The Pension Fund Association's Recently Released Proxy Voting Principles

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On 20 February 2003 Japan's Pension Fund Association ("the PFA") released their proxy voting principles and guidelines ("the Principles") regarding Japanese companies. The Principles came into operation in April 2003.

1. The PFA Leads Fund Managers to Strict Proxy Voting

The PFA, which is one of Japan's largest pension funds, manages the assets of Employees' Pension Fund schemes that have been wound up as well as the assets that will be needed to pay benefits to short-term members who have left individual fund by early retirement or job-change. As of March 2002, these assets, 33% of which were invested in Japanese equities, were worth some ¥5,400bn ($44bn).

In its current Statement of Investment Policy, adopted in 1999, the PFA indicates how its external managers are expected to exercise their proxy voting rights in accordance with its fiduciary duties. In October 2001, the PFA released its Proxy Voting Guidelines ("the Guidelines"), which indicate how its external managers should vote on corporate governance issues and report their voting records to the PFA. As a result of this, the PFA's external managers took action against proposals presented by a number of Japanese companies at their annual general meetings in fiscal 2001 by either voting against them or abstaining. These included proposals to award allowances to retiring directors (75 companies), elect statutory auditors [1](68 companies) and directors, and approve allocation of earnings.[2]

The Principles were drawn up independently of the Guidelines for external managers after the PFA began to manage assets in house (passive management of Japanese equities) in fiscal 2002.

[1] Statutory auditor (kansayaku) oversees directors' operation of business and stops their wrongdoing.

[2] For further details, see the PFA's web site (http://www.pfa.or.jp/)(Japanese only).

2. The content of the PFA's voting principles and guidelines(The Principles)

The Principles comprise three sections: (1) the PFA's basic view on proxy voting, (2) its principles on corporate governance and (3) specific guidelines on proxy voting.

The basic view that underlies the Principles requires companies (1) to run their businesses with a view to maximizing shareholder value in the long run, (2) to put in place internal mechanisms to ensure that shareholders' interests are safeguarded (e.g., by separating the functions of running a company and overseeing its management and by appointing more non-executive directors), and (3) to be accountable for their actions by ensuring that disclosure of corporate information is of the necessary quality and quantity.

1) Composition of the board of directors

In order to ensure that companies do endeavor to maximize shareholder value in the long run, the Principles require them to separate the functions of running a company and overseeing its management and to ensure that their boards of directors oversee their CEOs properly on behalf of shareholders. The guidelines in the third section therefore require (1) that the number of directors be such (i.e., no more than 20) as to allow proper discussion to take place and to make decisions quickly, (2) that at least a third of the board be independent directors with no vested interests in the company concerned and (3) that companies proposing to increase the number of their (executive) directors explain the reason clearly.

The Principles also encourage companies to adopt a so-called "company with committees within the board" system[3] and commend those that have decided to set up committee for significant assets[4] and executive officers. However, they do not approve of cases where all of the members of the board concurrently serve as executive officers.

[3] Under an amendment to the Commercial Code that came into effect on 1 April 2003, "large corporations" in Japan are allowed to establish a system of corporate governance consisting of a nominating committee, an audit committee and a remuneration committee as an alternative to the existing system whereby companies can have a board of statutory auditors separate from the board of directors.

[4] The committee has a legal authority to buy or sell certain significant assets and borrow a large amount of money on behalf of the board of directors.

2) Electing directors and statutory auditors

The Principles link the re-election of directors to two criteria: company performance and responsibility for corporate scandals. More explicitly,

- where shareholder value has clearly been diminished (e.g., if a company has made a loss with no dividend payouts for each of the past three years, or if it has made a cumulative after-tax loss over the past five years) or
- where a director of a company which has been involved in a scandal (e.g., a violation of any laws or some anti-social activity) is standing for re-election in spite of the serious effect that this has had on the company,

The PFA will either vote against such a proposal or abstain. In cases where a corporate scandal has occurred, they are required to assess its overall impact on the company in terms of factors such as sales or revenue, the share price and the company's reputation.

Some money managers use such performance criteria as an efficient way of deciding which companies' proposals they will examine in the limited time available to them. However, the Principles incorporate company performance in their guidelines on the grounds that the PFA will examine all company proposals.

As far as proposals to elect non-executive directors are concerned, the Principles require (1) that such directors be independent and have no vested interests in the company, and (2) that, where they serve on the boards of other companies, this should not be to an extent that is detrimental to the company's interests.

As far as proposals to elect statutory auditors are concerned, the Principles require that candidates should be independent of the management and that those who have served alternately as directors and statutory auditors should not be eligible.

Also, while the PFA, as a rule, supports proposals to increase the number of non-executive directors or statutory auditors, they do not accept proposals to increase the number of executive directors or reduce the number of statutory auditors unless a good reason is given.

3) Proposals concerning directors' remuneration

The Principles' requirements on directors' remuneration and retirement allowances are similar to those on the responsibility for company performance of persons standing for election as directors. More explicitly,

- where shareholder value has clearly been diminished (e.g., if a company has made a loss for each of the past three years, including the current one), the PFA requires to urge the company concerned to cut directors' remuneration or not to remunerate them at all, and
- where shareholder value has clearly been diminished (e.g., if a company has made a loss for three years in a row) or where a director or statutory auditor has resigned or is retiring because the company has been involved in a scandal, the PFA does not support a proposal to pay him a retirement allowance.

Also, where a company is proposing to increase directors' remuneration substantially, the Principles require it to justify the increase and to reduce the total amount of directors' remuneration where the number of directors is being reduced. Similarly, in order to maintain the independence of non-executive directors and outside statutory auditors, the PFA does not support proposals to pay them a retirement allowance.

As far as the granting of stock options is concerned, the PFA does not support such proposals (1) where this could diminish shareholder value by causing significant dilution (i.e., an increase in the potential dilution ratio of more than 5%) or (2) where a strike price of the options could make lower without shareholders' approvals, (3)where there is no clear link between the range of people granted such options and improvements in the company's performance.

4) Proposals concerning capital policies

As far as proposals on capital policies are concerned, the PFA does not support proposals on the allocation of earnings and proposals to reorganize the structure of a company in the following cases.

- where a company with a dismal performance record but ample capital fails to present suitable business plans and proposes to increase its retained earnings or
- where a company that is proposing to change its structure (e.g., by means of a merger, a share exchange or a demerger) with indicating providing neutral third-

party evidence (e.g., in support of the proposed merger ratio) that shareholder value will be diminished.

The PFA is likely to consider on a case-by-case basis proposals to issue preferred shares and proposals by companies whose finances have deteriorated rapidly to allocate their shares to certain third-party to carry out their restructuring plans.

5) Proposals concerning other matters

As far as proposals that affect a company's articles of incorporation are concerned, the Principles indicate that the PFA should generally support proposals by a company to change its name or its aims. The only points that the PFA needs to be careful about are that companies are required to give precise reasons for proposing to reduce the quorum needed for certain special resolutions and that the PFA should not support proposals to increase the number of shares authorized when this might dilute the holdings of existing shareholders significantly.

As far as proposals to elect an external accounting auditor are concerned, the PFA does not support them where the auditor's independence is in doubt. Similarly, the PFA examines all a company's proposals where it is proposing to replace an external accounting auditor with which it has disagreed about a matter of auditing policy.

The PFA examines on whether or not shareholders' resolutions are likely to increase shareholder value. Where they judge that a resolution is aimed mainly at solving a particular social or political problem, they are required not to support it.

3. A Comparison with the Proxy Voting Principles Used by US Institutional Investors

When the PFA drew up the Principles, it referred to the proxy voting principles used by US institutional investors, including the biggest of these, the California Public Employees' Retirement System (CalPERS). A comparison of the two reveals the following differences, which are the result of differences in US and Japanese company law and the different roles of boards of directors in the two countries.

1) Different attitudes to electing directors

The PFA's requirements that companies separate the functions of running a company and overseeing its management and that boards of directors oversee

management in order to safeguard shareholder value can also be found in US proxy voting principles. In the United States, however, the principles governing how directors are elected are concerned mainly with candidates' independence and the amount of time they devote to the company (e.g., as measured by their attendance at board meetings), and issues such as responsibility for company performance and for involvement in corporate scandals are not considered relevant.

The reason for this difference is that in the United States the role of the board of directors is considered to be purely that of overseeing management, led by the CEO, who are considered responsible for improving the company's performance and for establishing a system of internal controls designed to prevent scandals. If the company's performance deteriorates or the company is involved in a scandal, the board of directors is expected to call the CEO to account (if necessary by dismissing him) without any need for shareholders to exercise a check at the company's annual general meeting.

In Japan, however, the fact that most directors are executive directors means that the board of directors usually performs both the role of overseeing management and that of running the company. The Principles reflect this reality in that, while they encourage companies to separate these two functions, they also allow the PFA to take account of a company's performance and its involvement in scandals when electing directors.

This is not to say that US institutional investors are less concerned about a company's performance in electing directors. It is not unusual for focus funds, which aim to induce companies to improve their corporate governance and thereby their performance, to include company performance in their proxy voting principles. Similarly, it is not uncommon for institutional investors to use company performance as one of their screening criteria in order to approach companies directly or make proposals as shareholders.

2) Different attitudes to directors' remuneration

In Japan the board of directors usually asks shareholders to allow it to decide, on the basis of company rules, exactly how directors' remuneration and retirement allowances should be paid. However, the fact that most of the directors on Japanese boards are executive directors means that it is difficult to check whether directors' remuneration and retirement allowances reflect their contribution to company performance. The PFA considers company performance as the basis for deciding whether to support such a request from a board of directors.

In the United States, on the other hand, the fact that remuneration policy is decided by a remuneration committee, most of whose members are non-executive members, means that direct checks by shareholders are usually not considered necessary. Therefore it might be rare for US proxy voting principles to include a requirement that directors' remuneration be reduced if a company's performance is poor.

3) Different attitudes to stock option plans

In the United States the fact that the abuse of stock option plans by some companies has become a major issue has led many institutional investors to include detailed provisions on the use of this type of remuneration in their proxy voting principles. Their principles may therefore be required to consider the following when voting on a proposal concerning stock options : (1) the extent of the potential dilution effect; (2) whether there is any provision for changing the strike price; (3) whether there is any provision for shortening the lock-in period; (4) whether the options are reload options; (5) whether the strike price is below the market price of the underlying shares; and (6) whether the options are evergreen options.

In contrast, the Principles contain few such criteria, reflecting the fact that stock option plans are still relatively uncommon in Japan.

4) Different attitudes to takeover protections

In the United States many companies include in their articles of incorporation on how to protect hostile takeover bids. These include "poison pills," which allow bid targets to allot shares to particular shareholders at favorable prices, and "golden parachutes," which force successful bidders to pay directors a high level of retirement allowances. Many US institutional investors therefore include in their proxy voting principles on which protections of hostile takeover bids they do not support.

In contrast, the Principles do not contain any concerns about anti-takeover bids, simply requiring that companies give precise reasons for proposing to reduce the quorum needed for a special resolution.

4. Conclusion

The detailed and specific nature of the Principles and the fact they have been produced by one of Japan's leading pension funds mean that they are likely to influence proxy voting principles drawn up by other plan sponsors and money managers.

However, the detailed nature of the Principles means that money managers are likely to find it difficult to apply such guidelines faithfully if all they have to rely on are proxy materials of the kind produced by Japanese companies. The PFA would appear to be aware of this problem, however, and to have tried to put pressure on companies to improve their disclosure (e.g., by opposing proposals for which companies do not provide a clear explanation or reason). It is now up to listed companies to recognize the importance of and growing investor interest in corporate governance, and to be more forthcoming with the kind of information that money managers will need in order to exercise their voting rights.