making mid-to-long-term investments.
3. The current status of how particularly important information is explained when conducting dialogues concerning sustainable growth and mid-to-long-term investments and its challenges.
4. The status and evaluation of existing efforts for integrated reporting as a means for mid-to-long-term dialogues. What are desirable ways for effective (integrated) reporting?

#### (14) How Dialogue and Engagements are Conducted

How dialogues and engagements are being conducted between companies and investors? How should they be conducted? Are there any systems or practices that are preventing effective dialogues?

We would particularly welcome evidence on the following points:

1. Commonalities and differences in viewpoints between companies and investors
2. Differences in terminology (e.g. long-term/short-term) between companies and investors, challenges and solutions for sharing common understanding of such terms.
3. The current status and evaluation of various occasions for dialogues (e.g. investor relations meetings, shareholders' meetings).
4. The quality of the dialogues and engagements between companies and investors and their challenges.
5. The current efforts for improving the quality of the dialogues (education and training)

and the means for further improvement.

6. Systems and practices that prevent companies and investors from conducting dialogues.

End