Voting Guideline

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Introduction: Revisiting the meaning of investors' voting rights in the context of Japanese management culture

- Japanese management culture could be characterized as "long-term solidarism." Such a culture provides legitimacy to decide a company's management policy only to those parties who are committed to the company over the long term.
- On the other hand, the nature of public markets is to ensure "transferability" or "freedom of exit" for investors within any time horizon. We can understand the difficulty that Japanese management faces in reconciling this contradiction with the once-a-year voting that could decide the long-term direction of the business by a variety of investors with differing time horizons.
- It is easy for an investor to take a formulaic approach in exercising their voting rights. Many asset managers vote for or against each proposal based on "rules" in their often disclosed proxy voting policy. Proxy advisory firms also publish their guidelines that are professionally and meticulously designed, making it even easier for investors to process their votes through a formal methodology, particularly for independent asset managers with no specific interested parties.
- However, it is not easy to answer the basic question "What is the 'correct' vote?" How should one enforce corporate governance, which is considered universally, theoretically, and principally true within an indigenous, communal management culture like Japan via proxy voting? How should one distinguish between proper management decisions in the short term and those in the long term? Ultimately, what is corporate governance and for what purpose do shareholders exercise their voting rights? Such are philosophical questions we often ponder. Practically speaking, while we believe it dangerous to take a fundamentalist approach to corporate governance, we would be doing a disservice to Japan's free and capitalist economy by taking an overly systematic approach as well. Ultimately, the best method to address this issue is to fully consider each situation as it uniquely pertains to the company and management in question in a comprehensive and non-formulaic manner.
- On the pages that follow, you will find our current voting guidelines. It represents our sincere commitment to vote on behalf of our clients to ensure the best results for their companies and Japan society as a whole in order to ultimately fulfill our fiduciary duty toward our clients.

1. Basic Approach

We seek to create value exclusively through active engagement with investee companies. To do so, we invest in a concentrated number of select Japanese listed companies as a long-term shareholder and proactively work with management to change and grow their business. As an institutional inventor, we are fully aware of our "stewardship responsibility" to increase our clients' medium- to long-term returns by collaborating with portfolio companies to enhance value.

We believe proxy voting is but one method to promote the evolution of corporate management toward long-term value enhancement. Therefore, our proxy voting is characterized by:

i) Focusing on company-specific aspects (without dependence on externalistic or formulaic criteria), and

ii) Fostering the evolution of management with a long-term horizon (without particular emphasis on approval or disapproval of individual proposals for a specific fiscal year).

We believe that each business is positioned in a unique environment that has been formed over a long period of time, driven by specific characteristics of the organization and individual circumstances that arose, and thus need to focus on these particularities when making voting judgments.

For example, product lifecycles and users' tastes change significantly in a variety of time horizons depending on the industry. Therefore, the speed of decision making and the importance of continuity of management may be very different among companies and industries. A governance structure required by an industry facing global competition may be substantially different from that required by a purely domestic industry. Given that many Japanese companies still see the board of directors as an extension of senior managements' career path, a sudden introduction of a Western model separating oversight and execution or establishing executive compensation schemes often fail to meet their intended objectives.

Therefore, we believe proxy voting should take into account each unique circumstance surrounding the company and its organizational characteristics, and should further consider what is necessary to transform the business from where it currently stands to where it should ultimately be.

Furthermore, we believe that a company inevitably requires a long-term time horizon to allow its management to evolve.

There are plenty of standardized or formulaic criteria to decide on key issues such as appropriation of surplus, board composition, election of outside directors (and satisfaction of the independence criteria), and election of the representative director based on past indicators of capital productivity (such as ROE). We do not make our decision on such proposals simply for the sake of doing so but rather consider whether such choices will help evolve management in the long term.

In order to correctly make such assessments, we understand that we must have deeper dialogue with management in order for us to vote in the manner described above.

Because we solely pursue an engagement strategy, we exchange views with management on a frequent and regular basis in order to share and confront management issues together. As such, we also have intensive dialogue with each of portfolio companies regarding proposals to the general shareholders' meeting so that we can fully understand the background and intent behind the proposals rather than simply take them at face value. We vote for each proposal only after careful deliberation internally in our Investment Committee. However, on the rare occasion that we have no opportunity to have such dialogue with management, we would have no choice but to exercise our voting rights in accordance with relatively formalistic criteria that we define below.

2. Voting Guideline

(1) Executive and supervisory committees

1) Governance structure

- Effective corporate governance is difficult to implement and a formalistic approach tends to lose its substance. Furthermore, effective governance should vary depending on the operating environment of each individual company. Therefore, we believe it is difficult to establish a uniform criteria for governance structures that would be suitable across a variety of companies and industries. As such, we will assess each company on a case-by-case basis through dialogue with management.
- However, we believe that all companies should effectively introduce a function equivalent to that of an independent nomination and remuneration committee regardless of the governance structure adopted. We recommend that even "companies with an audit and supervisory committee" or "companies with a board of statutory auditors" should establish such committees on a voluntary basis.
- While all structures have both advantages and disadvantages, each company should select a structure taking into account its size and human resources capacity. The following define our basic view of each governance structure:

  i) A "company with a committee structure" (having a nominating committee, an audit committee, and a compensation committee) is the ideal governance structure in terms of supervision, remuneration and nomination of management although it imposes a heavy operational burden on the company.

  ii) A "company with an audit and supervisory committee" can strengthen the supervisory function with relatively little burden because the committee with an auditing function can provide independent opinions to the shareholders regarding remuneration and other personnel-related issues among its directors. We nevertheless would recommend that a company voluntarily establish remuneration and nomination committees as described above to reduce the risk of making uninformed or irrational opinions due to potential misinformation without such established committees. However, as a "company with an audit and supervisory committee" can consist of fewer outside directors than a "company with a board of statutory auditors", it may be adopting this structure solely to satisfy the minimum number of outside directors required by the Corporate Governance Code. Therefore, we will scrutinize the background and intent behind the transition to this structure through thorough dialogue with management.

  iii) A "company with a board of statutory auditors" has been common in Japanese corporate society but is seen to be less effective than companies with other governance structures in terms of the supervisory function since statutory auditors have no voting rights within the board and are not involved in determination of remuneration and nomination of directors. While a "company with a board of statutory auditors" has an advantage of carrying out the audit function consistently and independently over their four year term, it should consider additional measures to strengthen the effectiveness of supervision.

2) Appointment of directors and executive officers

- We only invest in companies managed by management teams we trust and can collaborate with in order to work together to enhance the corporate value over the medium- and long-term. Therefore, we will generally vote in favor of proposed directors and executive officers.

- We do not establish any uniform criteria for such appointments using quantitative performance thresholds such as ROE. Even if capital productivity has remained low over a long period of time, we will generally vote in favor of the appointees if we agree with the strategy and business plan to expand productivity and improve corporate value in the future.
- However, we, of course, vote against appointees if a company is found to have engaged in criminal activities or activities that are likely to damage its social credibility or with groups or individuals that have engaged in such activities.

3) Appointment of outside directors

- The Corporate Governance Code clearly cites the fiduciary responsibility of directors. We believe that the independent oversight role of outside directors embodies the essence of fiduciary responsibility in a concrete manner. More specifically, outside directors should create diversity in the management decision process by introducing an outsiders' professional perspective and represent the interests of shareholders by overseeing the value enhancement initiatives of management. In principle, we support appointments of and/or an increase in the number of outside directors if they can ensure independent and professional oversight.
- Outside directors of listed companies must have certain characteristics to fulfill their fiduciary responsibility. The following points are two specific elements:

  i) Knowledge and expertise in the fields of corporate management, financial accounting, investment management and/or corporate legal affairs

  As the role of outside directors is to oversee management, outside directors must have professional opinions regarding corporate management itself in order to evaluate whether the operations and decision making processes of the business are appropriate. Although the outside directors do not necessarily have to be responsible in a managerial position at that time, they must be equipped with a sufficient level of knowledge, expertise, and judgment required to evaluate corporate management.

  ii) Courage and resourcefulness to oppose the status quo of the organization

  As most directors in Japanese companies are ex-employees who have been promoted internally, the board of directors is dominated by a homogeneous group of people often with common values and opinions. As such, the role of outside directors should also be to openly express dissenting opinions if necessary defying the prevailing norms. The outside directors should be those who can speak directly and can question the status quo, leading to a more objective, rational, and diversified decision making environment.

  Based on the above criteria, we will determine the qualifications of the candidate for an outside director through dialogue with management and, specifically, whether he or she can represent the interests of shareholders within the board. Should we begin to question the qualifications of the candidate, we will attempt to assess the background and intent behind the nomination through dialogue with management

4) Appointment of statutory auditors and outside statutory auditors

- As the fundamental role of statutory auditors and outside statutory auditors is to supervise corporate management, we will assess the candidates with the same criteria as those for outside directors described above.

(2) Remuneration

1) Director remuneration

- In our opinion, Japanese listed companies generally have two problems of executive remuneration: a lack of linkage with performance and low transparency of the methodology. Director remuneration should be designed to tie short-, medium-, and long-term business performance and corporate value enhancement, and should specifically disclose the method of calculation. In principle, we will vote in favor of proposals to increase remuneration levels developed with both of these characteristics embedded. However, we need to fully understand the background and intent behind the remuneration methodology through dialogue with management.

2) Stock options

- We believe stock option plans are valuable tools to align the interests between management and shareholders. Of course, such assessments must be made on a case-by-case basis, taking into account issues such as dilution risk and the transfer of value from existing shareholders. However, we believe that, in general, the benefits of aligning the interests between management and shareholders outweigh the risks and costs from granting excessive incentives in corporate Japan today. Therefore, we will, in principle, vote in favor of proposals to grant stock options that link director remuneration with medium- to long-term business performance.
- In general, we support the idea of granting stock options to outside directors, although each circumstance is unique and must be evaluated separately. If the role of the outside directors is to perform a Western-style monitoring function of the board in order to control against excessive risk-taking, we believe granting such incentives is not appropriate. However, as explicitly stated in the Corporate Governance Code, the current emphasis of the role of outside directors as to encourage management to increase corporate value. From this perspective, we would prefer that companies grant stock options to its outside directors in order to align the interests between management and shareholders and therefore reward corporate value enhancement.

3) Director retirement bonuses

- From a legal perspective, the status of director is a contractual agreement between the company and the individual and, as such, compensation for services rendered during the contract term should have been fully accounted for in the form of director remuneration. Therefore, any additional payments as retirement bonuses should be unnecessary.
- However, we also recognize that, in most Japanese companies, the status of director is viewed as an extension of their status as employees, and retirement bonuses may substantially include an element of deferred remuneration. As such, we sympathize that a company would have difficulty immediately in terminating director retirement plans and that such directors should be rewarded for their past contributions in some method.
- Given these conflicting views, we will, in principle, vote in favor of directors' retirement bonuses only after sufficient dialogue with management on this issue and the retirement plan satisfies all of the the following requirements:

  i) The total value of retirement bonuses is determined according to a director retirement policy with a clearly defined formula that may be disclosed to shareholders upon request.

  ii) The company has consistently recognized reserve allowances in past years to pay the retirement bonus and such payments will not cause the company to recognize additional expenses such as extraordinary losses.

  iii) The total value of retirement bonus is in line with that of industry peers.

- However, we will, in principle, vote against retirement bonuses for retiring outside directors and statutory auditors due to their duty in management supervision rather than management execution.

(3) Capital policy

1) Dividends and appropriation of surplus capital

- We believe that a company's role is to reinvest cash flow back into its business in order to continue growth. Therefore, if it has abundant investment opportunities with expected returns in excess of its cost of capital and can continue to grow while maintaining or increasing long-term return on invested capital (ROIC), reinvestment is preferred over returning cash to shareholders in order to continue to enhance corporate value.
- However, if a company has difficulties in finding promising investment opportunities or it has excessive reserves and financial assets, we believe a company should return surplus capital to shareholders in an appropriate manner.
- We do not establish uniform criteria for dividends and appropriation of surplus capital. Instead, we judge the proposals on a case-by-case basis taking into account the following points through proactive dialogue with management:
  - i) Growth stage of the business: We will assess whether a company is in a high growth stage that requires its cash flows (or possibly other financing in some cases) for proactive reinvestment or in a stable or low growth stage that does not require such capital.
  - ii) Capital productivity (both past results and future prospects): If a company has achieved high capital productivity and is confident that it can continue to use its internal reserves with high capital productivity, we will not demand that capital be returned to shareholders. Conversely, if a company has not been able to exceed its cost of equity nor are they unlikely to do so, we will take a more critical view on its retained earnings and use of cash flows.
  - iii) Cost of capital: We will analyze whether a company understands and measures its own cost of capital as its hurdle rate when reinvesting surplus capital. If a company maintains high levels of retained earnings without recognizing its cost of capital, we will be more critical of its use of cash flows.
  - iv) Capital structure: We will analyze whether a company understands its optimal capital structure which takes into account its businesses and the commercial risks. While we do not believe that excessive financial leverage through debt financing is appropriate simply to raise ROEs, we do not support a company that maintains debt-free capital structure for the sake of doing so. We will vote in favor of proposals for a shareholder return policy if it is formulated based on a correct understanding of its own optimal capital structure. However, if a company does not nor will not do so and maintains a low dividend payout ratio, we will be more critical of its shareholder return policy.
  - v) Cash level: We will analyze whether a company recognizes its optimal cash level which takes into account its businesses and the commercial risks. If a company formulates the shareholder return policy by analyzing appropriate cash levels both in normal cycles and in times of stress, we will vote in favor of such policies. However, if a company does not nor will not recognize optimal cash levels and maintains a low dividend payout ratio, we will be more critical of its shareholder return policy.
- We recommend that companies disclose their key performance indicators (KPIs) that

they monitor over the medium- and long-term and their cost of capital together with their capital and shareholder return policy in order to properly evaluate the points above.

2) Share repurchases

- Our basic approach to addressing this issue is the same as in “i) Dividends and appropriation of surplus capital” above and will vote in favor of proposals for share repurchases using the same methodology above.
- However, whether a share repurchase is the appropriate method of returning capital to shareholders (vs dividends) would depend on the share price. If a company can repurchase its own shares at a price lower than its intrinsic value, it would have positive impact on corporate value. Therefore, it is necessary for a company to estimate its own fair value on a regular basis and determine whether the market is currently overvaluing or undervaluing its businesses.
- We will vote against proposals to acquire its own shares from limited shareholders under conditions that would be unfavorable to other existing shareholders.

3) Share issuances through third-party allotment

- Share issuances are obviously dilutive to existing shareholders while the potential returns from the capital increase is uncertain. Therefore, in order to judge whether the share issuance is appropriate, we would require transparency on the use of procured capital including, but not limited to, the business plan and expected return on investment from the additional capital, the current and future capital structure, and the issue price. We will then make a decision on a case-by-case basis after thorough dialogue with management to understand the background and intent of the issuance.

4) Mergers and acquisitions, business divestitures, spin-offs, management buyouts (MBO)

- The above transactions could change the value of the shares in a short period of time. In particular, an MBO may structurally cause significant conflicts of interest as overwhelmingly well-informed management purchase shares from comparatively poorly-informed shareholders. We will make a decision on a case-by-case basis after thorough dialogue with management to understand the background that caused the management to make these decisions and would require transparency of the decision-making process.

(4) Anti-takeover measures

- Anti-takeover measures often cause stakeholders to have very contrasting views. Some reasons we hear from management include:

  An anti-takeover measure

  a. provides management “an insurance against contingencies”;

  b. is less relevant for short-term shareholders as it does not affect short-term share prices; and

  c. protects management effectively from a governance perspective.

  The most unique reason that we have encountered from management is that “from the shareholders’ perspective, an anti-takeover measure is a method to hinder shareholders from freely selling their shares.”

- While every opinion arguably has its rationale to some extent (however slight), we believe that an anti-takeover measure is an issue that exemplifies management views as they are forced to make a decision among a variety of contrasting viewpoints and vested interests.
- In principle, we will vote against anti-takeover measures for the following reasons:

i) Even if an anti-takeover measure is not intended to protect management, it restricts individual shareholders' right to sell their shares.

ii) Compared to when anti-takeover measures were initially introduced, there are more legal tools in place through amendments to the Financial Instruments and Exchange Act in order to protect companies against abusive acquirers.

iii) Not only have a significant majority of companies never introduced such measures, the number of companies that have abolished anti-takeover measures have increased.

iv) Right or wrong, there have been very few successful hostile takeovers in Japan in the first place. Japanese corporate culture has been less acceptive of hostile takeovers in the past. Often times, a diverse array of social forces including employees, financial institutions, media, regulators, and courts supported management to oppose a hostile acquirer even if the proposed acquisition would likely have been in the best interests of stakeholders.

- However, we will oppose such measures simply at face value but will scrutinize the background and intent through thorough dialogue with management. We may occasionally support the proposal if and only if we completely agree with the reasons necessitating these measures, taking into account the track record of management to work for the benefit of shareholders, to improve capital productivity, and their awareness of being a public (listed) entity.

(5) Amendments to Articles of Incorporation

As there are a multitude of possible amendments to Articles of Incorporation, we list the most important matters below. However, as with other proposals, we will examine each amendment on a case-by-case basis to understand whether it will ultimately help increase corporate value in the medium- to long-term.

i) Authorizing the board of directors to determine dividends and appropriation of surplus capital at a "company with a board of statutory auditors"

- In principle, we will vote against such amendments unless there is a rational reason why this shareholder right should be relinquished.

ii) Share repurchases through board resolutions

- We believe flexible execution of share repurchases is an effective means of shareholder return. As such, we will, in principle, vote in favor of amendments that allow the board to execute share repurchases without requiring shareholders' consent. However, as described above, share repurchases are accretive to existing shareholders only at proper prices. As such, we will vote in favor of such amendments only on the condition that a company has a process of estimating its fair value and the buybacks are executed below that value.

iii) New business objectives

- Japanese companies often diversify their businesses for a variety of reasons. Therefore, we will assess each such amendment on a case-by-case basis after thorough dialogue with management in order to fully understand the background, intent, and objectives of the new businesses.

(6) Shareholder proposals

We will evaluate individual shareholder proposals on a case-by-case basis to understand whether it will ultimately help increase the corporate value from a medium- to long-term perspective.

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