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2011 Japan Proxy Voting Guidelines Summary

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Institutional Shareholder Services Inc.

ISS' 2011 Japan Proxy Voting Guidelines Summary

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The following guidelines will apply to Japanese companies, for meetings on or after February 1, 2011.

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1. Approval of Financial Statements

Vote FOR approval of financial statements, unless:

- External auditor expressed no opinion, or raised concerns; or
- Statutory auditors/audit committee raised concerns; or
- There are concerns about the financial statements presented or audit procedures used.

Summary

Most companies around the world submit these reports to shareholders for approval. However in Japan, this item will be put to a shareholder vote only in three situations: 1) the company in question is not required (because of its small size) to appoint an external auditor under the Corporate Law the auditors are unable to finish auditing in time for the audit report to be included in the proxy circular, or stock exchange rules, 2) the auditors raise questions about the financial statements, or 3) when shareholders will be asked to approve financial statements. In the former case, this item is a routine request which generally deserves support. However, a detailed case-by-case analysis will be called for in the latter cases.

2. Income Allocation

Vote FOR approval of income allocation, unless:

- Payout ratio is consistently low without adequate justification; or
- Payout ratio is too high, potentially damaging financial health.

Summary

In the past, the first voting resolution at nearly all Japanese AGMs was approval of the allocation of income and the final dividend for the year under review. However, companies that have amended their articles to authorize the board to determine income allocation are no longer required to seek shareholder approval of the income allocation. Likewise, companies that are not paying a dividend will also have no income allocation proposals.

As long as the dividend payout ratio is within a range of 15 percent to 100 percent, we generally support this resolution. If the payout ratio does not fall in this range, ISS will evaluate this resolution on a case-by-case basis. Particular attention will be paid to cases where a company proposes to pay a dividend exceeding its net profit, as such payments could damage the company's long-term financial health.

3. Election of Directors

ISS has two policies for director elections in Japan: one for companies with a statutory auditor board structure, and the other for companies with a U.S.-type three committee structure. Regardless of governance structure, Vote FOR the election of directors, except for:

- An outside director nominee who attended less than 75 percent of board meetings during the year under review¹; or
- A top executive² who is judged to be responsible for clear mismanagement or shareholder-unfriendly behavior; or
- A top executive at a company that has a controlling shareholder, where the board after the shareholder meeting does not include at least two independent directors based on ISS independence criteria for Japan.

In addition, at companies with a U.S.-type three committee structure, Vote FOR the election of directors, unless:

- The outside director nominee is regarded as non-independent based on ISS independence criteria for Japan, and the board after the shareholder meeting is not majority independent; or
- The director nominee who sits on the nomination committee is an insider or non-independent outsider, and the board after the shareholder meeting does not include at least two independent directors based on ISS independence criteria for Japan.

Independence criteria for Japan

Those outside director candidates falling into any of the following categories will be regarded as non-independent.

- Individuals who work or worked at major shareholders of the company in question
- Individuals who work or worked at main lenders to the company in question
- Individuals who work or worked at business partners of the company in question
- Individuals who are former partners of the company's audit firm
- Individuals who offer or offered professional services such as legal advice, financial advice, tax advice or consulting services to the company in question

Summary

Unlike U.S. boards, most Japanese boards are essentially executive committees and play a minimal role in management oversight. At companies with a statutory auditor structure (which account for about 98 percent of public Japanese companies), there is no requirement that boards have outside directors. Based on Japanese shareholder meetings covered by ISS in 2010, 49.6 percent still do not have any outsiders. However, companies with a U.S.-type three committee structure are required to have at least two outside directors.

Independence

Routinely opposing appointments to the board due to a lack of independent outsiders would be counterproductive because negative votes could actually vote down nominees at companies performing well, thereby causing disturbance to management, and an across-the-board policy to oppose these appointments would only weaken

1. The attendance of inside directors is not disclosed in Japan.

2. In most cases, the top executive will be the “shacho” (president). However, there are companies where the ultimate decision-making authority rests with the “kaicho” (executive chairman) or “daihyo torishimariyaku” (representative director).

the impact of votes based on more specific concerns. This consideration is more important than before because the types of proposals which companies are required to put to a shareholder vote have decreased in recent years after the enactment of the Corporate Law in 2006 which generally gives more authority to boards in managing companies than the old Commercial Code. Furthermore, the possibility that director nominees could be voted down cannot be ruled out, particularly in light of the recent trend where institutional shareholders – notably Japan-based asset managers – have come to take a more skeptical look at Japanese boards and cast more negative votes than before. ISS does not believe that it will be in the interests of long-term shareholders to vote against director candidates, in the absence of replacement candidates, merely for a lack of independence.

However, where a company chooses to adopt the so-called U.S.-type three committee structure, the role of outside directors becomes critical, and an emphasis on the independence of those directors is appropriate. Moreover, such companies are required to appoint at least two outside directors in the first place, and therefore, it is not unreasonable to take a more stringent approach as to board independence. At such companies, ISS opposes any outside director nominees who do not meet our criteria for independence.

Furthermore, we recommend voting against the reappointment of nomination committee members who are insiders or affiliated outsiders at companies with a three-committee system, unless the board after the shareholder meeting includes at least two independent directors, as those committee members should be held responsible for the lack of independence.

Attendance

We believe that effective management oversight can be realized by having independent board members who actively participate in board deliberations. As such, we pay attention to attendance rates. If an outside director attends fewer than 75 percent of board meetings, without a reasonable excuse, ISS will generally recommend a vote against that director's reelection.

Poor performance and corporate scandal

ISS also considers recommending votes against nominees for clear mismanagement, as manifested in egregiously poor stock and financial performance or corporate scandals, including fraudulent or criminal activity, which led to shareholder value destruction. Factors we evaluate to that end include financial impact, administrative orders by regulators, stock market reaction, as well as reputational damage.

Shareholder-unfriendly behavior

We factor in shareholder-unfriendly behavior in evaluating director election proposals. Such behavior may include the introduction of a poison pill without a shareholder vote, or a capital strategy leading to shareholder value destruction such as a dilutive third-party placement without a shareholder vote, as well as large-scale public offerings without convincing rationales.

New policy for companies with a three committee structure

For meetings in February 2011 and going forward, ISS will apply a new policy for companies with a three committee structure where we take a holistic approach. Under the new policy, as long as the board after the shareholder meeting is majority independent, ISS will not oppose affiliated outsiders.

New policy for companies with a controlling shareholder

Under the 2010 policy, we oppose the reelection of the top executives at any company that has a publicly-traded parent company, if the board after the shareholder meeting would not include at least two independent directors³ based on ISS independence criteria for Japan.

However, starting in February 2011, ISS modifies this policy by replacing "publicly-traded parent company" with "controlling shareholder." Regardless of whether controlling shareholders are themselves publicly traded companies, the protection of minority shareholders of controlled companies is equally important.

3. As an interim measure for 2010, ISS requested at least one independent outsider. However, starting 2011, we request two independent outsiders.

4. Election of Statutory Auditors

Vote FOR election of statutory auditors, unless:

- The outside statutory auditor nominee is regarded as non-independent based on ISS independence criteria for Japan⁴; or
- The outside statutory nominee attended less than 75 percent of meetings of the board of directors or board of statutory auditors during the year under review.

Summary

ISS believes that management oversight by independent statutory auditors is crucial to ensure that companies have better governance. Japan's Corporate Law allows companies to choose between two governance structures; a statutory auditor system, and a U.S.-type three committee system. About 98 percent of Japanese public companies employ a statutory auditor system, and for those companies, there is no legal requirement that boards have outside directors. Based on ISS Japanese research universe, 49.6 percent of companies with this governance structure still do not have any outsiders. At these companies, the board of directors essentially functions as an executive committee and plays a minimal role in management oversight; which is instead left to the board of statutory auditors.

Given the frequent lack of independent outside directors at Japanese companies, it is critically important to have independent outside statutory auditors. Therefore, ISS opposes any outside statutory auditor nominees who do not meet our criteria for independence. If outside nominees are voted down, companies need to appoint other outside candidates because the law requires that at least half of a company's statutory auditors be designated as outside statutory auditors. Because the law requires that the statutory auditor board be composed of at least three members, companies need to have at least two outside statutory auditors to meet the legal requirement.

As in the case of outside directors, we pay attention to attendance rates. If an outside statutory auditor attends fewer than 75 percent of meetings of the board of directors or board of statutory auditors, without a reasonable excuse, ISS will generally recommend a vote against that statutory auditor's reelection. In addition, ISS considers recommending votes against statutory auditor nominees in cases of corporate scandals, including fraudulent or criminal activity, which have led to shareholder value destruction.

4. ISS uses the same independence criteria for directors and statutory auditors. See "Election of Directors."

5. Article Amendments

Amendments are nearly always bundled together as a single voting resolution, and ISS' general approach is to oppose article amendments as a whole when they include changes we oppose. The following are some of the most common or significant types of changes to articles.

Expansion of business activities

Vote FOR this change, unless:

- A company has performed poorly for several years and seeks business expansion into a risky enterprise unrelated to its core business.

Adoption of a U.S.-style three committee board structure

Vote FOR this change, unless:

- None of the outside director candidates meets ISS criteria on independence⁵.

Increase in authorized capital

Vote FOR this change, unless:

- The increase in authorized capital exceeds 100 percent of the currently authorized capital; or
- The increase leaves the company with less than 30 percent of the proposed authorized capital outstanding; or
- The increase is intended for a poison pill which ISS opposes.

Creation/modification of preferred shares/class shares

Vote CASE-BY-CASE on this request

Repurchase of shares at board's discretion

Vote AGAINST this change.

Allow company to make rules governing exercise of shareholders' rights

Vote AGAINST this change.

Amendments related to takeover defenses

Vote FOR this change, unless:

- ISS opposes or has opposed the poison pill proposal by itself.

5. See "Election of Directors" for ISS criteria on independence.

Decrease in maximum board size

Vote FOR this change, unless:

- The decreases eliminate all vacant seats, leaving no flexibility to add shareholder nominees or other outsiders to the board without removing an incumbent director.

Supermajority vote requirement to remove a director

Vote AGAINST this change.

Reduce directors' term in office from two years to one year

Vote FOR this change.

Limitations of liability for directors/statutory auditors

Vote FOR this change.

Limitations of liability for external auditors

Vote AGAINST this change.

Payment of dividends at the board's discretion

Vote AGAINST this change.

MBO-related amendments

Vote CASE-BY-CASE on this request.

Summary

The governance profile of a Japanese company is largely stipulated in its articles of incorporation. Requests for amendments cover various issues ranging from capital increases and changes to capital structures, to changes to board size and composition. Takeover defense-related changes are often included in articles as well. Once the articles are amended to authorize a company to carry out a specific action, shareholders will usually have no opportunities to vote on such action in the future. Therefore, these resolutions require scrutiny. This is particularly true under the Corporate Law, enacted in 2006, which is largely designed to give more authority to boards than under the old Commercial Code, on condition that shareholders approve changes to articles of incorporation.

6. Annual Bonuses

Vote FOR approval of annual bonuses, unless:

- The company suffers from poor financial results or corporate scandals.

Summary

Some companies choose to seek shareholder approval to grant annual bonuses to directors and/or statutory auditors. The amounts are rarely excessive, and usually ISS supports the proposal. However, when companies suffer from poor financial and stock performance, or have experienced corporate scandals, ISS will consider voting against the proposals.

7. Retirement Bonuses/Special Payments in Connection with Abolition of Retirement Bonus System

Retirement Bonuses

Vote FOR approval of retirement bonuses, unless:

- Recipients include outsiders; or
- Neither the individual payments nor the aggregate amount of the payments is disclosed; or
- Recipients include those who can be held responsible for corporate scandal or poor financial performance which led to shareholder value destruction.

Special Payments in Connection with Abolition of Retirement Bonus System

Vote FOR approval of special payments in connection with abolition of retirement bonus system, unless:

- Recipients include outsiders; or
- Neither the individual payments nor the aggregate amount of the payments is disclosed; or
- Recipients include those who can be held responsible for corporate scandal or poor financial performance which led to shareholder value destruction.

Summary

The expectation of receiving a retirement bonus can serve as a disincentive for outside directors or statutory auditors to speak out against management. Accordingly, ISS opposes the payment of retirement bonuses to outsiders. (However, in rare occasions, ISS may support payment to outsiders on a case-by-case basis, if the individual amount is disclosed and the amount is not excessive.) In addition, we do not believe it is appropriate to grant retirement benefits to those who can be held responsible for shareholder value destruction resulting from corporate scandals or poor financial performance.

New policy

Starting in February 2011, ISS employs a new policy calling for disclosure of retirement bonus amounts, and special payments. If neither the individual payments nor the aggregate amount of the payments is disclosed, we oppose the payments.

8. Stock Option Plans/Deep-Discounted Stock Option Plans

Stock Option Plans

Vote FOR approval of stock option plans, unless:

- Total dilution from proposed plan(s) and previous option plans exceeds 5 percent for mature companies, or 10 percent for growth companies; or
- Recipients include individuals who are not in a position to affect the company's stock price, including employees of business partners or unspecified "collaborators;" or
- The maximum number of options that can be issued per year is not disclosed; or
- Exercise period starts within one year from grant and the exercise price will be set at a premium of less than 5 percent to fair market price (However, if specific performance hurdles are specified, this policy may not apply).

Deep-Discounted Stock Option Plans

Vote FOR approval of deep-discounted stock option plans, unless:

- Total dilution from proposed plan(s) and previous option plans exceeds 5 percent for mature companies, or 10 percent for growth companies; or
- Recipients include individuals who are not in a position to affect the company's stock price, including employees of business partners or unspecified "collaborators;" or
- The maximum number of options that can be issued per year is not disclosed; or
- No specific performance hurdles are specified (However, if the vesting period before exercise lasts for at least three years, this policy may not apply).

Summary

As the number of agenda items at Japanese companies has declined in recent years, compensation-related proposals have increased in relative importance. This is particularly true of stock options, which can be beneficial or disadvantageous to independent shareholders, depending on the plan design. ISS will evaluate stock options mainly in terms of potential dilution, option recipients, exercise period, exercise price, and performance hurdles (if any).

While dilution is an important factor in evaluating options, Japanese companies' dilution, particularly at large companies, has been modest. As such, this is seldom an issue. On the other hand, in order to align the interests of option recipients with those of independent shareholders, we believe that some mechanism to that end will be called for. We will pay attention to whether performance hurdles are disclosed in the proposal details.

New policy for deep-discounted options

Starting in February 2011, ISS employs a new policy calling for performance hurdles for deep-discounted options, in order to better align the interests of option recipients with those of shareholders. However, in the absence of such conditions, the new policy requires a vesting period of no less than three years from the grant date.

9. Director/Statutory Auditor Fees

Vote FOR proposals seeking to increase director/statutory auditor fees, unless:

- There are serious concerns about corporate malfeasance; or
- The company has suffered from prolonged poor financial and stock performance.

10. Audit Firm Appointments

Vote FOR the appointment of audit firms, unless:

- There are serious concerns about the accounts presented or the audit procedures used; or
- The auditors are being changed without explanation.

11. Share Repurchase Plans

Vote FOR the share repurchase plans, unless:

- The proposed repurchase plan exceeds 10 percent of issued share capital without explanation; or
- There are serious concerns about a possible adverse impact on shareholder value.

12. Takeover Defense Plans (Poison Pills)

Vote FOR approval of takeover defense plans (poison pills), unless:

(Necessary conditions)

- The board does not include at least 20 percent (but no fewer than two) independent directors⁶ after the shareholder meeting; or
- These independent directors fail to meet ISS guidelines on board meeting attendance⁷ or
- The directors are not subject to annual election; or
- One or more members of the bid evaluation committee cannot be regarded as independent based on ISS criteria for independence; or
- The trigger threshold is set less than 20 percent of shares outstanding; or
- The duration of the poison pill exceeds three years; or
- There are other protective or entrenchment tools that can serve as takeover defenses; including blocking stakes held by management-friendly shareholders, or setting the maximum board size to the actual board size to eliminate vacant seats, or tightening of procedures for removing a director from office; or
- The company fails to release its proxy circular at least three weeks prior to the meeting, to give shareholders sufficient time to study the details of the proposal and question management about them.

(Second stage of analysis)

- The company has not disclosed what specific steps it is taking to address the vulnerability to a takeover by enhancing shareholder value.

Summary

ISS recognizes that there may be circumstances in which a well-designed poison pill may strengthen the board's negotiating position and allow it to obtain more favorable terms from an acquirer. However, this scenario only applies when the target company's board is more concerned with shareholder value than with protecting its own position. In order for ISS to be able to support a poison pill in Japan, the above-mentioned conditions will have to be met. Interestingly, most companies which have failed to release proxy circulars at least three weeks before the meeting also failed at least one other criterion as well, implying that how early companies release their proxy materials is an excellent way to measure overall shareholder-friendliness.

ISS evaluates all poison pill proposals on a case-by-case basis, but our guidelines specify a number of necessary conditions which must all be met before we can even consider supporting a takeover defense. In the relatively few cases in which each of these necessary conditions is met, ISS will proceed to the second stage of the analysis, which is to assess the company's plans to enhance value. The implementation of a poison pill is an admission that the board sees the company as vulnerable to a takeover, so shareholders will need to see a plan to increase the share price, not merely a plan to entrench an underperforming management team.

Notwithstanding management fears, some of the companies implementing pills are in fact not especially vulnerable, because founding families, business partners or other insiders own more than a third of outstanding shares. This is enough to veto any special resolution, such as an article amendment or a merger - meaning that even if a hostile bidder is able to accumulate a sizable stake in such a company, that bidder will be unable to force

6. See "Election of Directors" for ISS criteria on independence.

7. See "Election of Directors" for ISS criteria on board meeting attendance.

any major restructuring moves opposed by the insiders. It is difficult to see what shareholders of such a company stand to gain from a poison pill.

Importantly, the primary problem at Japanese companies is not the terms of the poison pills themselves – these are often superior to those of US companies due to features such as relatively high trigger thresholds, clear sunset provisions and an absence of "dead hand" provisions. Rather, the main problem is with Japanese companies' insider-dominated boards and insufficient disclosure. We believe that the presence of a critical mass of independent directors is essential in order to ensure that a takeover defense is used not merely to entrench management, but to contribute to the enhancement of shareholder value.

Where a company has implemented a takeover defense without shareholder approval, and that defense allows the board to block the bid without input from shareholders, ISS will consider opposing the reelection of the representative director(s). This decision will depend on the terms of the defense plan itself, the company's overall governance profile (including board composition and information disclosure practices), and the company's performance under the current management team. However, because removing the top management of a successful company can cause more harm to shareholders than introducing a takeover defense, we will give careful consideration in these situations to management's track record and to the company's overall governance profile.

In evaluating poison pill renewals, we will apply the same necessary conditions we apply to new pills. At the same time, we will examine the company's share price performance, relative to its peers, since the pill was first put in place. Where the company has underperformed the market, it will be difficult to argue that shareholders have benefited from the pill, or that they should support its renewal.

13. Mergers & Acquisitions, Third-Party Share Issuances (Private Placements)

Vote CASE-BY-CASE on M&As and Third-Party Placements taking into account the following:

For every M&A and Third-Party Placement analysis, ISS reviews publicly available information as of the date of the report and evaluates the merits and drawbacks of the proposed transaction, balancing various and sometimes countervailing factors including:

- Valuation - Is the value to be received by the target shareholders (or paid by the acquirer) reasonable?
- Market reaction - How has the market responded to the proposed deal? A negative market reaction will cause ISS to scrutinize a deal more closely.
- Strategic rationale - Does the deal make sense strategically? From where is the value derived? Cost and revenue synergies should not be overly aggressive or optimistic, but reasonably achievable. Management should also have a favorable track record of successful integration of historical acquisitions.
- Conflicts of interest - Are insiders benefiting from the transaction disproportionately and inappropriately as compared to non-insider shareholders? ISS will consider whether any special interests may have influenced these directors and officers to support or recommend the merger.
- Governance - Will the combined company have a better or worse governance profile than the current governance profiles of the respective parties to the transaction? If the governance profile is to change for the worse, the burden is on the company to prove that other issues (such as valuation) outweigh any deterioration in governance.

14. Shareholder Proposals

Vote all shareholder proposals on a CASE-BY-CASE basis.

Vote FOR proposals that would improve the company's corporate governance or business profile at a reasonable cost.

Vote AGAINST proposals that limit the company's business activities or capabilities or result in significant costs being incurred with little or no benefit.

