

**The Seventeenth Council of Experts Concerning the Follow-up of  
Japan's Stewardship Code and Japan's Corporate Governance Code**

1. Date and Time: January 28, 2019 (Monday) 14:00-16:00
2. Venue: 13F, Central Government Building No. 7, Meeting Room

[Ikeo, Chairman] It's already the scheduled opening time. I'd like to open the seventeenth meeting of the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code.

We are informed that Mr. Takei will be a little late. Thank you very much for taking the time from your busy schedule.

Today, a representative from the Tokyo Stock Exchange, as the Secretariat, will first explain corporate responses to the Corporate Governance Code revised in June last year, and we will have a discussion.

Then, to hear about corporate governance issues from the perspective of corporate management, we invited Mr. Soichiro Sakuma, Executive Advisor of Nippon Steel & Sumitomo Metal Corporation (NSSMC), Mr. Masayoshi Matsumoto, Chairman & CEO of Sumitomo Electric Industries, Ltd. and Chairman of the Kansai Economic Federation (Kankeiren), and Mr. Somuku Iimura, Vice Chairman of Corporate Legislation Committee, Kankeiren. They will make presentations later today. Supposedly, Mr. Matsumoto and Mr. Iimura have just arrived at Haneda Airport, and will join us later.

Now we will proceed with today's agenda. First, there is an announcement from the Financial Services Agency (FSA).

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] With respect to the principle-based guidance on disclosures, which was discussed during the last meeting, we published the draft of the principles on disclosure of narrative information and called for public comments. The draft is open for comments until February 1. Similarly, with respect to the enhancement of disclosure items on "the list of institutional investors which accepted the

Stewardship Code”, which was also discussed during the last meeting, we posted them on the FSA’s website at the end of last December. For more detail, please refer to Reference Materials 1 and 2, which we distributed to the members, as necessary.

That’s all from me.

[Ikeo, Chairman] Thank you very much.

Now I’d like to ask the representative from the Tokyo Stock Exchange (TSE) to explain corporate responses to the revised Corporate Governance Code.

[Kikuchi, Head of Planning Section, Listing Department, TSE] I’ll explain corporate responses to the Corporate Governance Code revised last year in accordance with Material 1-1. To report on the latest ‘Comply or Explain’ status, we aggregated relevant data contained in Corporate Governance Reports, which were due end-December 2018.

Please turn to page 4. The graph shows compliance rates of companies. This time, percentages declined for both companies which complied with all principles and companies which complied with 90% or more of principles: you can see overall declines in the compliance rate. This is because of reductions in percentages of companies which complied with revised principles of the Code, which are illustrated on page 5.

The table on page 5 shows compliance rates for newly-added or revised principles. Among 8 principles which were revised this time, 5 principles recorded a decline in the compliance rate by 10% or more. Among 5 new principles, compliance rates for 2 principles were below 80%. We consider that such factors caused overall declines in the compliance rates.

On page 6, you can see a table showing compliance rates for all 78 principles. The table contains all principles, including principles which were not revised this time. We marked principles with the compliance rate below 90%, which is relatively low. Out of such 12 principles, 8 principles are either revised or newly-added principles. Conversely, among principles which were not revised this time, there was no significant decline in the compliance rate.

Please turn to page 8. From here, I’ll explain how companies addressed specific requirements of the Principles, topic by topic. First, we look at business management in consideration of cost of capital. The revised Principle 5.2 stipulates that before setting targets for profitability and capital efficiency, companies should accurately identify their cost of

capital. While this Principle requires companies to identify their cost of capital, it does not require disclosure of cost of capital itself. Therefore, it is rather difficult to figure out impacts of the revision, other than the compliance rate. We could not make comparison with the past data, either. Instead, we summarized the current situation by referring to each company's medium-term business plan.

The graph on the left shows how companies set their targets for capital efficiency. Approx. 63% of companies use ROE for their targets. The graph on the right shows numerical targets of those companies. While institutional investors expect companies to achieve a two-digit ROE, approx. 77% of companies set the target ROE at 10% or more.

Today we also distributed Material 1-2 for your reference. It contains specific examples of disclosures made by companies under the Code, as well as specific examples of explanations. As we included excerpts therein, a typical example of an explanation for this Principle is like this: companies will consider setting targets when they formulate their next medium-term business plans.

Please take a look at page 10. This section focuses on the status of fulfilling the board's functions. First, we look at the use of independent advisory committees. After the revision of this Principle, companies are required to make use of independent advisory committees, when considering nomination/remuneration of directors. The percentages of both companies with nomination committees and companies with remuneration committees increased by approx. 10% to mid-forty percent, accordingly. As explanations for non-compliance with this Principle, approx. 30% of companies reported that the use of such committees is currently under consideration, and some companies disclosed that they consider the establishment of such committees is not necessary at the moment. As a reason for non-compliance, they reported that because they make decisions by taking into account opinions or advice from their supervisory committee or independent directors, there should be no problem in terms of the independence and objectivity, and therefore, they consider it is not necessary to establish such committees at the moment.

Please turn to page 11. We analyzed the independence of advisory committees from two perspectives: the committee composition and attributes of committee chair. Approx. 30% of such committees meet independence criteria from these two perspectives: the majority of the

members are outside directors, and an outside director assumes the position of committee chair. Furthermore, if we include committees which satisfy one of these two criteria – specifically, as stated on the bottom of the page, committees consisting of a majority of outside directors but not chaired by an outside director, or committees consisting of an equal number of inside and outside directors and chaired by an outside director, we can say that more than 60% of both committees [i.e. nomination committees and remuneration committees] satisfy a certain independence condition.

Please turn to page 15. This is about ensuring diversity in the board. As elements of diversity, the revised principle clearly refers to gender and internationality. As shown in the left graph, roughly a half of JPX-Nikkei 400 companies appointed at least one female director. Among companies [listed on the TSE First Section] which provided explanations for non-compliance, approx. 50% of them stated that they are considering the appointment of female directors.

The right graph shows numbers of directors who are foreign nationals. Approx. 15% of [JPX-Nikkei 400] companies appointed foreign directors.

I'll move on to page 17, which is about reduction of cross-shareholdings. This principle was revised to require disclosure of policy regarding the reduction of cross-shareholdings. In addition, it stipulates that companies should examine whether the purpose of such shareholdings is appropriate and whether the benefits and risks from each holding cover their cost of capital, and then disclose the results of such an assessment.

The left graph shows what companies reported on their policies of cross-shareholdings. 74% of the companies clearly mentioned that they will reduce cross-shareholdings which become less meaningful.

The right graph shows whether companies explicitly referred to cost of capital in their disclosures of the assessment results. The result was roughly half and half. A typical explanation is that they continue to hold such shares when they deem it necessary for business alliances or maintaining/strengthening business relationships.

In addition, although it is not mentioned in this material, along with the revision of this principle, a new supplementary principle is added: a company should not hinder the sale of its shares held by cross-shareholders by, for instance, implying a possible reduction of business

transactions. In this regard, a few companies clearly stated, by taking the ‘Comply and Explain’ approach, that they will not hinder the sale.

Let’s move on to page 19 about asset owners, which is the last major topic. This principle [Principle 2.6] requires listed companies to take and disclose measures to improve human resources and operational practices to ensure that corporate pension funds perform their roles as asset owners. Upon checking disclosed measures, as shown in the left graph, we found that the most common measure is the assignment of qualified persons: 216 companies are taking this measure.

That’s all for my brief explanation about corporate responses to the revised Corporate Governance Code. For your reference, I’d like to briefly introduce the Tokyo Stock Exchange’s ongoing review for realizing an optimal market structure, which is summarized in the subsequent section from page 20. Although various media covered this initiative, we have not yet made any specific decisions at the moment. We established an advisory group of experts in October 2018, and have held a series of discussions there. We have issued a consultation paper in late December 2018, calling for public comments about issues with the current market structure and listing criteria as well as areas for improvement from 3 angles: (1) ideal entry-level market divisions; (2) ideal step-up market division; and (3) ideal market exit (delisting). Because the review of the listing framework affects a wide range of stakeholders, we would like to analyze/sort out opinions from the stakeholders, and then have in-depth discussions on an optimal market structure in the future.

That’s all from me.

[Ikeo, Chairman] Thank you very much. Now I’d like to move on to a discussion session. However, today we invited guests for their presentations and exchange of opinions, which are planned to start from around 14:30, so we have only 15 minutes for discussion now. Please understand the situation and cooperate for smooth proceedings. If you have any comments or questions regarding the explanation by the Tokyo Stock Exchange representative, please feel free to express them. Mr. Oguchi, please go ahead.

[Oguchi, member] Thank you very much for summarizing corporate responses in a short time. It was very informative.

I have recently read an article about the UK’s Code. It stated that, also in the UK,

disclosures are something like “Copy and Paste” instead of ‘Comply or Explain’. So, for the purpose of creating the environment where meaningful explanations are appreciated, I believe it is very important to share specific examples of descriptions cited in Material 1-2 or reference material, rather than Material 1-1.

As the time is limited, I’d like to make comments on only 3 points. They are related to the reference material. First, you referred to cost of capital. However, business risks and financial risks differ from company to company, so cost of equity capital also varies. Accordingly, target ROE also varies. In that sense, while an absolute value of ROE is important, it is, rather, the revised Principle 5.2, which requires business management in consideration of cost of capital, that contains a very important concept for companies and investors. Although actual figures may vary from company to company, the risk-free rate is generally 1-2%, and the risk premium is roughly 5-6%. Based on such common levels, for example, as shown in the example on page 4 of the reference material, I can understand the assumption that their cost of equity capital is 8%. However, on the bottom of page 3, a retailer stated that its cost of equity is calculated to be 2.8% based on CAPM; and a manufacturer (listed as second from the bottom) stated that its weighted average cost of capital (WACC) is calculated to be 1.5% after considering tax savings from interests on debt. Frankly speaking, I can hardly understand such a level. Disclosure allows for discussion, so disclosure itself should be appreciated. However, looking at such examples of disclosures, and presuming that there may be similar situations among companies which complied with this principle since it does not require disclosure as explained earlier, I felt this reference material is a fresh reminder that dialogue is very important in this regard.

My second point is about the use of highly-independent advisory committees. Currently, there are 3 forms of corporate organization in Japan. As for “Company with Supervisory Committee” which is the newly introduced form, there is a criticism from foreign investors that companies merely change outside *kansayaku* (corporate auditors) in Company with *Kansayaku* Board to independent directors, in order to comply with Principle 4.8 – the requirement for appointing at least 2 independent directors. I understand that supervisory committee has a new right, which is the right to state opinions on nomination of director candidates other than supervisory committee members as well as on such directors’ remuneration. However, it does not mean that companies do not need to establish independent advisory committees. In this

regard, as shown in the example of a company in the information and communications industry on page 7 of the reference material, while shifting its organizational form to “Company with Supervisory Committee”, the company actively makes use of independent directors, and actually established and runs independent advisory committees. Such a move sends a message that it is substantive, not just for satisfying numerical criteria, and dispels concerns that “Company with Supervisory Committee” lacks substance. I believe it is a positive initiative.

My last point is about cross-shareholdings. This Council has had extensive discussions on cross-shareholdings. Broadly speaking, such shareholdings have problems of both the hollowing-out of capital and the hollowing-out of voting rights. To solve both problems, the Code laid out a policy for reducing cross-shareholdings, in my understanding. However, with respect to these 2 problems, there is an implicit concern about a possible trade-off: if a return exceeds the cost of capital as explained earlier, voting rights can be sacrificed, although it is not stated that the hollowing-out of voting rights is acceptable. In case of investing in equities, resolving the problem of hollowing-out of capital could mean that cross-shareholders receive special benefits. If cross-shareholders, in exchange for such special benefits, exercise their voting rights to support any proposals of a company regardless of any problem with the management, it may compromise the effect of voting by ordinary institutional investors, which made genuine voting decisions, although the term “genuine” may not be appropriate. I have such a concern. Primarily, there is a problem of the hollowing-out of capital, and it is good to discuss it. However, I believe it should not be discussed separately from the exercise of voting rights. It is reasonable that cross-shareholders should exercise their voting rights from the perspective of fulfilling their fiduciary duty similarly to institutional investors, regardless of whether or not they can enjoy special benefits.

That’s all.

[Ikeo, Chairman] Thank you very much. Mr. Sampei, please go ahead.

[Sampei, member] Thank you. I’ll try to make it brief. Thank you very much for aggregating the data about whether companies complied with the revised Code or chose to provide explanations instead. However, the aggregate results – the compliance ratios and the explanation ratios – may take on a life of their own, and therefore, the use of the data, how to understand or interpret the data, would be important. From what I can see, I would welcome an

increase in the number of meaningful explanations. On the other hand, while companies reported they complied with principles, it sometimes is unclear about how they complied with what. For example, even though companies reported their compliance with a certain principle, accompanying descriptions make me wonder if they really complied with the principle: the most typical example is Principle 1.4. As for Principle 5.2 and Supplementary Principles 4.3.2 and 4.3.3, I cannot figure out how they complied with those principles. In their disclosures concerning Principle 3.1, some companies stated that they will explain how they consider cost of capital in reference materials for the next general shareholders meeting. Can we consider that they complied with the principle that way? Therefore, aggregating superficial ‘Comply or Explain’ data provides a certain kind of important information, but users need to be careful about that point. Some companies provided explanations under ‘Company and Explain’ approach, and such explanations are very useful.

This time, I saw an overall improvement with respect to Supplementary Principle 4.11.3 concerning the evaluation of the board’s effectiveness. Every company works on it, and forward-looking companies referred to the evaluation of committees’ effectiveness, which I believe very important. While the revised Code encourages companies to establish such committees as nomination or remuneration committee, I believe the fact that evaluations of their effectiveness have been conducted is important.

In this context, I have a suggestion. In case a company has one committee like the nomination and remuneration committee, which assumes both roles, the company could provide a brief description, just in 2 or 3 lines, about committee composition/member attributes, the frequency of meetings, and meeting agendas. Such information will be helpful to understand a proportion of nomination-related discussion and a proportion of remuneration-related discussion, in case a committee has both functions.

Although this may be unnecessary advice, I noticed an inconsistency in how companies report on their committees in the relevant table in Corporate Governance Reports, especially in case they have an optional nomination/remuneration committee: some companies provide information only in the column of nomination committee, while others provide the same information in both columns of nomination committee and of remuneration committee. I did a test search on the TSE’s website, the page of “search for corporate governance information”. If



the companies have not provided any information in the column of remuneration, when a user conducts a search for companies with remuneration committee, the search result does not include such companies. So, I have a request to the TSE. Please tell companies that in case they have a nomination/remuneration committee, they should provide the same information in both nomination committee and remuneration committee sections, so that tallying the data will be more accurate and users can obtain accurate search results. I have told such companies about that during individual meetings. That's one thing I picked up.

That's all.

[Ikeo, Chairman] Thank you very much. Anybody else?

I totally agree with Mr. Sampei's opinion. When companies provide adequate explanations instead of merely stating that they complied with principles, they create a positive image...that's not a right phrase...they give an impression that they are seriously working on corporate governance.

Does anybody have additional comments regarding the Tokyo Stock Exchange's explanation on corporate responses? OK?

Now I'd like to move on to the presentations by today's guest speakers.

First, I'd like to ask Mr. Sakuma, Executive Advisor of Nippon Steel & Sumitomo Metal Corporation (NSSMC) to make a presentation for approx. 15 minutes. Mr. Sakuma prepared Material 2 for this presentation. Now I'll hand it over to Mr. Sakuma.

[Mr. Sakuma, Executive Advisor, Nippon Steel & Sumitomo Metal Corporation (NSSMC)]  
I'm Sakuma from Nippon Steel & Sumitomo Metal Corporation. It's my pleasure to be here.

Today I'd like to talk in accordance with the presentation material distributed to you. Information corresponding to today's meeting agenda is summarized in the last part of the presentation material, and other pages contain the background information, which I'm going to briefly explain.

First, I'd like to introduce our corporate profile and management challenges. As mentioned in the presentation material, our main business is Steelmaking. One of other businesses, Chemicals business (other than steel) focuses on carbon chemicals which are used for steelmaking; New Materials business focuses on the metallurgy; and System Solutions business is conducted by a company processing information, which is the most important for

steel production and sales.

As we are a merged/integrated company, we have domestic bases throughout the country.

As for overseas operations, we mainly operate in North America as well as China and other Asian countries.

Please look at the page titled “Our positioning in the world”. Currently, more than half of the world steel production is carried out in China. In 2017, 5 out of the top 10 steelmakers are Chinese companies, mostly Chinese government-owned companies.

This table shows major export items of Japan. Actually, while the manufacturing industry in Japan has experienced ups and downs, steel has been unexpectedly doing well. I’m sorry if it sounds like bragging. What it means is that Japan still has the competitiveness in steelmaking. The reason is very simple. While raw materials for steelmaking account for a significant proportion of product cost, even China must import raw materials from Australia, etc., and we are competing under the same conditions. Therefore, the competitiveness stems from technical capabilities.

In fact, as a major goal, we are currently aiming at becoming “the Best Steelmaker with World-Leading Capabilities” and pursuing “unlimited possibilities of steel”. It means we strive to produce exceptional products and expand the global reach of our business.

Let me explain the background of this goal. Following the Plaza Accord in 1985, we saw a sharp appreciation of the yen. At that time, we had 31 furnaces at various domestic production sites, but we had to reduce the number of the furnaces to 13. Meanwhile, we strived to diversify business lines to be a conglomerate. As a result, most initiatives turned out to be unsuccessful. At that time, I was personally involved in such new lines of products as semiconductors, silicon wafer, and personal computers sold under the brand “Librex”, which you may no longer remember. In addition, we expanded our business lines to include copy machines, transmitters, real estate business, theme park “Space World” in Kitakyushu, and nursing homes for the aged, which we have operated until recently. We also engaged in the mail-order business. Although I was not involved, the Company also started the cultivation of caviar, *Hokaron* disposable pocket warmers, Maitake mushroom, etc., but most of them failed. Reflecting such consequences, we returned to the starting point.

Let me talk about our starting point. I’m sorry this part may be like a science class. While

iron is very close to people and abundantly exists, iron is, in fact, an extremely unique material on the earth. As shown in the second item, the crystal structure of iron changes by temperature, while maintaining its solid condition (ordinary temperatures). Only iron and titanium have such features on the earth, and it is only iron that changes its crystal structure twice. The most important thing is the third item: iron is magnetic. Only iron, nickel, and cobalt are ferromagnetic at ordinary temperatures. However, nickel and cobalt are rare metals which are too expensive to use, so it is only iron which can be actually used in this electronic society. Naturally, it is essential for core parts of power generators, electric transformers, and motors. From the industrial viewpoint, iron abundantly exists and is naturally cheap. Another point. As I mentioned earlier, iron has a unique characteristic, and steel has demonstrated the intensity only up to 10-20% of the theoretical value. In other words, further research & development may result in making steel that is several times stronger steel than the current one. In fact, we are conducting research toward that.

Also, its environmental burden is extremely low, not as you may have imagined. I'll tell you reasons. First of all, it is easy to recycle. If you bring a magnet over a pile of wastes, only iron will be attracted to the magnet. Besides, steel products are not deteriorated during the recycling process. It is not the case with aluminum, and others: aluminum is so deteriorated that it is only recycled to lower-grade products, and finally thrown away after repeating the recycling process. In case of steel, it can be 100% recycled. Looking at the entire life cycle, its carbon burden during production is much lower than that of aluminum or carbon fibers; and its burden is overwhelmingly low in terms of recycling. Accordingly, in terms of the LCA (life cycle assessment) analysis, its environmental burden is very low.

As for demand for steel, the global demand will definitely increase over the long term. In that sense, we believe that steelmaking is a necessary business for the earth, regardless of how the world may change, or regardless of new competitive materials.

The question here is who plays such a role [to satisfy demand]. Of course, we'd like to play the role. We summarized our 2020 Mid-Term Plan (three-year management plan from 2018 to 2020) in the presentation material. We plan to commit resources in response to future changes in the environment, and invest in plant and equipment for 1.7 trillion yen over 3 years. This almost means Capital Investment is more than Depreciation. In a sense, we are currently going

through a tough time.

This is our specific numerical target. Now I'd like to go into details. While we have various mid-term challenges as I mentioned earlier, what are our major challenges this year? They are very basic things: rebuilding the revenue base, accomplishing the Mid-Term Plan, etc., and promoting the operational reform, etc.

Among our challenges to rebuilding the revenue base, the first one is the safety. In your workplace, you rarely face a case where a physical action causes death to employees at work. In case of steelmaking, as you can see during a site visit, the workplace is surrounded by extremely heavy, hot, and large things. Although operations themselves are automated, maintenance, repair, and responses to troubles are done mainly by manual labor. So, every year, we set such a goal as "no serious accident", but we have not achieved the goal. At our steel plants, we have 90,000 workers, consisting of our own employees and employees of subcontracting companies. We are seriously working on mechanization, reduction of physical work demand, and improvement of discipline. The second challenge is stable production. This is the most effective for improving the revenue base. Conversely, we have not yet achieved it at the moment. Generally speaking, main steelmaking facilities of any Japanese companies were established during the high-growth years, and have been used for 40-50 years. Accordingly, there is a need for large-scale renewals. Of course, the maintenance has been carried out, but the maintenance cost is very large. These are just the background, not the cause, because there are steel plants which have not suffered any large troubles. If every steel plant experienced such an accident, the cause is considered to be what I mentioned earlier. However, that's not the case. We consider that there should be human or management problems, and are working on them.

Some time ago, steel was called the "rice of industries". Actually, steelmaking has similar features as agriculture. It is affected by weather. If the sea is stormy, there will be a delay in shipment, as we mainly rely on sea transportation. If we have a heavy rain, we will need to adjust the sourcing of raw materials. If it suddenly gets cold, steel plates waiting for shipment will get rusted due to condensation. Although this is not limited to iron and steel, due to the recent abnormal weather, we suffer from flood or water damage. As mentioned earlier, iron's crystal structure changes due to temperatures, so it is a raw thing. Unless we deliver a certain

type of steel products to customers as soon as they are ready, they will become hardened and cannot be pressed. There are such special products. Responding to changing weather, which has been abnormal these days, is also an immediate challenge. The third challenge is demonstrating sales capabilities, while maximizing added value. To be specific, it is about price increase. The fourth challenge is strengthening overseas businesses, naturally including possible exits from unprofitable, continuing businesses.

Next, I'd like to talk about the current status of our corporate governance. We adopted the form of Company with Audit & Supervisory Board [note: equivalent to "Company with *Kansayaku* Board" defined in the Corporate Governance Code].

This table shows the current board structure. The participants in board meetings consist of 11 executive directors, 3 outside directors, and 7 Audit & Supervisory Board members (*kansayaku*): This is the structure with 11 people assuming executive roles, and 10 people monitoring/supervising business execution. As we are a Company with Audit & Supervisory Board, we established Nomination and Compensation Advisory Committee as an optional committee.

Compensation for directors consists only of monthly compensation paid in cash, and the entire amount is performance-linked. To be specific, the amount is linked with our consolidated profit/loss as well as ordinary income of the steelmaking segment in the previous year.

The next section is about our challenges with respect to corporate governance. The first point is "implementation", which is extremely important. As I explained earlier, we are struggling with immediate areas of focus. With respect to the production plan or sales plan, we are striving to avoid the situation like "first-class planning, second-class implementation, and top of the top-class excuses". However, there is no bright idea for strengthening implementation capabilities, and we are steadily working on it, while being reprimanded by outside officers. In terms of governance, it is important for the board to have members capable of reprimanding executive directors, ensuring that executive directors in question accept such a reprimand.

The next point is the board composition. Of course, it is under consideration toward the annual general shareholders' meeting to be held in coming June. In general, executive directors

are basically selected from internal human resources. I'm not sure about the future, but at the moment, we have qualified people within the company. I think this is a reality of Japanese companies in a certain sense. Unlike Europe and the United States, the entire Japanese society lacks the mobility of human resources. There is no two-way mobility between public and private sectors, as well as between academia and private sector. So, we cannot expect increased mobility at the officer level.

In this regard, a merger is a dramatic opportunity for bringing in human resources from outside in a certain sense. As you know, our company was established 6 years ago through a merger between the former Nippon Steel Corporation and the former Sumitomo Metal Industries. At first, from the viewpoint of officers from each of the former companies, the board had so many "outside" officers. That was a reality. Personally, I consider that a merger has an extremely positive effect in terms of bringing in human resources, and improving transparency and accountability of governance.

Currently, we have 7 qualified outside officers. In this regard, I have a doubt about overemphasizing the need for independent officers. As mentioned earlier, a more important thing is that when a director is reprimanded, the director accepts or truly understands what he/she is reprimanded for, instead of pretending to be obedient on the surface but disobedient in mind.

We have an outside officer from a mega bank. Why do we become humble when he expresses his opinion? It is not because we care about the business relationship with the bank. It is because he has influence over the financial community and the industrial circle, and if there is any problem with our governance, our general reputation may be damaged. That's what we care about.

Female officers. Frankly speaking, before we talk about the officer level, there are few women in managerial positions, such as managers and general managers in the first place. I think this is the problem, and it will take time to solve the problem.

Concerning compensation for officers, I earlier told you that all compensation is performance-linked, but there remains a problem with a gap in timing. Accordingly, there is room for improvement. However, it does not mean that the incentive is not at all working. Due to the time constraint, I won't tell you the details, but frankly, I got an impression that the

officers are assuming their roles, not incentivized by compensation. I think government workers understand it very well.

As for cross-shareholdings, at the time of the merger in 2012, the number of our holdings was 495, and now it is reduced to 361. You might consider the number is still large, but it is partly because we are a merged company, and partly because the former top management was devoted to ESG investments. However, most of the remaining holdings are stocks of unlisted companies. Individual values are extremely small. They are associated with infrastructure development during the high-growth years: our small contributions to railway, broadcasting, newspaper companies, etc. still remain. I think you are interested in our holdings of stocks of listed companies. They are associated with our users, consumers, financial institutions, and business alliances. We have been discussing the need for such holdings at board meetings, taking into account our financial needs, as necessary, and checking “inventory”.

The last point is compliance, which is our endless challenge. If we are not careful enough, long years of efforts will be immediately brought to nothing. Our company learned a hard lesson from the violation of the Anti-Monopoly Act in the past. As a lesson learned, we are considering how we can ensure a “good communication flow” within the company or the group. Speaking of compliance, ensuring good governance is important and of course necessary, but discussions on ideal governance tend to focus on the governance structure, especially the upper structure. In order for the board of directors to perform its functions, it is important to avoid the situation where information is not sufficiently provided for deliberations; ideally the board should collect the right amount of information. This is not limited to compliance, but applies to everywhere. It is essential to ensure a good information flow within the company, in other words, to establish a mechanism enabling a natural flow of firsthand perspectives of frontline employees. It includes information about internal control, J-SOX (whistleblowing system), and stress check which has recently become mandatory for business offices. We make use of columns for free descriptions on relevant matters. We also strive to ensure information sharing with auditing by Audit & Supervisory Board members. Each company takes its own creative approach to address the issue.

Although this is not unique for our company, in addition to the whistleblowing system, we established and utilize a mechanism where any accident/incident is reported directly to the

internal control group according to certain rules. We conduct an annual employee survey for all employees, which includes columns for free descriptions. Furthermore, we hold town hall meetings, where managers from all manufacturing divisions and managers from the corporate division sit together and have discussions. As a result, although this is an activity for the middle management, information on such discussions is reported to senior management. At any rate, I believe it is more important to secure a mechanism for information flowing rather than information gathering.

Under the three-way auditing system, Audit & Supervisory Board members, including outside members, earnestly work on auditing, including site visits: the members thoroughly check whether our internal auditing and internal control are properly functioning.

Today, due to the time constraint, I intentionally talked about unsophisticated parts of our company on the frontline level. While facing such challenges, we went through the merger between former Nippon Steel Corporation and former Sumitomo Metal Industries, acquisition of 100% ownership of Nisshin Steel, and acquisition of a Swedish company; and other ongoing initiatives, which are at the final stage, include the acquisition of 100% ownership of Sanyo Special Steel, and the acquisition of Essar, an Indian company which has an integrated steel plant. Effective from April this year, we will make a new start by changing our trade name to Nippon Steel Corporation in order to develop as a steelmaker with origins in Japan, globally pursuing unlimited possibilities of steel.

Anyway, with respect to our corporate governance in the future, we believe that it is important to respond to the Corporate Governance Code substantially, not for the form's sake, in order to steadily address changes in the business environment and our group's management challenges.

That's all from me. Thank you very much.

[Ikeo, Chairman] Thank you very much.

Now, in light of Mr. Sakuma's presentation, I'd like to open the Q&A and discussion session. Who would like to speak first?

Anybody? OK, Mr. Sampei, please go ahead.

[Sampei, member] Mr. Sakuma, thank you very much for your presentation. I'm Sampei from Fidelity International. While you briefly summarized corporate governance of your



company, you did not use a keyword “minority shareholders”. When we talk about corporate governance, I think managing conflicts of interest with minority shareholders is one of the core issues. In this regard, what policy or philosophy does your company have? And how does your company implement such a policy, etc.?

[Ikeo, Chairman] Could you answer the question?

[Mr. Sakuma, Executive Advisor, NSSMC] Thank you for the question. Traditionally, our company has taken various steps, considering that minority shareholders are very important. I'll give you some easy-to-understand examples. We regularly hold IR briefings for general shareholders in major cities in Japan to explain our business overview. We believe that one of the best ways to understand our company is to see the front line of production, our steel plants. As our shareholders reside throughout the country, we organize plant tours in each region. We first ensure that the minority shareholders understand what we are doing and what our strategies are. Naturally, we have more intensive questions and answers there compared to those at general shareholders' meetings. I have also provided explanations on many such occasions, striving to obtain their deeper understanding.

That's all.

[Ikeo, Chairman] All right?

Let me ask a question. You said that your company needs to make a huge investment of 1.7 trillion yen. In that connection, could you tell us more about your company's basic philosophy of capital policy? Specifically, what is the best way for funding that much investment? I'd appreciate it, if you would provide a supplementary explanation from the perspective of capital policy.

[Mr. Sakuma, Executive Advisor, NSSMC] Thank you very much. To achieve sustainable growth, this capital expenditure is essential. However, we will see its effect in the distant future. A typical example is the expenditure for coke ovens. We made this decision from the mid- to long-term perspectives, as we are determined to make steel in Japan. Conversely, we believe this is essential. Therefore, we need to accomplish it at any cost. Concerning your question, we also have financial health targets, including D/E ratio, in our Mid-Term Plan, and need to achieve both. Taking the earlier-mentioned cross-shareholdings among other things as an easy-to-understand example, we plan to reduce shares by determining which shares can be sold,

in order to address the needs.

Another point. The most important thing is to increase profits. By achieving the earlier-mentioned basic goals – safety and stable production – in every way possible, we will generate cash in the short term. I believe that is important.

That's all.

[Ikeo, Chairman] I have an additional question. You said your company generates profits and use them for investments: that means retained earnings. I'd like to know your payout policy vis-à-vis capital policy. When earnings are strong, that's fine. However, how do you allocate profits to retained earnings, and to shareholder returns in terms of dividend propensity or share buy-back? I'd like to know your policy about that.

[Mr. Sakuma, Executive Advisor, NSSMC] Thank you for the question. We set the target dividend propensity at around 30%, and are striving to achieve the target. As for retaining earnings, our company has debts, and does not really have cash in hand. Earnings go to facilities, fixed assets. In that context, we are working on achieving the dividend propensity of 30% first.

That's all.

[Ikeo, Chairman] Mr. Iwama, please.

[Iwama, member] I'm Iwama. I had assumed the position of Chairman of the Japan Investment Advisers Association until 2 years ago, and before that, I had worked for Tokio Marine. I'd like to ask 2 questions.

I understand your company is basically working hard to make steel in Japan at any cost. Considering the current circumstances, I can smoothly understand your various policies from that perspective. However, your company has gone through mergers, and is to change the trade name in April, and is at the stage of considering how you operate globally. Are you going to maintain the current policies, including the governance policy? What future challenges are recognized? This is my first question.

Another question is how your companies consider cost of capital. I'd like to ask you these 2 questions.

[Mr. Sakuma, Executive Advisor, NSSMC] Thank you very much. As for the question about the future, we will be definitely based in Japan, but we consider that the model will be

certainly changing. Traditionally, all upstream processes requiring the heaviest capital expenditures – specifically from blast furnaces, which turn iron ore into iron, and converters – have been done in Japan, and manufacturing of products has been done in overseas countries. However, considering the issue of domestic demand in Japan, as well as the circumstance where major markets in the world are increasingly becoming independent, and some markets may be closing the door, local procurement/production will be required. Therefore, as the first case, we are going to acquire Essar, an integrated company in India, so the model will certainly change in the future. Meanwhile, as I mentioned earlier, stop of investments at this moment means that we will no longer be able to make steel in Japan in the future. So, we will undertake necessary renewal of facilities/equipment mainly for the upstream processes, including coke ovens. In a certain sense, we will do both. That's the current model, but as a matter of fact, we will not be sticking to this model forever. The model will change corresponding to the business environment from time to time.

As for the question about cost of capital, we have huge debts, and we are in the highly capital-intensive industry, so we always think about cost of capital. Although I cannot tell you specific figures, when we make any investment decisions, cost of capital is the biggest point of discussion in a certain sense. Cost of capital is not the only determinant, but we regard it as the most important factor, of course.

That's all.

[Ikeo, Chairman] Mr. Kawamura, please go ahead.

[Kawamura, member] Thank you. I'd like to ask a question about details on page 17 to page 18: specifically, the description that the amount of compensation is based on consolidated profit/loss for the current year as well as ordinary income of the steelmaking segment in the previous year. The table on page 17 shows names of diverse members, from the senior management to division; and there should be executive officers who are not listed in the table. There should be various members. I suppose that compensation for senior management is linked with the company's profit for the current year, and compensation for other officers is linked with ordinary income because it more closely reflects profits from their day-to-day performance. Is there any measure, like some percentages based on this, and some percentages based on that, to determine compensation amounts? When you refer to [ordinary income of]

only the steelmaking segment, how are people in other segments evaluated? As a practitioner, I'm interested in such details.

[Mr. Sakuma, Executive Advisor, NSSMC] Thank you for the question. I can just tell you the current status. Conclusion first. This rule is applied to our executive officers who are senior corporate managers other than directors. The same rule is used. We calculate a weighted value based on both profit/loss for the current year and ordinary income of the steelmaking segment.

[Kawamura, member] All of them?

[Mr. Sakuma, Executive Advisor, NSSMC] Yes, all of them. As I explained our corporate profile, 90% of our earnings come from steelmaking. Other businesses are also very closely related to steelmaking, so there is no significant deviation between them. In our case, bonuses for labor union members are calculated by a certain formula, which was already disclosed, based on the ordinary income from the steelmaking segment.

[Kawamura, member] I'm sorry about asking such a detailed question, but when you apply a certain ratio to determine compensation for individual officers, do you differentiate the ratio depending on official positions?

[Mr. Sakuma, Executive Advisor, NSSMC] We don't use different ratios depending on official positions. However, there is a base amount for each type of officers, depending on official positions. To align compensation with performance, we use only these 2 elements. Strictly speaking, as for compensation for outside officers included in the table, swings are very limited, and consequently we pay fixed amounts. We have disclosed officers' compensation, so if you analyze the disclosed data, you can find how we pay compensation.

That's all.

[Kawamura, member] So compensation amounts for individual officers are determined by 5 members of Compensation Advisory Committee on page 17. Right?

[Mr. Sakuma, Executive Advisor, NSSMC] The Committee deliberates the matter, but the decision is made by our board of directors. Accordingly, the Committee discusses whether proposed compensation is OK. Taking the result into account, the board makes a decision. Then the board's decision is automatically implemented.

[Kawamura, member] That's easy to understand.

[Mr. Sakuma, Executive Advisor, NSSMC] As such, it is quite easy to understand, but

compared to other companies, I feel that amounts significantly go up and down in our company. As we are not very profitable, that's inevitable.

[Kawamura, member] Usually, compensation includes the fixed portion, so the amounts are smoothed out, but I think your company's case is very clear. Thank you very much.

[Ikeo, Chairman] Mr. Oguchi, please go ahead.

[Oguchi, member] Thank you. I'm aware that your company always speaks up on behalf of Japanese Companies with Audit & Supervisory Board (also called Companies with *Kansayaku* Board) at meetings with investors, promoting benefits of the organizational form. So I understand you adopted this organizational form with firm belief. In accordance with your presentation material, specifically page 16 as well as page 21 and thereafter, I assume you wanted to explain why your company adopted the form "Company with Audit & Supervisory Board", but did not explain much probably due to time constraints. Could you tell us strengths of "Company with Audit & Supervisory Board"? In other words, while talking with foreign investors, who are not familiar with this organizational form, what do you think they don't understand properly? Have you found any gap?

[Mr. Sakuma, Executive Advisor, NSSMC] Thank you for the question. We are aware that it is not easy for foreign institutional investors to understand it. Taking it into account, when we meet with them, we first explain the functions of the Audit & Supervisory Board (*Kansayaku* Board). Its members have extremely strong power: that is the conclusion of our explanation. Then the investors say, "But they don't have any voting rights at the Board of Directors." Certainly they cannot cast any votes. Actually, as you know, the Audit & Supervisory Board adopts an independent system, where the decision-making authority is given to each member. So if a member finds any problem, he/she may refuse to provide a clean opinion in the Audit Report. If that happens, President and executive management will have to resign, because usually an adverse opinion is not written in the Audit Report. In that sense, Audit & Supervisory Board members have very strong power. Another point is that there are no restrictions in their activities. Therefore, outside members physically conduct on-site inspections even in other countries, although they are very busy people. All of their opinions based on actual on-site inspections are reported to the management. They express their opinions from viewpoints different from ours. Their viewpoints are different from those of our

internal auditors. There are things in common, but viewpoints are different. So we receive valuable opinions from them. Furthermore, as you know, all necessary expenses incurred by Audit & Supervisory Board members are borne by the company, so at the time of the earlier-mentioned violation of the Anti-Monopoly Act, Audit & Supervisory Board members independently engaged a law firm and conducted a full-scale investigation, separately from the investigation by the executive management. Consequently, we need to have dual systems: Audit & Supervisory Board members conduct auditing, which is completely independent from auditing by the internal audit team. Although both of them naturally share information, we have dual auditing functions. This is costly, but the percentage to the total cost is not large. Rather, we gain more than we spend, that's why we are doing it this way.

I think this is commonly felt among companies with outside Audit & Supervisory Board members: with respect to opinions from outside Audit & Supervisory Board members, it is more important for the Board of Directors to receive their opinions on strategies – in our case, critical opinions on “safety” and “stable production” – rather than those on compliance issues. Very bitter for us. In that sense, it is almost the same as having 7 outside directors.

That's all.

[Oguchi, member] Thank you very much.

[Ikeo, Chairman] Who would like to talk next? Mr. Tanaka, please.

[Tanaka, member] Thank you very much for your presentation. Personally, when I used to work for a bank, I was in charge of your company twice. I experienced guided tours at most plants listed here. In fact, since then, I have learned a lot of things from your company. Having listened to your presentation today, I got an impression that the situation has changed from those days in many ways. Before I ask you some questions, I'd like to make a comment on page 7 of your presentation material showing major export items of Japan. While steel accounts for 4.2%, a lot of steel is included in automobiles and auto parts. In that sense, the role of steelmaking should be considered in a broader framework. That's what I felt.

Meanwhile, as stated in the previous page, in 2007, the world's crude steel production by steelmakers suddenly changed. At that time, M&As were frequently implemented on the global level, where Mittal was a key player, and I was also in charge of several M&As. In those days, in Japan's industrial structure shown on page 7, our bank was aware that your company had an

important role – your company should play a stable leading role in Japan’s industrial structure, and increased cross-held shares of your company, if I remember correctly. I assume the bank sold such shares by now, though. What I want to say is that I believe cross-shareholdings could be more dynamic. It is not something you have to keep holding forever, without mutual annual reviews, once you purchased such shares. I’ve been thinking so, since those days. Looking at specific examples of disclosure quoted in today’s material, an annual review of cross-shareholdings is introduced as a best practice. I appreciate it. Your company also conducts such a review. I feel there has been progress in various areas. Compared to those days, I feel various policies of your company have changed.

Now I’d like to ask a few questions. First question. When we discuss the Corporate Governance Code and the Stewardship Code, we often refer to a sustainable increase in corporate value over the mid- to long-term. In your company, what do you currently consider the corporate value to be, and how do you measure it? I think this is a very important point from the investors’ viewpoint.

Second question. On page 22 [about Japan-US comparison of the authorities of the Board of Directors], the left column [for Board’s authority in Japan] includes decision-making concerning important matters of business execution. As you know, one of major differences between Company with Audit & Supervisory Board (also called Company with *Kansayaku* Board) and other organizational forms is that, in the former, the Board of Directors must make decisions on important business execution. Therefore, unless the Board of Directors meets at least once a month, the company cannot execute business quickly. Such a burden is a frequent topic of discussion. Currently, how often does your Board of Directors meet? Do you think it is a heavy burden for the business management? This is my second question.

Third question. I know many Audit & Supervisory Board members of your company. They are qualified people. However, I think that auditing the entire company, such a large company like yours, by a limited number of people places a heavy burden on them. Is there any support system for Audit & Supervisory Board members? In the past, because it is an independent system, where decision-making power is given to each member, he/she was expected to conduct audits by himself/herself. These days, how do you provide support to them? I’d like to ask these 3 questions.

[Mr. Sakuma, Executive Advisor, NSSMC] Thank you for the questions. First, with respect to corporate value, it is evaluated based primarily on short-term profit, and how much profit the company can earn over the mid- to long-term. As for the short-term value, obviously, market value is considered. In our way of thinking, we look at our fundamental value, and analyze a gap between that value and the current market value. We consider there is a gap. However, we believe it is useless to talk about stock prices when considering corporate value. I think we need to define our corporate value to a certain extent.

With respect to the frequency of the Board of Directors meetings in Companies with Audit & Supervisory Board, our Board meets roughly once a month – it is quite often. In case of companies with committees which do not have Audit & Supervisory Board, according to the Companies Act, the executive management, specifically President, has the authority to make any decisions, including those on significant investments. However, looking at what is actually happening among companies with committees in Japan, important decisions are eventually made by the Board of Directors. It is an additional layer for decision-making. From the perspective of risk management. As far as we know, it is not true that the Boards in those companies do not make any decisions. Conversely, in case of Companies with Audit & Supervisory Board, it is too hard for the Board of Directors to make all decisions, so they need to set the criteria of importance. Subtraction is necessary here. Otherwise, monthly meetings are not sufficient. Some people wonder whether, in case the Board meets only once a month, it may affect business operations in terms of agility. No, it doesn't affect. The Board can appropriately function on such a schedule. In international bids and tenders, we have competed against European/US companies, and never experienced a disadvantage in terms of time. Taking into account time required for preparation, the executive management, in advance, secures a time slot for decision-making during a Board meeting. We can manage it as necessary. However, agendas need to be set in a carefully planned manner and decisions need to be made on a tight schedule. So, what we are doing may be against the reform of working practice. Anyway, we have cleared the hurdle.

What was your third question?

[Ikeo, Chairman] Support system.

[Mr. Sakuma, Executive Advisor, NSSMC] Yes, support system. We have a system to



support Audit & Supervisory Board members. We have several dedicated staff members including General Manager, but the number is not sufficient for taking care of everything. We then promote information sharing to some extent, including information from the internal audit department. However, excessive reliance on the information from the internal audit department by the Audit & Supervisory Board members makes auditing by the Board meaningless. Therefore, the Audit & Supervisory Board members formulate an audit plan first, and conduct auditing in a frequent manner as I mentioned earlier. For example, they conduct on-site inspections several dozens of times per year, for inspections of the company alone. In addition, they conduct inspections of group companies several dozens of times. They also conduct hearings of individual cases – several hundreds of times per year. In the past, it was said that *kansayaku* (equivalent to Audit & Supervisory Board member) had luncheon meetings, while eating soba and drinking Japanese *sake*. That is an urban legend. Now they are working extremely hard. I assume that outside members find it tough to serve as our Audit & Supervisory members.

That's all.

[Ikeo, Chairman] Thank you very much. Now I'd like to move on to the presentation by Mr. Masayoshi Matsumoto, Chairman & CEO of Sumitomo Electric Industries, Ltd. and Chairman of the Kansai Economic Federation (*Kankeiren*), and Mr. Somuku Iimura, Vice Chairman of Corporate Legislation Committee, *Kankeiren*. I'm sorry, but I have to ask you to make presentations for approx. 15 minutes in total. Material 3 is the reference material for this presentation. Now I'm handing it over to you.

[Mr. Matsumoto, Chairman & CEO, Sumitomo Electric Industries] I'm here in the capacity of Chairman of Sumitomo Electric Industries, Ltd. as well as Chairman of the Kansai Economic Federation (*Kankeiren*). Today, after the presentation with Lawyer Iimura, we will answer your questions, if any.

First of all, I'd like to thank you for inviting us to the Follow-up Council to make a presentation and exchange opinions.

The Corporate Governance Code, as generally recognized, by clearly stipulating important principles underlying corporate management, provides the framework to remind companies to be aware of things, which they tend to miss because of the obviousness. We believe the Code is

very meaningful in that sense,. On the other hand, we consider that the revision to the Code last June posed some issues. The Kansai Economic Federation conducted a survey among its member companies concerning the revised Code and quarterly disclosures at the end of last year. Accordingly, we received first-hand opinions from the economic community in Kansai region. Today, I'd like to share such information with you, and also talk about corporate governance issues, from the standpoint of corporate management, based on my day-to-day experience.

Before talking about specifics, I'd like to explain our basic view on corporate governance. Please refer to page 2 of the reference material [Material 3]. We summarized our view in four points from (1) to (4). I'll explain them in numerical order. The first point is "How Japanese companies have increased their corporate value". We have a credo "*Sanpo yoshi*" (a win-win-win for all three parties – seller, buyer and the society) as a common business philosophy of Japanese companies. Its origin is the way of business by merchants in Kansai region and their ethic, and it has been transferred to generation after generation up to the present date.

In the Sumitomo Group, the credo "Benefit for self and others, private and public interests are one and the same" has been passed on for generations. It means that Sumitomo's business, while benefiting Sumitomo, must also benefit the nation and benefit the society. I joined the Sumitomo Group 50 years ago, and have heard the credo from the top management so many times. This credo is based on the business philosophy established by the founder of the Sumitomo family 450 years ago. Sumitomo must benefit itself, as well as the nation and the society.

Corporate activities become viable with the involvement of various stakeholders, including shareholders, employees, customers, trading partners, and local communities. We all know that Japanese companies have increased their corporate value based on relationships with such stakeholders up until now. Japanese companies would not have grown like this without relationships with diverse stakeholders over the mid- to long-term.

The next point is "Excessive emphasis on Return on Equity (ROE) as a management indicator". We are aware that ROE is increasingly becoming a center of focus as such an indicator. We have checked business plans of various companies on their websites, and found

that many companies adopted ROE as their numerical target. Certainly, ROE is one of the indicators, and in order to secure the comparability with other companies, we, Sumitomo Electric Industries, eventually refers to the target ROE of 8% or more in the Mid-Term Plan. However, we use ROIC as well. ROE does not give you the entire picture of capital efficiency, so we believe it is not appropriate to focus exclusively on a single indicator. We are concerned that ROE-oriented corporate management may result in encouraging short-term profit orientation, excessive dividend distribution, or share buyback, thus impeding sustainable growth of companies.

The third point is “Concerns about going against the long-term perspectives”. Currently, the global trends, including SDGs, are developed from the mid- to long-term perspectives or sustainable perspectives. As I mentioned earlier, Japanese companies have increased their corporate value, based on relationships with various stakeholders over the long term. Long-term/sustainable perspectives, while fully taking into account relationships with various stakeholders, are the underlying business philosophy of Japanese companies, which is aligned with the global trends, including SDGs. I believe that Japan should take an initiative in light of such trends. In this regard, I’m afraid that an excessive emphasis on ROE, which I mentioned earlier, and the quarterly disclosure system go against the global trend of the times, in terms of institutional design.

Finally, the fourth point is “How the Corporate Governance Code should be”. We believe that an important point here is not to build merely formal governance, but to establish governance with substance. The top management of companies should also accurately identify areas for improvement and strengthening with respect to their corporate management and businesses; and sincerely consider how to build governance with substance and how to obtain understanding of that matter from shareholders/investors, who occupy an important position among stakeholders.

Next, using the remaining time, I’d like to talk about the recently-published opinion of Kankeiren, and the issues which we recognized concerning the revised Corporate Governance Code. Please note that these are premised on the basic view [of corporate governance] which I explained earlier.

Now I’ll explain the recently-published opinions of Kankeiren. Please take a look at page 4.

In April 2018, Kankeiren published “Opinions on Effective Corporate Governance Reform”. As the first point of discussion, Kankeiren suggested that the quarterly-disclosure requirement should be abolished, because it found 3 negative effects of such disclosures as written in the reference material. The first reason is that quarterly disclosures encourage short-term profit orientation. The second reason is that information required for quarterly disclosures is boilerplate information for form’s sake, which is not useful for increasing corporate value over the mid- to long-term. The third reason is that such disclosures go against the Work Style Reform. In addition, we feel that quarterly disclosures do not actually lead to effective dialogue between companies and investors. Reporting on a quarterly basis is too frequent. We assume that companies and investors could not have in-depth discussion about issues of mid- to long-term management, etc., which should be a priority topic.

Later, I’ll return to the discussion about quarterly disclosures in connection with our survey for the member companies. Now I’m moving on to the next item.

The second point is that the Code should allow the flexibility in board composition depending on specific circumstances of a company. While the Code includes such descriptions as “at least one-third of outside directors” and “gender and international experience”, we are concerned that such descriptions may encourage companies to nominate directors who meet such formal requirements. As for female directors, we consider we should promote the appointment of women as directors for the purpose of enhancing the ability to respond to the changing environment surrounding companies, but in reality, the number of female candidates is small in the first place. To seek candidates from within and outside the company, the top management should realize that it is essential to create an environment toward career development of women first, instead of being conscious about gender under the Code.

The third point is that the institutional design should allow for the flexibility in cross-shareholdings. Purposes of the shareholdings changed over time from securing stable shareholders to business alliance or strategic alliance. Instead of uniformly requiring formal disclosures, the Code should promote mutual understanding [of cross-shareholdings] through dialogue between companies and investors, so that it eventually facilitates understanding among investors and shareholders.

On the bottom of this page, we summarized what we deem as problematic concerning the

Code revised on June 1, 2018. The Code requires companies to examine whether the purpose of cross-shareholdings is appropriate, and so forth. We are worried that such stipulations in the Code might overly push companies to take a certain behavior. Furthermore, although it is not written in the reference material, the institutional design of the Code overall should be carried out, taking into account the reality of not only companies, but also investors who use disclosed information. Even if disclosures are enhanced, such disclosures may place excessive burden on users for checking the information, and as a result, the information may not be used. Then the cost incurred for the institutional design comes to nothing, and consequently, that will not lead to benefits of the entire nation.

I'll move on to page 6. The fourth point is that a full-fledged discussion on proxy advisor regulations should be started. The Stewardship Code now incorporates the principle that requires disclosures of voting results. As such, influence of proxy advisors is increasing becoming enormous. Meanwhile, Japan has no regulation in the area of proxy advice. We believe it is time to start the full-fledged discussion in order to secure the transparency in information disseminated.

The last point is about ROE, which I referred to earlier while explaining our basic view. In addition, two more issues concerning the revised Code are summarized on the bottom of the page. The first one is about disclosure requirements for corporate pension funds as asset owners. This may also induce merely formal responses. While there are many important corporate activities, the Code requires companies to assign qualified persons and disclose measures taken only for corporate funds. We consider that is biased.

The second one is about companies' perception [of 'Explain' as in 'Comply or Explain']. Probably because Japanese companies are too dutiful, they have such a perception that 'Explain' is a wrong thing to do. Accordingly, an overwhelming majority of Japanese companies have complied with the Code. I believe that it is necessary to widely inform them of the intent of 'Comply or Explain' approach once again.

Please turn to page 8. Based on feedback from 119 member companies of Kankeiren submitted at the end of last year, I'd like to explain what the companies think about quarterly disclosures and the Corporate Governance Code.

First, I'd like to look at the number of days from the quarterly record date to the disclosure

date. Companies which make a disclosure within 30 days account for only approx. 20%, and companies which need 31 days or more account for approx. 60%. You can see a high degree of administrative burden from this data.

Please turn to page 9. We summarized major opinions on a desirable direction of future overhaul of the quarterly disclosure system. Among 7 options, only a few companies selected option #5 “No need to review/change the current system”. As a desirable direction of the overhaul, many companies reported that, although it is desirable to abolish the quarterly disclosure requirement, it is better to immediately start working toward improving the quarterly disclosure system on a step-by-step basis, through the following options: “Quarterly disclosure should be required only for the second quarter” or “Report and earnings summary should be integrated”.

I’ll move on to page 10. The table shows major opinions calling for reviewing principles of the Corporate Governance Code revised on June 1, 2018, of which many companies call for the review. I’d like to talk about principle 1.4 concerning cross-shareholdings, which is listed on the top of the table. The current stipulation of the Code is on the premise that cross-shareholdings are to be reduced, and thus has a strong bias against cross-shareholdings by spreading the idea that cross-shareholdings are wrong. As I mentioned our basic view earlier, the important thing is not Form, but Substance.

Finally, please take a look at the summary on page 12. I’d like to highlight 3 important points, which I’d like to share with you, once again. The first point is “Refrain from encouraging companies to perform merely formal, specific behaviors, and return to the original intent of the Code”. The second point is “Need to communicate the intent of ‘Comply or Explain’ approach of the Code”. The third point is “Abolish the quarterly disclosure requirement which uniformly obliges companies to disclose financial results in every 3 months”. I’d like the Follow-up Council to take these 3 points into account, when holding meetings in the future and considering the disclosure system.

That’s all for the explanation from me.

[Mr. Iimura, Vice Chairman of Corporate Legislation Committee, Kankeiren] I’m Iimura, serving as Vice Committee Chairman of Kankeiren. Due to time constraints, I will just briefly report on the survey results [in accordance with Material 3-3]. We conducted the survey from

November 14 to December 7, and received responses from 119 companies in Kansai region. You can see specific results in the reference material. Table 3 shows responses to such questions as which general principle of the Code needs to be revised, or whether the Corporate Governance Code, as a whole, needs to be reconsidered. Especially, our members are concerned about Principle 4.1 which requires the board to oversee [the implementation of] a succession plan; Principle 4.8 which is worded as if appointing at least one-third of directors as independent directors were an explicit rule; Principle 4.10 which requires companies to employ optional mechanisms [committees] for nomination and remuneration, and Principle 4.11 which requires companies to consider diversity in terms of gender and international experience when appointing directors. The respondents pointed out that all of these principles induce companies to perform specific, formal behaviors, and the Code should take into account specific characteristics of individual companies. You can see from the overall survey results that the companies place importance on and reasonably respect the Corporate Governance Code.

With respect to quarterly disclosures, as explained by Chairman, there is a consensus among Kankeiren member companies that the quarterly disclosure requirement should be abolished in the future. However, in their responses to the survey, they expressed their view that it is not realistic to abolish the quarterly disclosure requirement immediately, and suggested as an interim measure that the quarterly disclosure requirement should be limited to the second quarter, or that the quarterly report and quarterly earnings summary should be integrated.

Briefly summarizing the survey results, as Chairman Matsumoto mentioned earlier, the institutional design of disclosures should take into account the reality of investors who use disclosed information. As you know, Principle 7 of the Stewardship Code stipulates that institutional investors should have skills and resources necessary for making proper judgments associated with engagement with companies. I believe that investors participating in this meeting thoroughly review disclosed information, but when investors receive a massive amount of numerical information, and just look at ROE, can they make proper judgments? I'd like you to understand tremendous efforts – time and energy – are required for companies to prepare such information. Looking at the current complicated disclosure system, we got an impression that disclosures are beyond the capacity of information users. Unless users fully use

disclosed information, the institutional design will turn out to lack cost-effectiveness, and thus will not result in benefits for the entire nation. Therefore, Kankeiren considers that the disclosure system should be designed by taking a balance between companies' situations and investors' situations, as you can find from the survey results.

That's all.

[Ikeo, Chairman] Thank you very much. Now we will take your questions and comments on the presentations, and continue discussion. Although the presentations referred to quarterly disclosures, the topic is currently discussed at a separate venue, namely the Working Group on Corporate Disclosure of the Financial System Council. Accordingly, as we have limited time, I'd appreciate it, if you focus on governance issues.

Who would like to go first? Anybody? Mr. Iwama, please.

[Iwama, member] Thank you very much for your presentations. I'd like to ask a few questions. The first question is about ROE. Recently, the Nikkei reported that the US companies generate 40% of the world's revenue. In that context, it is said that the profitability of Japanese companies is still low. While equity markets are highly internationalized, and foreign investors have been increasingly holding shares of Japanese companies, I assume that not only Japanese investors, but also foreign investors look at various factors, including the efficiency or profitability of companies, from the perspective of whether they are sustainable over the long term. In doing so, although I totally agree that ROE is not the only indicator, I think ROE symbolically reflects a view that the overall profitability needs to be improved. In that sense, I think it is reasonable to say "No" to the ROE-oriented trend, but I'd like to know what you think about the profitability. This is my first question.

I have another question. I also think traditional Japanese style of corporate management has some good points. I used to be a board member of a Japanese company, and I was accused of such tradition [by foreign nationals] and often responded to them, "Japan has Japanese style." On the other hand, there is a global trend. Furthermore, when Japanese companies should go international and win global competition, ROE can provide some corporate value or the quality of corporate management. In this light, what future challenges does Kankeiren see, and how does it respond to the challenges?

[Mr. Matsumoto, Chairman & CEO, Sumitomo Electric Industries] I've run the company for



quite a long time. I'm not an expert of law or accounting. If we were a service company, ROE would be fine. However, from the standpoint of the top management of a company in the manufacturing sector which has supported Japan's economy, I believe ROIC (return on invested capital) is very important when managing the company. When professor Ito published his review, emphasizing ROE, I expressed my opposition to his view in a considerable way, asserting that it does not reflect the reality of companies. Meanwhile, ROIC includes elements of ROE. Therefore, if a company achieves high ROIC – say at 8, 9, or 10%, ROE will be at least 8% for structural reasons. If you would like to insist on ROE, you could externally announce your target ROE at 8% or 9%. However, the top management looks at the true nature, asset efficiency – how efficiently a company manages its assets, and what profits it gains as a result. This is the management's way of thinking, so ROIC is very important. The formula for ROIC includes elements of the formula for ROE. Therefore, the profitability can be calculated by ROIC. Within Kankeiren, we had a discussion on this issue. The majority of members in Kansai region said, "It is OK to have 2 indicators, but you don't have to emphasize only ROE." Kankeiren consists of 1,300 large companies, and therefore, the majority of them have such a way of thinking. Most people say, "Why do they focus only on ROE?" This is the reality. It is a little problematic to talk about ROE externally. In the United States, companies are increasingly taking a public interest capitalistic approach. The same in Europe. Many from the academic circle support the approach. Especially, the top management of large companies in Japan quite understands the way of thinking under the public interest capitalism: this is a common perception among Kankeiren members. This is also the answer to your question about the current Japanese management. During the early stage of capitalism in Japan originated from Ohmi merchants, the traditional management style evolved, and still remains strong in Kansai region. Especially, *zaibatsu* firms (industrial and financial business conglomerates) have conducted businesses for several hundred years. They identify who their stakeholders are, and strongly believe that they are supported by stakeholders, not only shareholders. Especially, the origin of Sumitomo and Itochu is in Osaka. Mitsui and Mitsubishi also originally come from Osaka. Generally, such philosophy has been pervasive for 300 to 400 years. Over there, such credos as "Benefit for self and others, private and public interests are one and the same" and "*Sanpo Yoshi*" have been inherited for generations. At the time of the succession of

President, some groups of companies do not appoint a person, who does not understand such a way of thinking, as new President, although they may be correcting problems of the succession process right now.

[Iwama, member] I understand your perception of ROE. Then, do you mean Kankeiren would like to promote ROIC?

[Mr. Matsumoto, Chairman & CEO, Sumitomo Electric Industries] I'm saying either is fine. However, manufacturers generally say, "Why not use ROIC?"

[Iwama, member] Personally, I also think it is OK to go with ROIC. I agree that ROE is not the only one indicator. Anyway, it obviously is a duty of investors to thoroughly consider the profitability. Furthermore, as for stakeholders, it is not necessarily sufficient for long-term investors to secure only interests of shareholders. Therefore, I think they can have intensive dialogue in that sense.

[Mr. Matsumoto, Chairman & CEO, Sumitomo Electric Industries] Basically, companies cannot be run without dialogue or communication. Companies can gain understanding by steadily and constantly communicating with all stakeholders, not limited to shareholders. That's the essence.

[Ikeo, Chairman] Concerning the point just mentioned, the Corporate Governance Code itself stipulates that way. It only uses the term "capital efficiency". I don't think ROE is a good indicator, either. The Corporate Governance Code does not refer to ROE. It just states that companies are expected to enhance capital efficiency, and to increase corporate value over the mid- to long-term through cooperation with stakeholders. That's how the Code is structured.

Now, I'll hand it over to Mr. Sampei.

[Sampei, member] Thank you very much for your presentation. I exchanged opinions with Mr. Matsumoto, when you were President.

[Mr. Matsumoto, Chairman & CEO, Sumitomo Electric Industries] I'm sorry about our heated argument back then.

[Sampei, member] No, no. I remember we extensively discussed the future course of ROIC by segment. In practice, when we break down a profitability indicator by segment, we cannot use ROE, so we discussed the use of ROIC. However, investors look at various indicators, and therefore always look at ROE, which represents the profitability for shareholders, as one of

indicators.

On page 2 of your presentation material, you used such terms as “*Sampo Yoshi* (win-win-win)”, “excessive emphasis on ROE” and “concerns about going against the trend”. Actually, I conducted intensive research on Ohmi merchants [who established the credo “*Sampo Yoshi*”]. I have visited Shiga prefecture [the origin of Ohmi merchants], including several visits to Shiga University and old-established families to review ancient documents, and finally calculated ROE of Ohmi merchants. I could not calculate ROIC because information was insufficient. Fortunately, many families of Ohmi merchants adopted the double-entry bookkeeping, so we can see their equity. Consequently, I obtained data from the Nakai family, which cannot be missed in the research of Ohmi merchants, and calculated annual ROE over 61 years [1735-1796] when the Founder, Gen’emon Nakai was doing business. The ROE was 18.8%. I also calculated the inflation rate at that time from the data obtained from the National Diet Library. As the inflation was calculated to be 0.9%, I think the ROE was at a good level. Although he pursued “low-margin, high-turnover; profits are great blessings”, the ROE is extremely high due to a high turnover ratio. It was not true that *Sampo Yoshi* does not go well with ROE. Rather, their long-lasting prosperity was supported by capital efficiency. Their thorough management resulted in their survival, while distributing profits to various stakeholders.

Next, I’d like to move on to issues your recognized concerning cross-shareholdings on page 5, and corporate pension funds on page 6. With respect to cross-shareholdings, the Code was revised in a way to delete “so-called [cross-shareholdings]” [note: the term “so-called” was used only in the previous Japanese version], and clarify that “deemed shareholdings” disclosed in the Securities Report are included. I was wondering if it is appropriate to mention this here, but the two companies, which today’s guest speakers represented, have significant “deemed shareholdings”. They stipulate that “The board examined whether it is appropriate to hold such shares” in the Corporate Governance Reports; and Principle 2.6 concerning corporate pension funds stipulates that “the asset management committee” examines the adequacy. As for “deemed shareholdings”, what we can see is only top 10 stocks reported in the Securities Report, but the aggregate value is equivalent to roughly a quarter of the pension assets. Nonetheless, it is written that the ratio of equities to pension assets is 48.5%. That

means a half of its equity portfolio should be the “deemed shareholdings”. Under such a condition, does the board properly conduct its fiduciary duties? I hear from many companies that there are various reasons for cross-shareholdings, but I’m not convinced that they are holding such shares as a result of proper examination. I’d like companies to look at such an issue carefully. Especially, in case of pension funds, because the funds are for retirement benefits for employees, they have responsibilities toward the stakeholders being employees, not the stakeholders being shareholders. Accordingly, if the Chairman of the Board explained here what they are doing as a result of what they discussed, it would be great, but I’m sorry to say that I don’t think the board has discussed the matter that much. Therefore, the Code was revised to suggest that they should do that.

[Mr. Matsumoto, Chairman & CEO, Sumitomo Electric Industries] I constantly tell staff members it seems we hold unnecessary shares. I regularly check the list, ask them why we hold such shares, and instruct them to sell such shares. However, we hold a large number of stocks. Even though we reduced large shareholdings, the aggregate total of many small shareholdings is still large. I instructed them to sell such shares as well. We are just on the way. We’d like to correct the situation. I believe that it is unnecessary to hold such shares, and am currently providing instructions toward the reduction.

[Ikeo, Chairman] Thank you very much. Mr. Kawamura, please.

[Kawamura, member] I agree with Mr. Matsumoto. The most important thing concerning governance initiatives is written on the last page of Material 3-3, the opinion statement of Kankeiren. On page 5 of Material 3-3, it is stated that the ultimate goal is sustainable increase in corporate value. We believe we had extensive discussions here in line with that, but it seems that side issues of the outcome were highlighted. Our view is the same as what is written there. Therefore, Japanese companies need to increase sustainable corporate value. Compared with companies in other countries, we considered there is room for increasing corporate value, and discussed what should be done. With such an intent, we achieved certain progress in “growth-oriented governance”.

There is another aspect, “defensive governance”. Assuming there is any trouble with a company, we extensively discussed what corrective measures can be considered, and how the board should act. In this regard, the Kansai Economic Federation pointed out various issues.

We added those points, as they were, to the revised Code. Looking at the big picture, there certainly is a global move toward reconsidering capitalism, and everyone feels the need for correcting the greedy capitalism. Therefore, as a global trend, I think companies will return to the direction toward something like Ohmi merchants as mentioned earlier. However, in case of Japan, I believe that companies are in the stage of improving their earnings power. European and US companies will move toward the Japanese style. There is a concern that unless European and US companies return to the direction of the public interest capitalism, they will face risks. They are taking or will take such a move. Then is that OK for Japanese companies to stay at the current position? I personally think Japanese companies should move toward the European/US style. For that purpose, I believe the Corporate Governance Code is necessary and effective. The biggest problem with Japan is the lack of challenges for innovation for the past 20 years. Unless we further challenge innovation employing wisdom, we will not be able to maintain the world class economy, while the population is declining. I don't mean we should move toward the greedy capitalism, but each company should seriously consider innovation. I would say the transformation, far beyond the reform. Aiming at the transformation, the entire nation of Japan should work on increasing earnings power, and the Corporate Governance Code supports such efforts. I think that is the best. Therefore, beyond the discussion on which is better, ROE or ROIC, I believe we should develop something like an ultimate joint proposal.

[Mr. Matsumoto, Chairman & CEO, Sumitomo Electric Industries] I agree with Mr. Kawamura. When I make a presentation, I emphasize my points to a certain degree. However, top management of a company is like he said. We know the reality that without innovation, we will lose everything, and make significant investments in R&D from time to time. On the other hand, we are wondering why we are seeing excessive instability of the society under the current capitalism. Considering the current situation, top management should reconsider such matters. This is the view of Kankeiren. However, it is useless to discuss only such matters without making money. So I agree with what Mr. Kawamura mentioned in this regard, and would like to work on it from a different angle. When I return to Kansai, I'll tell Presidents of 1,300 member companies of Kankeiren about that.

[Ikeo, Chairman] Thank you very much. Time is running out. Mr. Callon, please go ahead.

[Callon, member] Thank you very much, Chairman Matsumoto.

I will briefly discuss 3 points.

First, I also agree with the abolishment of the quarterly disclosure requirement. Companies Semi-annual disclosures provide sufficient useful information for investors, so from the standpoint of an investor, I believe that companies should aim at enhancing their disclosures on a semi-annual basis in accordance with “selection and concentration” approach. In that sense, I agree with him,

As for the second and third points, I must express opposing views. Mr. Matsumoto shared his views very frankly. So please allow me to frankly make comments due to time constraints.

One is about gender diversity. The revised Code refers to diversity in the board composition in terms of gender, and I think it is very good. Talent and capabilities are not disproportionately given to men. Even though a half of the population is women, few women are in the top management positions. Obviously, there are some problems. In the reference material, it is pointed out that many companies have hard time seeking candidates. I’m sorry to tell you this, but is that really a problem? Regardless of gender, both men and women face some difficulties at work. However, if an important goal is a difficulty, we manage to overcome such a difficulty. The promotion of women’s participation and advancement in the work place is one of social issues, as well as human rights issue. And in order to secure the abundance in Japan in the future, it is very important to go with help from women. This is my second point.

My third point is about ROE. We sometimes hear about ROE bashing recently. The reason why ROE is an important management indicator is because it is literally the return on equity. It is an indicator to express how a company is using its shareholders’ equity to create profits. It is the same as looking at interest rates on deposits at Japan Post Bank. Concerning interest rates on your money deposited, if you are told, “Don’t take a close look at interest rates,” you will think that is ridiculous. Maintaining high ROE, in other words, high capital productivity benefits Japan. As you mentioned, ROE is not the only indicator. I agree with you. ROIC and other management indicators are also important. However, if you discount the importance of ROE, it may result in placing less importance not only on shareholders’ needs, but also on increasing capital productivity in Japan and solving the problem with pension. I hope you would also aim at achieving a high level of ROE among other indicators, as ROE has an effect

like Sampo Yoshi in a broad sense. I'm sorry for taking a long time and not speaking fluent Japanese. I'd appreciate it if you took my opinions into account.

[Mr. Matsumoto, Chairman & CEO, Sumitomo Electric Industries] All right.

[Ikeo, Chairman] I know it would be better to have 30 more minutes for active discussion, but I regret that it's already the scheduled closing time and I must close today's discussion. As I always tell you, our discussion is not over, and will be continued in the coming months. So I'd like to close today's discussion.

Once again, I'd like to thank Mr. Sakuma, Mr. Matsumoto, and Mr. Iimura for joining us, taking the time from your busy schedule.

Lastly, the Secretariat will make some announcements.

[Inoue, Director of the Corporate Accounting and Disclosure Division, FSA] As for the date of the next meeting of the Follow-up Council, we will fix the date which is convenient for you, and let you know later.

That's all from the Secretariat.

[Ikeo, Chairman] Thank you.

Now I declare the meeting adjourned. Thank you very much.

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