Japan

Proxy Voting Guidelines

2015 Benchmark Policy Recommendations

Effective for Meetings on or after February 1, 2015

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1. ROUTINE/MISCELLANEOUS

Approval of Financial Statements

General Recommendation: Generally vote for the 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.

Income Allocation

General Recommendation: Generally 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.

Election of Statutory Auditors

General Recommendation: Generally vote for the election of statutory auditors, unless:

- The outside statutory auditor nominee is regarded as non-independent based on ISS independence criteria for Japan; 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; or
- The statutory auditor is judged to be responsible for clear mismanagement or shareholder-unfriendly behavior.
- Egregious actions related to a statutory auditor's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

Audit Firm Appointments

General Recommendation: Generally vote for the appointment of audit firms, unless there are serious concerns related to changing auditors.

2. ELECTION OF DIRECTORS

General Recommendation: ISS has three policies for director elections in Japan: one for companies with a statutory auditor board structure, one for companies with a U.S.-type three committee structure, and one for companies with a board with audit committee structure.

1. **At companies with a statutory auditory structure**: vote for the election of directors, except:

- Top executive(s)[1] at a company that has underperformed in terms of capital efficiency (i.e., when the company has posted average return on equity (ROE) of less than five percent over the last five fiscal years)[2], unless an improvement[3] is observed;
- Top executive(s) if the board, after the shareholder meeting, does not include at least one outsider, regardless of independence;
- Top executive(s) 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;
- An outside director nominee who attended less than 75 percent of board meetings during the year under review[4]; or
- Top executive(s) who are responsible for not implementing a shareholder proposal which has received a majority[5] of votes cast, or not putting a similar proposal on the ballot as a management proposal the following year (with a management recommendation of for), when that proposal is deemed to be in the interest of independent shareholders.

2. **At companies with a U.S.-type three committee structure:** (In addition to the guidelines for companies with a statutory auditor structure) vote for the election of directors, except where:

- An 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
- Where the company has a controlling shareholder, a director nominee sits on the nomination committee and is an insider, or non-independent outsider, when the board, after the shareholder meeting, does not include at least two independent directors based on ISS independence criteria for Japan.

3. **At companies with a board with audit committee structure:** (In addition to the guidelines for companies with a statutory auditor structure) vote for the election of directors, except where:

- An outside director nominee who is also nominated as an audit committee member[6] is regarded as non-independent based on ISS independence criteria for Japan.

Regardless of governance structure, under extraordinary circumstances, vote against individual directors, members of a committee, or the entire board, due to:

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[1] In most cases, the top executive will be the "shacho" (president). However, there are companies where the decision-making authority also rests with the "kaicho" (executive chairman) or "daihyo torishimariyaku" (representative director).
[2] Exceptions may be considered for cases such as where the top executive has newly joined the company in connection with a bailout or restructuring. This policy will not be applied to companies which have been public for less than five years.
[3] Improvement is defined as ROE of five percent or greater for the most recent fiscal year.
[4] The attendance of inside directors is not disclosed in Japan.
[5] Many Japanese shareholder proposals are submitted as article amendments, which require supermajority support in order to pass.
[6] Outside director nominees who are not nominated as audit committee members are not subject to this policy.

- Material failures of governance, stewardship, risk oversight, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

Mulitple Outsiders- Policy for 2016

General Recommendation: Starting in February 2016, vote against the top executive(s) at a company if the board after the shareholder meeting does not include multiple outsiders[7].

Discussion
ISS believes that a voting policy in a given market should reflect specific characteristics of that market. In Japan, lack of board independence is the core governance issue. A lack of board independence makes it difficult for shareholders' voices to be reflected in board discussions. Japanese boards are often criticized for shareholder unfriendly decisions, such as hoarding cash, and tying up assets in cross-shareholdings. In other cases, they appear reluctant to sell or shut down unprofitable businesses, thus putting the interests of company insiders ahead of the benefits for common shareholders. Alternatively, Japanese corporate managers are often criticized for not taking risks in making value enhancing strategic investment decisions for future growth, due to a consensus-based decision-making process on boards dominated by insiders.

These problematic practices, which tend to lead to low capital efficiency, can be assessed by evaluating ROE. The updated policy therefore is adopted to augment the current policy of opposing top executives on all-insider boards (intended to increase board independence), by newly applying a financial metric which measures shareholder value creation, which in turn should be the ultimate goal of increasing board independence.

ROE is not the sole indicator to measure shareholder value creation, but it still can be a viable metric in the context of Japanese corporate governance for the following reasons.

First, many investors have cited low capital efficiency as a primary reason for the low returns from Japanese equity investments over the years. Indeed, Japanese companies' ROE is low compared to other markets. According to the Ito Review[8] by the Ministry of Economy, Trade and Industry, the average ROE for fiscal 2012 was only 5.3 percent for Japanese companies, compared to 22.6 percent for U.S. companies and 15.0 percent for European companies. In the report, Japanese companies are encouraged to increase their ROEs "in a manner befitting their respective businesses and connect this activity to generating sustainable growth." It also notes that "… [Japanese] companies should be conscious that the minimum expected level of ROE is 8%, and should strive to further increase their ROEs beyond this level…"

Second, the recent corporate governance debate in Japan has evolved with ROE as an important element. The Abe administration's economic policy includes measures to improve Japanese companies' capital efficiency. The administration requested the Tokyo Stock Exchange and Nikkei to create a new equity index to be composed of companies deemed shareholder friendly. The new JPX Nikkei 400 index, launched in response to the request, evaluates, among other factors, ROE to select index component companies, with a view to increasing awareness of the importance of ROE among Japanese companies.

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[7] "Multiple outsiders" could mean two outsiders (regardless of independence) or two outsiders (at least one of whom is independent). The definition may depend on factors such as the provisions of Japan's Corporate Governance Code, currently in the draft stage. The new policy may initially be applied only to large companies (i.e., those in major indices).
[8] http://www.meti.go.jp/english/press/2014/0806_04.html

In addition, at the request of the administration, the Financial Services Agency released in February Japan's Stewardship Code[9] for investors holding Japanese equities, which aims to increase constructive shareholder engagement with companies. Measures to increase capital efficiency are cited in the code as one topic for such engagement. As of August 29, 160 institutions have signed the code.

According to ISS' 2013-14 policy survey results, a significant majority of investor respondents indicated that ISS should either always consider company performance when evaluating directors or consider it when a company has exhibited problematic governance practices that the board does not appear to be addressing.

In fact, Japanese institutional shareholders have already used ROE (in many cases a 3 - 5 percent ROE threshold) as a key factor when evaluating director election proposals, to address the issue of low capital efficiency at Japanese companies. The approach was originally inspired by the Pension Fund Association (PFA) of Japan, which employed a director election policy factoring in ROE beginning in 2007. Although the PFA currently does not have a stated ROE-based director election policy, domestic institutional shareholders continue to employ ROE in voting on directors.

As Japanese boards virtually function as management committees, rather than as supervising organs, it is reasonable for shareholders to oppose top executives when performance is poor. Note that 98 percent of Japanese companies employ a statutory auditor system, under which they do not have legally binding nomination committees. Therefore, it is unrealistic to expect that board members could remove top executives when necessary. The updated policy reflects the unique market circumstances of Japan.

The 5 percent threshold was chosen as a minimum ROE level acceptable to investors as an equity risk premium, based on discussions with institutional investors in Japan holding Japanese equities. Therefore, the threshold should be interpreted as a minimum acceptable level and not as a target. The five year measurement period was chosen so as not to penalize companies for a short-term performance downturn which could be needed for investments for sustainable growth over the long term.

Multiple Outsiders: Corporate governance in Japan has long been criticized for lack of outside director oversight. However, the situation has changed. Companies with at least one outside director made up a minority of those companies tracked by ISS until recently, but the proportion of such companies, which had been increasing by one to two percentage points every year, began to increase sharply in 2013. As of June 2014, only 29 percent of listed company boards lack even a single outside director, according to ISS data.

In 2013, ISS began recommending against top executives if the board after the shareholder meeting did not include at least one outsider, regardless of independence. It was in 2010 when more than half of Japanese companies started to have at least one outsider for the first time. Given that a majority of Japanese boards have at least one outsider, having outsiders on the board is no longer an alien concept among the Japanese business community, corporations and institutional shareholders alike.

In fact, today, a majority of large Japanese companies already have at least two outside directors. Of Nikkei 225 index member companies, 72 percent have multiple outsiders, and of companies constituting the JPX-Nikkei 400 index, 55 percent have multiple outsiders (as of September 2014). Given this progress, strengthening the board independence threshold by requiring multiple outsiders, particularly for such large companies, is reasonable.

Under the new approach, the policy will not be implemented until 2016. This one-year moratorium is intended to give companies sufficient time to recruit qualified outside director candidates. For 2015, we will not recommend against a top executive if the board has only one outsider.

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[9] http://www.fsa.go.jp/en/refer/councils/stewardship/index.html

ISS Independence criteria for Japan

Those outside director candidates falling into any of the following categories should 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/banks to the company in question;
- Individuals who work or worked at the lead underwriter(s) of the company in question;
- Individuals who work or worked at business partners of the company in question and the transaction value is material from the recipient's perspective or is not disclosed;
- Individuals who worked at 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; or
- Individuals who have a relative(s) working at the company in question.

3. 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 ISS opposes. The following are some of the most common or significant types of changes to articles.

Expansion of business activities

General Recommendation: Generally vote for an expansion of business activities, 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

General Recommendation: Generally vote for the adoption of a U.S. style, three-committee board structure, unless none of the outside director candidates meets ISS criteria on independence.

Adoption of a Board with Audit Committee Structure (Japan)

General Recommendation: Generally vote for an article amendment to adopt a board with audit committee structure. However, if the adoption of the new governance structure would eliminate shareholders' ability to submit shareholder proposals on income allocation, vote against the article amendments. Vote case-by-case if the board currently has a three-committee structure.

Increase in authorized capital

General Recommendation: Generally vote case-by-case on this request if the company explicitly provides reasons for the increase.

If the company does not provide reasons for the increase, generally vote for proposals to increase authorized capital, 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

General Recommendation: Generally vote case-by-case on this request.

Repurchase of shares at board's discretion

General Recommendation: Generally vote against this change.

Allow company to make rules governing the exercise of shareholders' rights

General Recommendation: Generally vote against this change.

Limit rights of odd shareholders

General Recommendation: Generally vote for this change.

Lower quorum requirement

General Recommendation: Generally vote against this proposal.

Amendments related to takeover defenses

General Recommendation: Generally vote for this proposal, unless ISS opposes or has opposed the poison pill proposal by itself.

Decrease in maximum board size

General Recommendation: Generally vote for this proposal, unless the decrease eliminates 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

General Recommendation: Generally vote against proposals seeking a supermajority requirement to remove a director.

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

General Recommendation: Generally vote for proposals to reduce a director's term to one year.

Remove language preventing classification of board

General Recommendation: Generally vote against proposals seeking to remove language preventing classified boards.

Limitations of liability for directors/statutory auditors

General Recommendation: Generally vote for this proposal.

Limitations of liability for external auditors

General Recommendation: Generally vote against proposals limiting liability for external auditors.

Payment of dividends at the board's discretion

General Recommendation: Generally vote against proposals allowing the board to pay dividends at its discretion.

Management buyout related amendments

General Recommendation: Generally vote case-by-case on management related buyout amendments.

4. COMPENSATION

Annual Bonuses for Directors/Statutory Auditors

General Recommendation: Vote for approval of annual bonuses, unless recipients include those who are judged to be responsible for clear mismanagement or shareholder-unfriendly behavior.

Retirement Bonuses

General Recommendation: Generally vote for approval of retirement bonuses, unless:

- Recipients include outsiders[10]; or
- Neither the individual payments nor the aggregate amount of the payments is disclosed; or
- Recipients include those who are judged to be responsible for clear mismanagement or shareholder-unfriendly behavior.

Special Payments in Connection with Abolition of Retirement Bonus System

General Recommendation: Generally vote for approval of special payments in connection with abolition of retirement bonus system, unless:

- Recipients include outsiders[11]; or
- Neither the individual payments nor the aggregate amount of the payments is disclosed; or
- Recipients include those who are judged to be responsible for clear mismanagement or shareholder-unfriendly behavior.

Stock Option Plans/Deep-Discounted Stock Option Plans

Stock Option Plans

General Recommendation: Generally 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;

[10] However, in rare occasions, ISS may support payment to outsiders on a case-by-case basis, if the individual amount is disclosed and not excessive.
[11] Id.

- 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.

Deep-Discounted Stock Option Plans

General Recommendation: Generally 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).

Director Compensation Ceiling

General Recommendation: Generally vote for proposals seeking to increase director fees, if:

- The specific reason(s) for the increase are explained; or
- The company is introducing or increasing a ceiling for performance-based compensation.

Vote case-by-case on proposals seeking to increase director fees, taking into account the company's stock price performance and capital efficiency if:

- The proposals are intended to increase fixed cash compensation or do not specify whether it is fixed or performance-based compensation which will be increased.

Generally vote against proposals seeking to increase director fees if there are serious concerns about corporate malfeasance.

Statutory Auditor Compensation Ceiling

General Recommendation: Generally vote for proposals seeking to increase statutory auditor compensation ceiling, unless statutory auditors are judged to be responsible for clear mismanagement or shareholder-unfriendly behavior.

5. SHARE REPURCHASE PLANS

General Recommendation: 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.

6. TAKEOVER DEFENSE PLANS (POISON PILLS)

General Recommendation: Generally vote for the 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 directors after the shareholder meeting; or
- These independent directors fail to meet ISS guidelines on board meeting attendance; 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 at 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.

7. MERGERS & ACQUISITIONS, THIRD-PARTY SHARE ISSUANCES (PRIVATE PLACEMENTS)

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:

General Recommendation: Generally vote case-by-case on mergers, acquisitions, and third-party placements, taking into account the following:

- 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.

8. SHAREHOLDER PROPOSALS

General Recommendation: Vote all shareholder proposals on a case-by-case basis.

Generally vote for proposals that would improve the company's corporate governance or business profile at a reasonable cost.

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

9. SOCIAL/ENVIRONMENTAL ISSUES

Global Approach

Issues covered under the policy include a wide range of topics, including consumer and product safety, environment and energy, labor covered standards and human rights, workplace and board diversity, and corporate political issues. While a variety of factors goes into each analysis, the overall principle guiding all vote recommendations focuses on how the proposal may enhance or protect shareholder value in either the short term or long term.

General Recommendation: Generally vote case-by-case, taking into consideration whether implementation of the proposal is likely to enhance or protect shareholder value, and in addition the following will be considered:

- If the issues presented in the proposal are more appropriately or effectively dealt with through legislation or government regulation;
- If the company has already responded in an appropriate and sufficient manner to the issue(s) raised in the proposal;
- Whether the proposal's request is unduly burdensome (scope, timeframe, or cost) or overly prescriptive;
- The company's approach compared with any industry standard practices for addressing the issue(s) raised by the proposal;
- If the proposal requests increased disclosure or greater transparency, whether or not reasonable and sufficient information is currently available to shareholders from the company or from other publicly available sources; and
- If the proposal requests increased disclosure or greater transparency, whether or not implementation would reveal proprietary or confidential information that could place the company at a competitive disadvantage.

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