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PEGASUS

A NEWSLETTER FOR THE CAUX ROUND TABLE FOR MORAL CAPITALISM NETWORK LOOKING AT BUSINESS ABOVE THE CLUTTER AND CONFETTI

Pegasus

Introduction

The current COVID-19 pandemic is making tangible a truth so banal and omnipresent that we consistently just overlook it. In not directing our attention to this reality, we may be shortchanging ourselves in how we organize our lives collectively.

This reality also provides the larger structure of human affairs, which responds well to the practices of moral capitalism.

From this perspective of what is a moral capitalism, I am thinking about modern civilization as an organic, somewhat living being, with three major working parts: business, government and civil society.

Each sector is a leg supporting firmly one very sturdy stool on which our civilization can rest sustainably. In short, business (capitalism) produces wealth; government produces public goods; and civil society produces norms. Take any one leg away and the stool collapses from lack of balance. The two other legs can't hold it up on their own.

Business needs the public goods provided by government and the social and human capitals provided by both government and civil society in order to create wealth. Government needs wealth from business and social and human capital from civil society in order to create and maintain public goods. Civil society needs wealth from business and public goods from government to do its work of norm production and maintenance and providing social and human capitals.

Our global response to the new coronavirus is revealing just how necessary the three sectors are for one another. As businesses close down, jobs are lost, income earned declines, companies lose money, the economy goes into recession. Governments and civil society immediately feel the consequences of less income and wealth. Government spending spikes up without income to pay for it.

But for business to regain prosperity, it needs both government to regulate well and protect the public health and civil society successfully to encourage individuals to adapt their lives cheerfully to new restraints and so more quickly bring an end to the contagion.

Governments need to balance preserving economic health against the need to protect citizens from the virus. Civil society needs to engage communities, neighborhoods, families and individuals to at once be isolated until the contagion dies out and be social in support of one another.

Using simplistic metaphors, we might present capitalism as the circulatory system sustaining each living social cell with nourishment; government as the musculoskeletal frame holding the organism together and allowing it to work in the world; and civil society as the cognitive/neural system guiding the organism.

With its giving priority to the stakeholders of a firm, moral capitalism intentionally integrates the function of business with the reciprocating functions of government and civil society for the optimal health of the entire society. I

n this issue, we bring to your attention three essays. First, a longer one by George Hara, outlines a Japanese theory of capitalism which expressly and intentionally integrates the three sectors of modern civilization with one another.

The other comments discuss global warming and climate change. One is the proceedings of a round table on climate change convened recently here in St. Paul and the other a comment from Patrick Rhone on our staff.

Climate change, like the spread of the new coronavirus, confronts all three sectors simultaneously. It calls on capitalism to change its sources of energy and the design of many products. It calls on government to impose restrictions and to set targets and incentives for the private sector to modify its behaviors. These restrictions, targets and incentives lead to the production of public goods and the reduction of public "bads." Thirdly, climate change confronts civil society with the need to evolve new norms for consumer behaviors and acceptable living standards.

Thanks to COVID-19 and climate change, we have a lot to think about and do.

Stephen B. Young
Global Executive Director
Caux Round Table for Moral Capitalism

Public Interest Capitalism & Going Beyond ROE (Abridged)

Article Contributed and written by

George Hara

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About George Hara

In 1984, Mr. Hara founded DEFTA Partners and became a partner at Accel Partners in the 1990's. He helped to create and manage IT firms as chairman, board member of companies such as *Borland* (2nd largest PC software), *PictureTel* (teleconference), *Oplus Technologies* (Merged with Intel in 2005), *Broadware* (merged with Cisco in 2007), *Transitive* Technology (merged with IBM in 2008) and *Fortinet* (NASDAQ IPO in 2009). While creating ventures in advanced nations, Mr. Hara founded DEFTA Development Holdings to bring cost effective information infrastructure technologies to less developed countries in Asia and Africa through private and public sector initiatives.

In the public sector, Mr. Hara serves as Chairman of the *Alliance Forum Foundation*, an international organization in special consultative status with the UN Economic and Social Council. He has served on the boards of the San Francisco Opera, San Francisco Zoo, University of San Francisco, Tokyo Foundation, and Hara Research which offers fellowships for interdisciplinary between life& computer science. Mr. Hara was a UN Fellow and holds LL.B. from Keio Univ. and M.S. from the Graduate School of Engineering at Stanford University.

1. Encouraging medium and long-term investment
(Published on January 6, 2016)

The style of management prevalent in the US with excess focus on shareholder interests and return on equity (ROE) may one day lead many socially beneficial companies to failure. A company should be considered as a public institution and should not solely belong to its stockholders. The profit must be distributed to all of the company's stakeholders (called "Shachu" in Japanese) including the employees, customers, suppliers, local communities, and even the planet. While a stockholder who supports the company's growth by holding his shares for the long-term could be considered to be one of the true owners of the company, the goal of many investment funds is simply to artificially boost the stock price for immediate gains. These funds should not be considered foremost when deciding how to run a company.

マイクロファイナンスの使命

ROEを超える経営

中間層育て過激派抑える

This series of articles was published in Nikkei Sangyo Shimbun in 2016. Charts were added later.

Under these circumstances, I don't believe that lowering corporate taxes lead to higher wages or more business investments. Instead, most of the profit would be allocated to stockholders as dividends or through stock buyback programs with the intention of increasing share price.

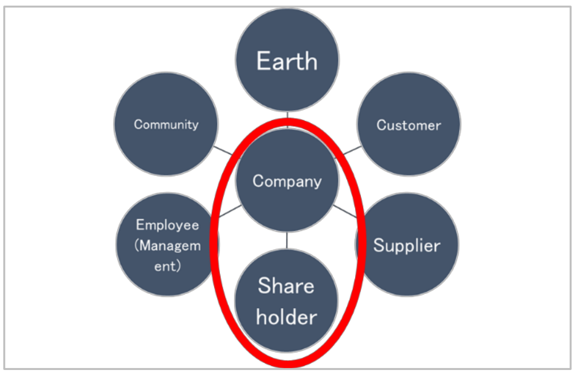
When a company uses its funds to maximize shareholder returns rather than to invest for growth, long-term prospects of the company decline, and therefore long-term stockholders may suffer a loss. The employees are also discouraged to spend money since their raises always seem very limited compared to shareholder return. Employment stalls, and the income gap widens. The disparities become a cause of conflict that makes the world more unstable.

In my opinion, the purpose of a company, as a public institution, is to contribute to the society through its business. In order to achieve this, the company must:

1. Allocate its profit to all of its stakeholders or "Shachu" that support the company, not just to its stockholders;
2. Strive for sustainable growth; and
3. Challenge itself to improve existing products and services and venture into new growth businesses.

These are three of the fundamental management principles based on what I call "Public Interest Capitalism."

<Shareholder Capitalism>



<Public Interest Capitalism>

Because the shareholder-centric model of capitalism ("Shareholder-centric Capitalism") demands that management teams maximize share prices in the short run, long-term R&D projects become less prioritized and pushed aside. In particular, ambitious R&D projects that have the potential to create new core businesses and even an entirely new industry are no exception. Thus, I believe that there is a need to encourage medium- and long-term risk taking and investment. In order to create and maintain stable economic growth in the developed countries of the 21st century, the development of new businesses and future key industries based on Public Interest Capitalism is crucial.

The idea of Public Interest Capitalism plays an important role not only in advanced countries but also in underdeveloped countries, because it encourages economic independence. In 2030, the population of advanced nations will only account for 12% of the whole world's population, and the remaining 88% will live in the developing world, primarily in Asia, Africa and Latin America. Companies in advanced countries need to establish strong ties with underdeveloped countries in order to survive. However, shareholder-centric management and capitalism will only cause tension in the process.

Japan should be the advocate for Public Interest Capitalism in the world – If the principle becomes prevalent that the company is a public institution that is responsible for distributing the value it creates to all of its stakeholders, wealth will spread, which will develop a robust middle class all over the world.

Akira Amari, Japan's Minister of State for Economic and Fiscal Policy, said in agreement, "Our country should pursue a capitalist system of our own. It's called Public Interest Capitalism." I believe that Public Interest Capitalism is becoming the path to the future prosperity.

2. The ill effects of shareholder capitalism (Published on January 13, 2016)

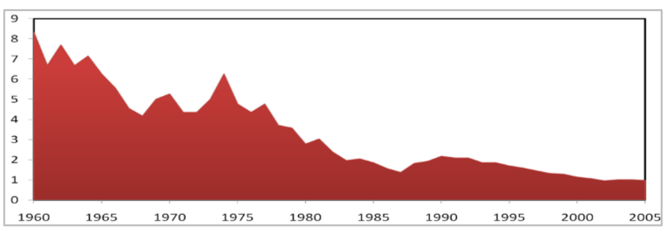
The concept of capitalism increasingly prevalent in the globalized world today is based on the idea that the company is owned by stockholders. If this kind of capitalism prevails, the results will be catastrophic.

In a company governed solely by stockholders' interests, stockholders want the highest possible return in the short term. If a company returns $1 billion in the span of 10 years to its stockholders, they expect to receive another $1 billion return within a shorter time frame the next period.

Internal rate of return (IRR) is a popular measurement used by investors. Because IRR is designed for higher returns when a particular amount of cash is returned to the investor in a shorter term, the measurement tends to cater towards speculators rather than investors. If this measurement is applied to gauge the performance of whole industries that make up the real economy, lengthy research and development that lower the IRR have no place. In other words, IRR cannot be used to measure the profitability of industries such as manufacturing.

According to the research by the Alliance Forum Foundation, an organization I represent, the average stock holding period for NYSE was eight years in 1960. It had, however, dropped dramatically to less than one year by 2005. With supercomputers trading stocks at every microsecond, it also becomes nearly impossible to calculate the stock holding period.

<Avg. Stock Holding Period: NYSE>



Source: NYSE Euronext, "Facts and Figures > NYSE Historical Statistics > NYSE Overview Statistics"

With the recent rally in the Japanese stock markets, we have started to often hear "invest rather than save." However, we should be careful as we are simply moving towards speculation rather than investment.

Speculation is a zero-sum game that creates winners and losers – where wealth becomes concentrated into a small group of individuals and the remaining majority loses everything. Imagine that a hundred people bet $100 each in a game of rock-paper-scissors. One person wins the $10,000 pot, and the other ninety-nine people lose. The sum of the money involved is always $10,000, and no new value is created during the speculative game.

Shareholder capitalism, along with market fundamentalism, eventually leads to speculative financial capitalism. Speculation always creates a bubble economy, which of course is a major cause of instability in financial markets throughout the world.

There are activist funds or investors called "momentum players," whose sole interest is in short-term gains. When these momentum players gain traction, wealthy speculators become wealthier while the middle-class investors who tend to hold for longer periods are pushed down. At such a point, stock markets, along with the companies whose stocks are traded there, are a tool for speculators to profit.

The idea – that companies belong to their shareholders and that therefore companies exist for their shareholders – is a principle almost religion-like amongst financial speculators. To them, the sole duty of corporate managers is to maximize shareholder value or market capitalization. In Shareholder-centric Capitalism, rather than creating value through research and development, a quick "forced" boost in results are preferred. Stockholders also tend not to agree with long-term projects, which naturally makes the management more short-term oriented.

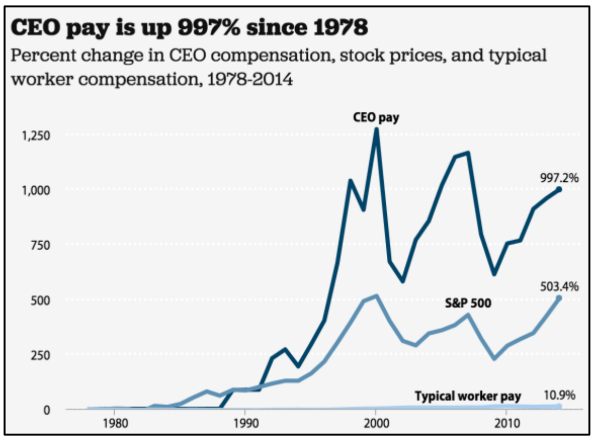
To the speculative investors, industries such as manufacturing and retail distribution are not efficient since they require substantial R&D or the holding of inventory: their IRRs are too low. If speculators become a major stockholder, they try to make the company's business that supports the real economy turn into a fund-like, finance-based business. These problematic speculators expect the management not to focus on R&D but on M&A. They demand that retained earnings be distributed as dividends or through stock buybacks – all to maximize short-term returns for shareholders.

3. "Companies belong to its shareholders" (Published on January 20, 2016)

If Japan imitates the American style of corporate management, it is possible that the salaries of Japanese corporate managers would grow exponentially. From 1936 to the early 1980s, the average yearly salary of the

CEOs of major American companies was around $1 million. It started to rise quickly, however, in the mid-1980s and reached $14 million in 2008 before the financial crisis spurred by the collapse of Lehman Brothers. On the other hand, what is less known that the median annual income for American men in his 30s dropped by 12% between 1974 and 2008. It is strange that the income of CEOs rose while employees' salary fell and shows the growing disparity arising from Shareholder-centric Capitalism.

<Pay Increase Comparison: CEOs & Workers>



Source: Economic Policy Institute

Here is another phenomenon, strange even to those who agree with shareholder capitalism prevalent in the US. In 2008, when American Airlines was suffering financially, its management asked for a $400 million pay cut from the employees. The employees, thinking that finding a new job would be impossible in a recessionary economy, agreed. However, after this massive pay cut, the management received a bonus in stocks worth about $240 million.

This would not happen in Japan. I suspect that almost everyone in Japan would say, "Since the employees accepted a pay cut for the company to survive the crisis, the management must share the burden by accepting an even bigger pay cut."

I, too, pointed out this unfair practice to various American corporate managers. Surprisingly, however, very few agreed that there was a problem at all. Most of the managers simply believe, "Companies belong to their shareholders." Their logic is that the management successfully reduced the company's cost – the employees' pay – in order to save the company, which belongs to its shareholders. As a result, the managers enhanced the value of the company, and thus deserve a big bonus.

From a corporate governance standpoint, most Japanese people would feel that such reasoning is wrong. In the US, however, outside board directors who play an important role of overseeing corporate governance do not criticize the logic.

The key role of corporate governance in the US is to ensure that the management is maximizing the shareholders' interest. If Japan adopts corporate governance based on the theory that companies are owned by their stockholders, not only would the morale of Japanese workers decline, but the company also would be out of alignment with our societal norms. Japanese companies would increasingly turn into mere profit-scheming machines.

Although the American people don't all necessarily agree with such a style of corporate governance, it has already become part of the whole system. As a venture capitalist, I have served as a chairman and outside director of many small and large corporations. Once a company becomes listed on US stock exchanges, I start to notice in the company a feeling of responsibility to maximize stockholder value.

Fund managers who would like to see a short-term increase in share prices need the management to cooperate, and support stock option programs where the management's compensation is interlocked with the share price. The hike in CEO's salary is largely a result of increasing stock options (and other equity based compensation) given to them. Once corporate managers receive stock options, they attempt to manage the company so as to raise the stock price in the short run, because, if successful, they will benefit, too.

Stock options must be exercised before the term expires, or they become worthless. The more options a manager has, the more he would like to raise the share prices before his tenure ends. Stock options make the interest of shareholders match with that of the management: short-term gain in stock prices. The framework is well structured – it slants management toward self-interested greed.

4. Stock Options (Published on January 27, 2016)

Stock options in the US cause many problems since both investment fund managers and the management want a quick hike in a share price. Because corporate managers are tempted to raise stock prices quickly before their term ends, they put in place stock buyback programs or artificially raise return on equity (ROE).

<Return on Equity: Explained>

$$ROE = \frac{Net\ Profit}{Shareholders'\ Equity} = \frac{Net\ Profit}{Assets - Liabilities}$$

The management can successfully raise ROE by **increasing net profit** (e.g., sales).

The management can also artificially raise ROE by **decreasing assets** (e.g., cash, investments, facilities).

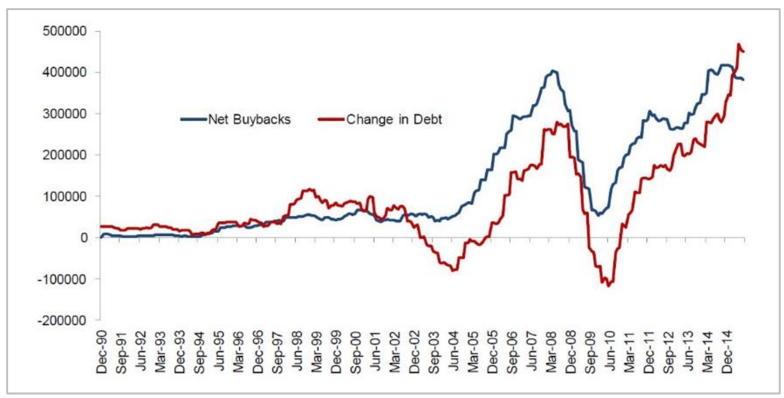
The true duty of the management is to grow the company sustainably and to share the profit with all the stakeholders ("Shachu" in Japanese). In most public companies in the US, this duty seems to have disappeared.

Schemes where compensations and share prices are interlocked, such as stock options, have become more like bribes (rather than incentives) given to corporate managers by speculative fund investors or directors. Recently, some institutional investors have begun to think that huge compensation to the management is a problem and have asked for limits. They are, however, just dealing with a problem they originally caused, which is now getting out of control.

In the 1980s the US government supported Iraq's Saddam Hussein administration in order to confine Iran. Later, Hussein became too powerful and became a threat to the US. The relationship between institutional investors and the corporate management in the US is rather similar.

What do you think if a company you work for generates a net profit of $100 million, and the total amount allocated for stock repurchases and dividends for the same period is $168 million? You might wonder in disbelief why the management has to please the shareholders to such an extreme extent, but this was an actual case that happened to a large ICT device company in the US. From the mid-2000s to the mid-2010s, the amount spent on this company's stock repurchase programs and dividends exceeded the net profit by 168%. This was a practice that started when the company hired a new CEO who focused on increasing the stock performance. The CEO conducted massive layoffs at a time when the profit was peaking in order to enhance the ROE and stock price. Though this may be an extreme example, there are many companies listed on US stock exchanges which spend more for dividends and buybacks than their net profit generated. We need to evaluate whether this kind of corporate management is acceptable.

<US Companies' buybacks are funded by debt>



Source: SG Cross Asset Research/Equity Quant, MSCI

If outside board directors ignore other directors and only care about the stockholders' value, what is the use of having outside directors at all? How can they perform corporate governance if supposedly neutral outside directors only focus on stockholders' interest? As a venture capitalist serving as an outside director for US and European companies, I have realized this is a big problem.

More and more people today ask to strengthen corporate governance in Japan. However, we need to first evaluate deeply the Western style of corporate governance and then create a style that incents the sustainable development of the business and the economy as a whole. Japan has a history of recreating foreign systems to fit the country's needs and culture, not just copying them.

For companies listed on stock exchanges, stock options, buybacks and excessive dividends cause an unfair profit distribution. The system of profit distribution has to be set so that the company shares the profit with the entire Shachu, not only the shareholders and management but also with the employees, customers, local communities, and the planet.

However, in some cases, stock options are an effective tool to grow a company. In private startup companies, in which the major stockholders are only the founders and venture capitalists, stock option programs provide an efficient way to distribute the company's ownership to the employees or other stakeholders outside the company. In such instances, stock options also can enhance the value and sustainability of the Shachu.

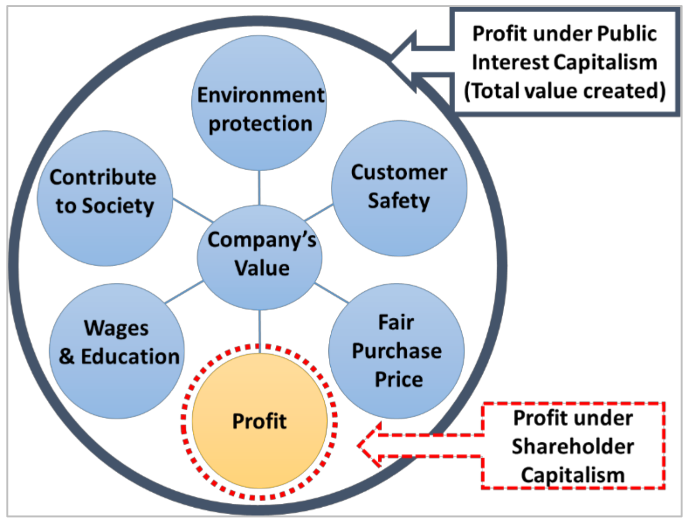
5. Fair Distribution of Profits (Published on February 3, 2016)

Fairness in the distribution of profits is an important matter when evaluating a company's value. Yoshiyuki Kasai, Honorary Chairman of the Central Japan Railway Company (JR Tokai), once told me the following story.

When Mr. Kasai, as President of JR Tokai, reported the company's financial statements to its foreign stockholders in New York, the stockholders noted that the company replaced Shinkansen (bullet train) cars before the end of their life. The investors insisted that the longer the company uses the train cars, the more profit the company could produce, and therefore the bigger the dividends it could pay. The shareholders also stated that keeping the old train cars would increase the company's ROE as well as the stock price. Mr. Kasai replied to them, "Tokaido Shinkansen has never caused a fatal accident since 1964 when we started operating it. The reason is that we focus on safety. Investment in passenger safety is our first priority." He explained that by focusing on safety, customers feel more confident and use Shinkansen more often, and then sales increase along with the stock price. Mr. Kasai's management was based on this principle.

When determining how to allocate profits to the company's stakeholders ("Shachu" in Japanese) in a fair way, he was probably thinking that an excessive increase in the dividends might decrease the profit allocation for the customers – safety. I think this is an ideal way of corporate management.

<What is Corporate Profit?>



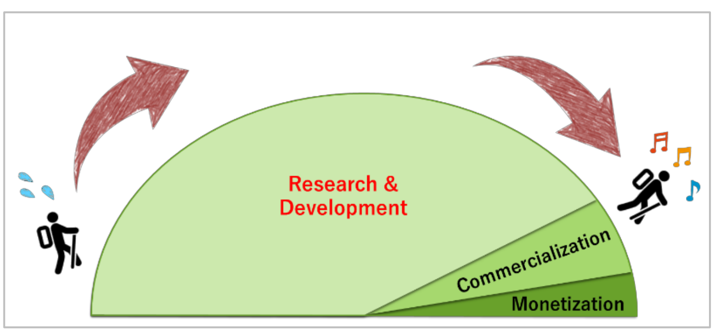
When some people hear the phrase "public interest," they mistakenly feel that being profitable goes against it, but Public Interest Capitalism does pursue profits, and in fact, producing profits is the priority. Public interest refers to the sum of profits that are distributed to each and all of Shachu. A company is a public institution, and its duty is to distribute the profits to all Shachu that comprises the company, such as the employees, customers, suppliers, local communities, the planet, shareholders, and the management for the long term. The management needs to have a balanced business with short, medium, and long-term projects combined. In terms of the profit distribution to those who support the company's sustainability such as the employees and society at large, however, short-term views have no place.

Public Interest Capitalism also encourages an entrepreneurial spirit to pioneer innovations and improvements. In many cases, it takes quite a long time for a company to commercialize a unique technology into a product. In places like the US where the economic model rewards short-sighted management, even when the company wants to conduct a long-term R&D project, the investors or outside directors are unlikely to allow it. If Japan could build an ecosystem where long-term projects are instead encouraged, many American companies might even move to Japan.

A group of experts, part of Japan's Council on Economic and Fiscal Policy, has started discussing the "Desirable Market Economy System" since April of 2014. I, as the group's Deputy Chairman, suggested the implementation of incentives for long-term stockholders such as higher dividends and preferential tax treatments for long-term shareholders.

In November of 2014, Toray received orders for carbon fibers, to be used for a new model of airplanes, from Boeing. It was a huge deal, with sales reaching $10 billion over the 10-year term. However, it took about 50 years for Toray's carbon fibers to be profitable. Because of other profitable businesses that supported the lengthy R&D of carbon fibers, the technology was successfully commercialized. The success was not only the result of Toray's other profitable projects but also the culture of the company that the management has long cherished – the culture to grow and complete a project that may lead to the company's sustainable growth even when it is unprofitable in the short run.

<Commercialization & monetization is not innovation>



6. Parting with the pursuit of short-term profits (Published on February 10, 2016)

We must advocate the principle that companies are public institutions in the 21st century. That companies belong to their stockholders, an idea that destabilizes the society, has to be denied. Currently, the value of a company is expressed in its market capitalization. Market capitalization is calculated by the stock price multiplied by the number of stocks issued. In order to increase market capitalization, the management tries to increase return on equity (ROE), which is highly correlated to the stock price.

Focusing only on ROE, however, leads to excessive return for stockholders. It can discourage the investment in future projects as well as the distribution of profits to other stakeholders ("Shachu" in Japanese), such as the employees, clients, communities, and the planet. This behavioral thinking can exacerbate the severe disparity in the world.

Shachu means all members of the community who supports the business. Many call it stakeholders, but stakeholders are often indicative of simply having some interest in the business. If the management considers the employees as just someone having some interest in the company, the company is no longer a public institution. In order to create a company that serves the public interest, where all the profits are shared in a fair way to the entire Shachu, it is important to have a long-term view on management.

<Shachu>

Towards such a goal, Japan can take initiatives, such as abolishing corporate quarterly reporting. I hope Prime Minister Abe advocates it at the G7 Summit in Ise-Shima in May.

Japan's stock exchanges and the Financial Instruments and Exchange Act require public companies to produce and disclose quarterly reports and quarterly briefing notes. By disclosing these two quarterly documents, investors and stock analysts become more short-term oriented, which hinders management with a long-term horizon.

It makes little sense to produce short-term profits by squeezing investments in human resources, education, and technology. Also, some companies, such as railroad operators, have seasonally unique earnings, but speculative investors are very sensitive to even a slight drop.

A company's quarterly financial report which exists only to please these speculators is dated and no longer necessary. As the number of foreign stockholders with ideas based on shareholder capitalism increases, we should advocate the abolishment of quarterly reporting in order to prevent short-term and speculative profit taking. Both the market value accounting system and asset-impairment accounting system prevent or discourage the management to invest in long-term R&D that starts from scratch.

Many R&D-focused startup companies incur cumulative losses for the first several years. Fortinet Inc., for example, where I invested and worked as an outside board director since its foundation, had a cumulative loss of $100 million after five years in operation without significant sales. The auditor sought to classify certain assets as "impaired" and the added extraordinary loss would have made the company bankrupt, but I did not agree. In the ninth year after its foundation, Fortinet became listed on NASDAQ and grew to be one of the worlds' top network security companies. Most venture capitalists or large corporations would not invest in this kind of business models which require long-term development. Under the current accounting system, acquiring later-stage startup companies is more rewarding to large corporations than investing in startups.

When I served as Honorary Co-chair of the Republican Party's Business Advisory Board, Mr. Charles Holliday, then-Chairman and CEO of DuPont complained to me saying, "Not only DuPont but also most American public companies are no longer able to take on long-term R&D projects like Toray's carbon fiber." After losing its R&D capabilities, DuPont's merger with Dow Chemical was a likely result.

The value of a company is created by co-operation of all Shachu. It is impossible to measure such value with ROE. In order to evaluate the true value of a company, we need to change the current framework that puts a spotlight on only one aspect of the company.

7. Our corporate governance is not following the Western model (Published on February 24, 2016)

How can Japan find and exercise our own model of corporate governance, without following the Western style?

On October 29, 2015, the Alliance Forum Foundation held the "World Alliance Forum Tokyo Roundtable." The conference released guidelines called "From Discussion to Action" on corporate governance and sustainable management.

The guidelines included:

1. The establishment of the Association of Outside Board Directors for Public Interest Capitalism
2. The abolition of corporate quarterly reporting
3. Regulation setting for share repurchase programs
4. The development of a new measurement of company value instead of ROE

The Corporate Governance Code recommends appointing more than two outside directors, with responsibility for supervising long-term management. However, just like in the US or UK, the Japanese Corporate Governance Code and outside directors end up encouraging the optimization of short-term profits for stockholders. Public companies have since increased dividends and stock repurchases while the compensation return to their employees does not seem as good. This is why we need outside directors who practice Public Interest Capitalism.

When asked, “If the company you manage had an after-tax profit of $10 billion, would you spend it all for the stockholders’ benefits, through dividends and share repurchase programs?” Most managers in not only Japan, but also Europe and underdeveloped countries, say such a profit allocation is unacceptable. Some might consider it deleterious to the health of the company and society. However, in the US, this abnormal phenomenon is a very common practice. Many companies have established policies that allow the sum of dividends and stock repurchases to exceed the after-tax profit of the company. Between 2004 and 2013, Hewlett-Packard (HP), Pfizer, and IBM returned to their shareholder through dividends or stock repurchases 168%, 137%, and 113%, of their after-tax profits respectively. It was a whopping 280% at Time Warner.

<(Stock Repurchases + Dividends)/Net Income, 2004-2013 (%)>

hp	154%
Microsoft	105%
IBM	113%
P&G	122%
Pfizer	146%
TimeWarner	305%
Disney	103%

Source: Stock Buybacks: From retain-and-reinvest to downsize-and-distribute by William Lazonick, April 2015

IBM plans to add $4 billion in its share repurchase program (to $6.4 billion total) even after the company announced their fourteenth consecutive quarterly revenue decline in the third quarter of 2015. In 2010, Microsoft, taking advantage of the low interest rate environment, issued corporate bonds to fund dividends and stock repurchases. Although the stock price did hike quickly after the announcement, it is really questionable to repurchase stocks using interest-bearing debts. It is not acceptable that stockholders, among entire Shachu (employees, clients, communities, and the planet), are the only ones benefitting.

Outside directors, who are supposed to be neutral in corporate governance, do not criticize these practices. They only function from the purview of stockholders’ interest. This is the exact reason why the American style of corporate governance is not working.

Earlier in this series, I wrote how American Airlines’s management received a huge bonus after massive employee pay cuts, because the management supposedly improved the company’s value. Although, in my opinion, this is totally against the spirit of corporate governance, the outside directors have no problem with it. Such a style of corporate governance only focuses on short-term and speculative stockholders’ gains.

It is obvious that this model of corporate governance would not function in the 21st century. By all means, we should be against adopting these policies in Japan, even though I regret that we already have similar versions of corporate governance in place.

Japan should implement its own principles of corporate governance, not the dated Western version. With the Western style, key industries such as manufacturing might be forced to start returning to the stockholders with debt leveraged stock repurchases and dividend increases. We should not let Japan’s manufacturing businesses turn to M&A or use debt leverage in the simple goal to reward their stockholders.

8. Becoming a public institution in the society (Published on March 3, 2016)

In my previous column, I explained how the Western style of corporate governance – as well as their assigned roles of outside directors – is not functioning. In response, I would like to establish the Association of Outside Board Directors for Public Interest Capitalism. To practice the kind of corporate governance required for companies to operate as “public institutions,” here I will raise three important responsibilities of outside directors.

First, outside directors have to ensure that their companies are managed sustainably. They must make sure that the management is allocating well-balanced funds for both short and long-term projects. To invest in new projects in the future and to prepare for unexpected incidents, outside directors also need to encourage sufficient retained earnings. They should discourage artificially raising ROE as a means to increase their stock performance.

Second, outside board directors must ensure that the management allocate profits to the entire Shachu (the employees, customers, communities, and the planet, etc.) in a fair way, instead of focusing solely on investor returns.

Third, outside directors have to build an environment where the entrepreneurial spirit thrives. A core duty of management is to create new ventures. Outside directors are to encourage the management to evaluate, undertake risk and start new businesses.

Some outside directors are experts in the industry while others are not. The role of non-expert outside directors is not to propose new projects but to encourage the employees to give ideas even when the board room and the management tend to be conservative.

Short-term shareholders want to sell their shares before the price drops. Their objective is not consistent with the company's sustainability. Some proxy advisors, too, prioritize shareholder distributions over the sustainability of companies.

While the Stewardship Code encourages communications between the management and investors, the first priority should always be sustainable growth of the company. Japan should further consider reforming its corporate law accordingly and become a model for other countries.

In order to reward long-term shareholders, companies should be allowed to pay dividends in proportion to how long a particular investor has held the shares. For example, if Investor A has held a stock for one year, he will receive ten cents as dividends, and if investor B has held the stock for two years, she will receive twenty cents, etc.

It is also necessary to establish a framework so companies can deal with activist investors' outrageous demands – such as a 100%-plus increase of dividends and listing a heavily investor-focused outside director candidate. One idea is requiring shareholders to have held the stock at least for three years before they can participate in the decision making through voting.

Linking the rate of dividend increases to the rate of employee compensation increases is another idea of a framework that would prevent speculative investors from demanding an extreme spike in dividends. The same framework can be applied to stock buyback programs – e.g., no stock repurchases without higher employee compensation. Also, the companies should be able to monitor those investors who have sold their shares prior to voting due to an increase in the share price and to make sure that they are not allowed to vote, because currently, these *previous* stockholders are able to vote in the annual meetings and the like. Corporate quarterly reporting also has to be abolished. I believe there is a strong consensus among corporate managers and unions alike, against "short-termism" that negatively affects employees and the society at large.

The Alliance Forum Foundation has researched and come up with "ROC" (Return On Company), a new index that measures the value of the company, instead of ROE. ROC evaluates the sum of all the returns to the entire Shachu.

<Return on Company: Explained>

$$ROC = Profit\ Allocation\ to\ entire\ "Shachu"$$

The management can raise ROC by ensuring a **<u>fair allocation of profits</u>** to each and every member that supports and makes up a company.

Higher ROC indicates long-term prosperity of the company, which is linked to **<u>higher stock prices in the future.</u>**

The company that distributes its profit to the entire Shachu will eventually bring a higher return to stockholders. According to financial data of listed companies, a higher ROC tends to correlate with a higher future ROE, which implies that ROC is a long-term version of ROE. We are now trying to simplify the index's calculation method because accurately measuring ROC is quite cumbersome.

If we are able to establish a new investment theory by linking ROC with stock prices, even speculators would invest in companies with sustainability and a fair profit distribution to Shachu, which would then spur stock prices. When we succeed in establishing this new index and popularizing it, investors would buy stocks or bonds of companies that act as "public institutions."

9. The transition to innovative key industry (Published on March 9, 2016)

Public Interest Capitalism enables the growth of companies that share profits equally with the entire Shachu (the employees, communities and stockholders, etc.) with a medium and long-term focus. It encourages the management to take on long-term projects, which may lead to creating new innovative businesses and industries in the future. By distributing profits equally to Shachu, the middle class also grows, and the world becomes more stable. It also spurs Japanese companies to expand their businesses in underdeveloped countries and establish stronger relationships with them.

The current key industry is without a doubt the computer-centric IT industry. However, key industries change with time – it was the steel industry forty years ago and the textile industry eighty years ago. As such, the IT industry cannot lead the economy forever. When the decline of tech giants, Google, Apple, and the like start, what kind of industries will take its place?

Shareholder capitalism that is prominent in the US and UK, the most important focus is the maximization of investors' short-term gains. This sort of capitalism turns into "speculative finance." Because speculative trading is a zero-sum game that does not create any additional value, it is not a real industry. Finance's true role is to support the real industries that make up the real economy. If the financial industry becomes a key industry, however, it will encourage money games, which is far from its true role.

In 1981 when I was a student at Stanford University, I wrote, "In the 1980's, there will be a 'digital' revolution where computer and communications technologies integrate. That new technology will create the IT industry, which will prosper as the economy's key industry until about 2040. Around 2015, the PC-centric era will come to an end, and a new era of PUC (pervasive ubiquitous communications) will arrive. As PUC develops, the IT and biotechnology industries will become integrated and enable an 'analogue' revolution with analog control technologies."

Currently, the integration of the IT and biotechnology industries is taking place everywhere. This marriage will be the core of the new key industries such as advanced medicine and digital health. (Chart on the next page)

During the early years of the IT industry, most prominent companies were created in the US, and Japan could only copy them. However, in the coming era of IT and biotechnology, it is possible for Japan to take the lead in the new field of advanced medicine. For that to happen, we need to combine:

1. Developing technologies
2. Building frameworks
3. Cultivating human resources

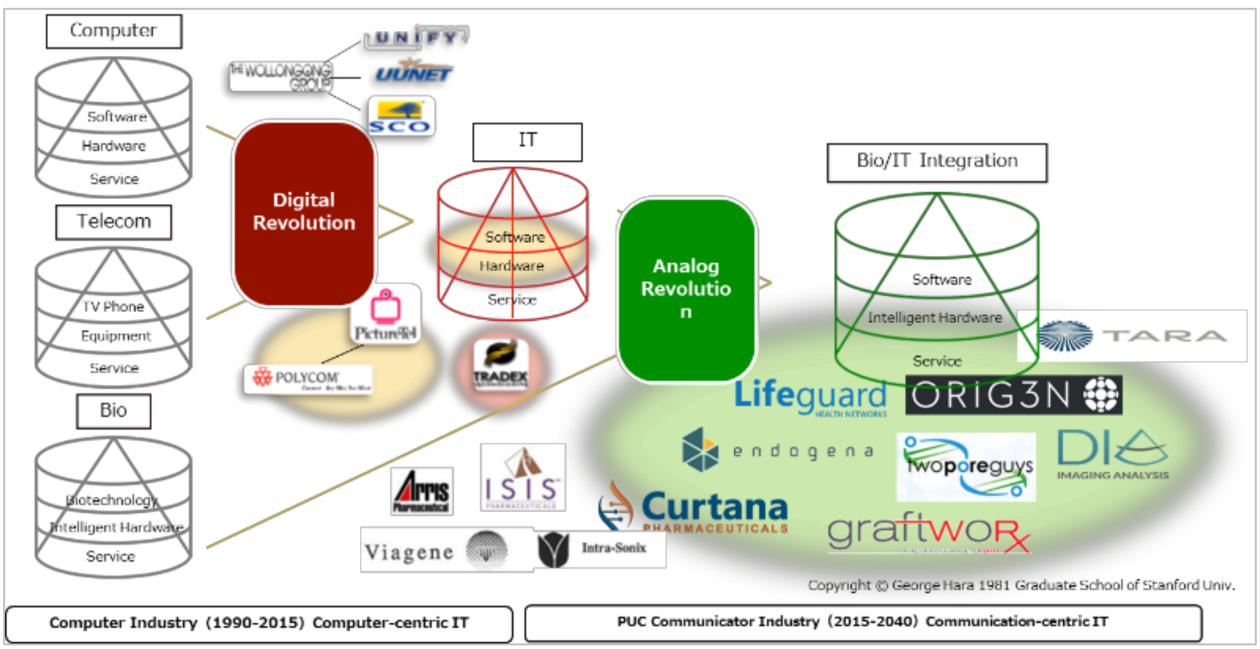
Within advanced medicine, especially in the field of regenerative medicine, many Japanese scientists are achieving outstanding results. In basic research, Professor Shinya Yamanaka of Kyoto University was awarded in 2012 the Noble Prize. In the application arena in different specialties Japan researchers are at the forefront. Amongst the most notable are Professor Yoshiki Sawa of Osaka University developing cell sheets for hearts, Professor Hideyuki Okano of Keio University specializing in spinal regeneration, and Dr. Masayo Takahashi of Riken, working on retinal regeneration.

Although there are many obstacles involved in the commercialization process, regenerative medicine will develop treatments for currently incurable diseases such as ALS and Parkinson's disease. I believe that the goal for medicine is to enable people to live in full health for their entire life, and these new technologies can make it possible.

The Alliance Forum Foundation, which I represent, has been holding an annual international conference on regenerative medicine and its commercialization in San Francisco since 2013. In this forum, leaders of the public-sector organizations such as the Japan Medical Association, the Japan Society for the Promotion of Science, and the Japan Science and Technology Agency, as well as business executives, are in attendance. Deals such as Fujifilm's acquisition of a large biotechnology business and the collaboration between Kyoto University and Professor Yamanaka have its origins at this conference, which will be next held on November 21 and 22, 2016.

This year, the Alliance Forum Foundation is going to hold a similar forum at the Awaji Yumebutai International Convention Center in Japan on March 25 and 26. The theme is Advanced Healthcare Technologies and the National Strategic Special Zones. I hope many people will attend and experience the opportunity towards action.

<Convergence of Industries & New Key Industries, by George Hara>



"Climate Change"

Caux Round Table for Moral Capitalism
Business and Public Policy Round Table
February 27, 2020
University Club of St. Paul

Proceedings

Chair and Facilitator: Stephen B. Young, Global Executive Director, Caux Round Table for Moral Capitalism

Participant Remarks:

- Since houses can be built to dramatically reduce energy consumption, builders and developers should build to meet such specifications.

- We so often use metaphors from the agricultural age – plant a seed, fertilize, harvest. Today, we need frames for thinking, which trigger commitments to faster timelines for getting results.

- The educational achievement of our citizens is woeful. In the 1950s, when there was a demand for teachers to educate the new generation of Baby Boomers, schools of education lowered their standards to ease recruitment of new teachers. In the following decades, the knowledge base imparted to students by these less well-prepared teachers declined. To upgrade the knowledge capital of citizens, we need continuing education for teachers to upgrade their ability to deliver more knowledge.

- Further, few people today can think with sophistication and so cannot readily foresee in good time the 2nd and 3rd order consequences of decisions we make today.

- Education on better decision-making on consumption choices is needed. The public needs to be shamed into avoiding purchases of "evil" goods and services.]

- We should reduce our needs and wants, which will lead to less consumption of energy.

- Also needed: inculcating a mindset of sustainability; revising perceptions of what provides the most long-term value for money and the benefits of investing for future advantages. We need an inflection point to overcome resistance and acquiescence to the status quo, a motivation to have "all hands-on deck."

- When life-style changes are needed, first, leadership must step up to drive a change in values.

- The implication is that the materialism – food, housing, transportation, energy - sustaining our civilization needs to be replaced completely and quickly. That is a tall order

- Our civilization is now on the plateau of an S curve evolution. The first slope of the curve was technology to products and services. Now, a new S curve is needed or the system will decline the creation of industrial civilization through the application of science to technology and from its current plateau towards less productivity. This stagnation in productivity is already happening in the E.U. and the U.S. Disruption must occur to start a new upward sloping S curve.

- Our GDP, which sustains our daily well-being, varies directly with exploitation of carbon.

- We can't abandon the fossil fuel industry, but could impose modifications of costs, such as with cap and trade carbon vouchers. But the industry has publics dependent on its provision of energy to hold hostages against rapid change.

- It is also hard to institute remedial action for a global problem – national actions seem too ineffective and international actions – such as a global carbon tax - too difficult to coordinate among sovereign nations.

- Competition among nations leads those with high costs to off load production to jurisdictions that do not charge markets for pollution or for improving working conditions.

- Goods and services are priced so that they can be bought, subjecting introduction of new technologies to limitations imposed by marginal utility of price. The majority of people in the world have very high marginal utility of each additional dollar available to them. They are not potential customers in private markets for new technologies that can reduce carbon discharge into or remove carbon from the atmosphere.

- The atmosphere is a free good, so it succumbs to the tragedy of the commons – uncoordinated exploitation by self-seeking free riders.

- A great barrier to the exponential expansion of electricity for energy consumption is the limited capacity of batteries. They are still chemical technology when non-chemical, electrical storage is very hard to scale.

- An approach is to consider risk management at every turn of events and opportunity. What risk level is acceptable?

- With the earth itself as a capital asset sustaining humanity, we are consuming assets every year and not replacing our capital.

University Club, Saint Paul, MN

Summary Observations:

1) Global warming demands a systems theory, a field theory of multiple interdependences and causations; a framing of apparent chaos as a more linear path forward.

2) More attention should be given to carbon sinks as part of remediation of global warming. For example, grasses with a particular C-4 gene pull far more carbon out of the atmosphere than do most other trees and plants. Genetic modification of common trees would permit much more sequestration of carbon than presently occurs.

3) Denominating goods and services as public goods or bads or as private goods, accurately documenting externalities, would lead to more responsible pricing for advancing or retarding their contributions to global cooling or global warming.

4) Minimizing the tragedy of the commons by promoting personal responsibility.

5) Setting standards for quality of life – consumption patterns, meeting status needs and overcoming status anxieties. But who is to judge what is the good life – for themselves and for others? And who will get to enforce restrictions of quality of life decisions?

6) Should we assume to live with higher costs necessary to remediate global warming as a charitable contribution to the common good or for our own self-interest rightly understood upon the whole?

Earth as Stakeholder

by Patrick Rhone

The world is changing. The climate is warming. The oceans are rising. The coast is flooding. There are more droughts and more heat waves. Increasing intensity and strength of forest fires and hurricanes. As I write this, in March in Southern Minnesota where the average temperatures between 1980 and 2010 ranged between single digit highs and negative double digit lows, for the past several years, it has been highs in the double digits and lows in the same. They say a rising tide lifts all boats. A rise too high can equally sink them.

The science and evidence on the human role in all of this is overwhelming by any measure of the term. Besides, at this point with the problems and costs of this crisis now on our doorstep, arguing about who delivered it to our house is largely academic and does nothing to deal with the package itself.

Within the core principles laid out in the founding days of the Caux Round Table for Moral Capitalism are some ideas that I believe are foundational for building the thinking, strategies and systems we will need to start taking action on climate change. (If you've not read these principles in awhile, I urge you to do so). Perhaps the most important idea is that of "stakeholders."

In those principles, stakeholders are identified as:

- Customers
- Employees
- Shareholders
- Suppliers
- Competitors
- Communities

The idea being that for businesses, governments and societies to work well, all of these stakeholders must be treated with equal value. All of these stakeholders must be respected. The converse of this is true as well; that the falterings and failures of businesses, governments and societies can be found in one or more of these being out of proper balance. It also highlights the interdependence and symbiosis of business and stakeholders — that none can sustain without the other.

How do we apply the principles laid out for businesses, governments and societies to the urgent problem of climate change? To do so, we must formally recognize one more key stakeholder:

- Earth

When Earth is a stakeholder, businesses following our principles would be compelled to give planetary considerations equal weight in making decisions. Not only thinking about how and why to build a new product or where to build a new factory might affect customers, suppliers or the share price, but also how it will affect the planet and its climate.

We must start by specifically naming the Earth itself a stakeholder. In the same way that business relies on all of the other stakeholders in order to be profitable, sustainable and thereby successful, we must also recognize that businesses — all businesses — rely on the Earth, its resources and the health and vitality of its population to survive. Making Earth a separate and independent stakeholder (as opposed to being assumed and implied) also highlights what might otherwise be lost in the obvious — the interdependence and symbiosis of business, stakeholders and the planet on which all of this occurs — that none can sustain without the health of the other.

Outro

It's difficult to imagine what one can say about today's pandemic that has not been said many, many times already. And yet, even if almost everything has been said, it is essential that we repeat these ideas over and over until they come to alter our perception of "reality."

And what is that reality? It's very simple: we are all in this together. All of us. With perhaps the exception of some tropical countries, all the nations of the world are equally endangered. Pandemics like COVID-19 have no regard for class, color, ethnicity or religious affiliation. Money cannot limit the spread of this illness, nor nationality, nor any other of the concepts we impose on the human race that ignore the deeper reality that we are all "God's hungry children," as the expression has it, who are born, die and rely at the beginning and often at the end on the help of others willing to sacrifice comfort and sometimes even safety in exchange for giving us as individuals a chance to spend our allotted time here on Earth.

Capitalism, as even Karl Marx – no fan of capitalism – observed, has since its origins in the late 17th and 18th century Europe, created vastly more net wealth than all previous economic systems since the beginning of human civilization put together. And whatever we might think of Marx, his call for some way to control capitalism's drive to maximize wealth, whatever the cost, even the despoliation of our species and the natural environment, is worth heeding closely. Simply put, we need to find some way to create a sustainable version of capitalism that serves not just the wealth of shareholders, but the inalienable needs of all of us, all stakeholders, including the natural world that sustains human civilization and, ultimately, human survival.

This concept is at the heart of the Caux Round Table for Moral Capitalism's call for a "moral capitalism" – a sustainable economic system that serves the interests and basic needs of everyone, not just the billionaire class. Let us, however, be very clear on this point: the problems we face are not caused by the wealthy; the wall created between the rich and everyone else is a symptom of a capitalism in which the "free market," that is, of course, not at all free, but relies on the internalizing of profit and the externalizing of costs ad infinitum, is elevated to a God-like status as a source of moral, as well as monetary values. In such a world, we are all at risk of damnation.

In Boccaccio's The Decameron, a haunting parable of a doomed attempt to escape the Black Death, which ultimately took the lives of more than half the population of the world, we encounter a group of wealthy individuals who hole themselves up on a country estate, hoping that this would place them beyond the reach of a 14th century pandemic that makes COVID-19 seem like little more than a bad cold. Their efforts, of course, were doomed to fail and in time, the plague would devour rich and poor alike. Even more recently, we have witnessed how the arrival of European explorers in the Americas devastated a native population with no inherited immunity to a host of terrible diseases; some estimates of the mortality rate run as high as 90 percent of the total population in Central Mexico.

Then, as now, there was no place to run, no place to hide. The one truly realistic hope is that we learn from the past and band together to find ways to blunt the spread of today's pandemic.

Failing that, then we can only pray that God will help us if we prove unable to help ourselves.

Rich Broderick
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Caux Round Table for Moral Capitalism

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