
The Exercise of Voting Rights in Japanese Companies by Foreign Shareholders

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In Japan, companies with a high foreign ownership ratio have traditionally tended to be interested in how foreign shareholders exercise their voting rights mainly in order to secure a quorum at their annual general meetings.¹ In recent years, however, changes both at home and overseas in how shareholders exercise their voting rights have forced Japanese companies to take an interest for wider reasons.

This report looks at these changes and explains in detail what Japanese issuers need to know about the process by which foreign shareholders exercise their voting rights.

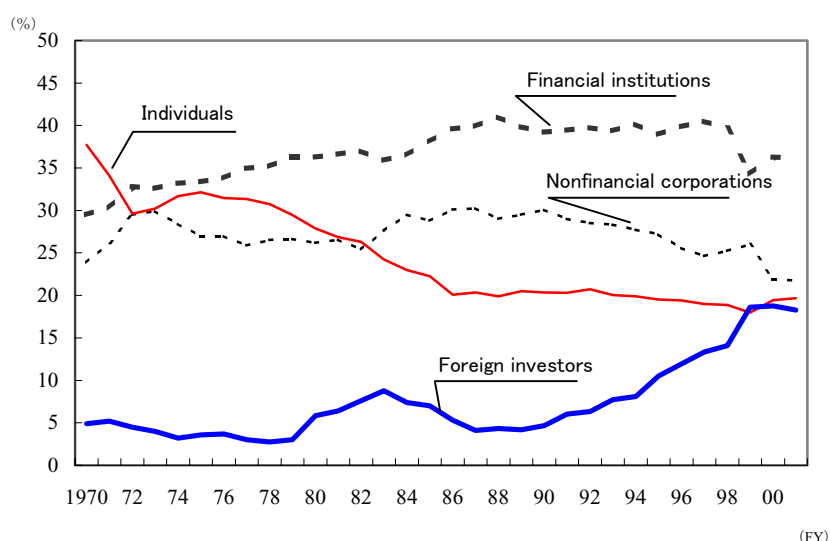
1. Recent Changes in the Way Foreign Shareholders Exercise Their Voting Rights

During the past few years there have been some changes in connection with the way foreign shareholders exercise their voting rights in Japanese companies.

The first of these changes is the fact that foreign shareholders (especially US pension funds) are making increased use of their voting rights. The main reason for this is the fact that the foreign ownership ratio (in money terms) increased throughout the 1990s and by the end of fiscal 2001 was more than three times higher than 10 years previously, although it declined during that year by 0.5 percentage points to 18.3%—partly as a result of the fact that the shares owned by foreign investors fell disproportionately sharply in value (see Figure 1).

¹ The fact that the Commercial Code (as amended in 2002) reduced the quorum for a special resolution at an annual general meeting (from half) to one third of the total number of voting rights could mean that, in future, Japanese companies will make less of an effort to achieve a quorum.

Figure 1 Stock Ownership Ratios by Investor Category



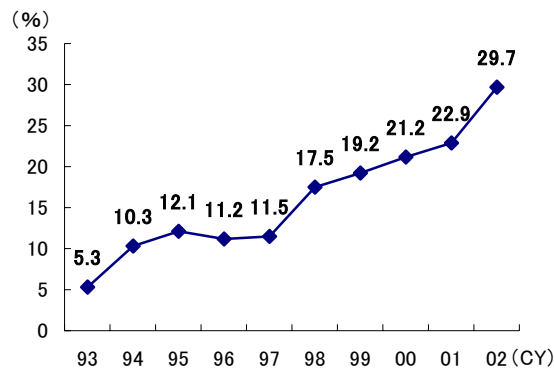
Source: Stock Exchanges, Survey of Share Ownership.

The second reason is the fact that an increasing number of foreign shareholders are exercising their voting rights in Japanese companies. For some time foreign investors have voted in their own countries against proposals which appeared to conflict with their voting guidelines, but an increasing number are now adopting a similar approach to investments in companies from other countries. According to an annual survey on the annual general meetings of Japanese companies by the Commercial Law Center, the percentage of foreign investors² voting against company proposals has increased every year and was 29.7% (585 companies) during the period July 2001 to June 2002 (see Figure 2). The most common type of proposal which foreign investors voted against during this period was on retirement benefits for retiring directors, while the next most common types of proposal were on appropriation of earnings and the election of directors (see Figure 3).

This increase in voting by foreign shareholders means that, under certain circumstances, the share of votes against proposals by Japanese companies could increase.

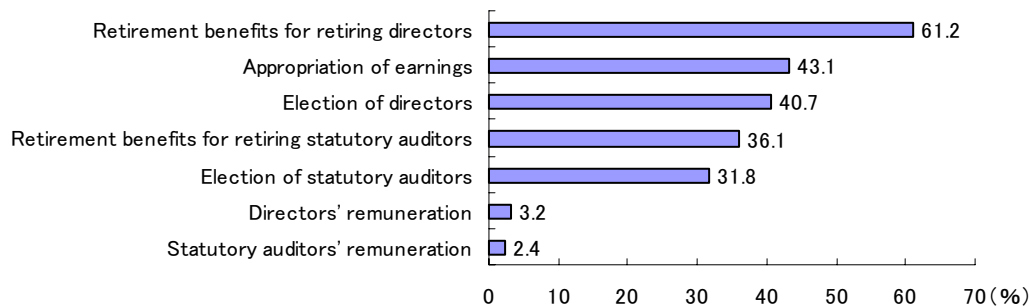
² "Foreign investors" here refers to foreign institutional investors (including pension funds and investment trusts), Japanese institutional investors (including trust banks and insurance companies) and principal shareholders (including investment funds).

Figure 2 Percentage of Japanese Companies Replying That Foreign Investors Voted against a Company Proposal



Source: NRI, from annual surveys on the annual general meetings of Japanese companies by the Commercial Law Center.

Figure 3 Company Proposals That Foreign Investors Voted against (includes double counting)



Note: Based on the 585 companies that replied that their foreign shareholders had voted against the proposal concerned.

Source: NRI, from Commercial Law Center, Annual Survey on Annual General Meetings (2002).

The second change in connection with the way foreign shareholders exercise their voting rights is the fact that shareholders in Japanese companies are now beginning to make their own proposals, which often involves active approaches to other shareholders, including soliciting their proxies.³ In 2002 Japan experienced its first two proxy fights—much to the interest of foreign investors.⁴ Although all the shareholder proposals were rejected, they included proposals to increase dividends, to increase the amount of shares companies can buy back, and to elect non-executive directors. As was pointed out at the time, many foreign shareholders, who invest

³ According to the annual survey on the annual general meetings of Japanese companies by the Commercial Law Center for 2002, during the period July 2001 to June 2002 there were 14 cases of listed companies where shareholders chose to exercise their right to make a proposal. The actual number of shareholder proposals has remained fairly constant in recent years.

⁴ These involved Tokyo Style (TSE, First Section) and Drake Bean Morin Japan (JASDAQ).

purely on the basis of investment return, can be expected to vote for shareholder proposals, depending on their content.

Therefore, given the growing importance to companies of how foreign shareholders vote, Japanese companies need to understand the process by which their foreign shareholders arrive at their voting decisions if they are to communicate with them effectively.

2. The Process by Which Foreign Shareholders Vote

1) Multiple intermediaries in the voting process: global custodians and subcustodians

There are two reasons why the process by which foreign shareholders exercise their voting rights in Japanese companies is more complicated than in the case of Japanese shareholders.

First, the shareholder listed in the register of shareholders and the agent responsible for issuing the voting instructions are normally different.

When foreign institutions invest in a Japanese company, the name on the share certificate is not that of the beneficial shareholder (e.g., pension fund) but that of its global custodian. The name in the register of shareholders, for example, will be that of a global custodian such as State Street Bank and Trust Company. A global custodian is a bank that offers global custody services such as the settlement and custody of securities, multicurrency accounting, and collection of interest and dividends. Pension funds and other institutional investors normally sign a trust agreement with a global custodian in order to carry out their global investment. Because of the large capital investment such services require, the global custody business has been the subject of considerable restructuring and consolidation, and is currently dominated by a small number of major US and European banks (see Figure 4).

However, global custodians do not issue voting instructions. Occasionally, beneficial shareholders (e.g., pension funds) issue instructions themselves, but this is normally done either by the fund managers or the department for issuing instructions in the company entrusted by the shareholder with managing its funds.

Figure 4 Funds Managed by Global Custodians (as of end-March 2002)

Rank	Bank	Global custody assets (\$ millions)	Percentage of total custody assets
1	Citibank	3,453	67.0%
2	J.P. Morgan Chase & Co.	2,022	30.6
3	Bank of New York	1,920	28.0
4	Deutsche Bank	1,720	47.0
5	BNP Paribas	1,430	80.1
6	State Street Corp.	1,147	18.1
7	Brown Brothers Harriman	528	66.0
8	RBC Financial Group	497	54.0
9	Mellon Group	492	16.9
10	Northern Trust Co.	470	27.4

Source: Institutional Investor (September 2002)

When a company sends out documents relating to shareholder meetings such as notices and proposals, it sends them to global custodians as it has no way of knowing the name of the beneficial shareholders. This is why global custodians are involved as intermediaries in the voting process. This is similar to the situation in Japan when a trust bank manages funds on its trust account: the identity of both the fund management company and the beneficial shareholder will not be immediately apparent.

The second reason why the process by which foreign shareholders exercise their voting rights in Japanese companies is more complicated than in the case of Japanese shareholders is that investing in overseas equities involves agents, which engage in various local procedures, other than global custodians.

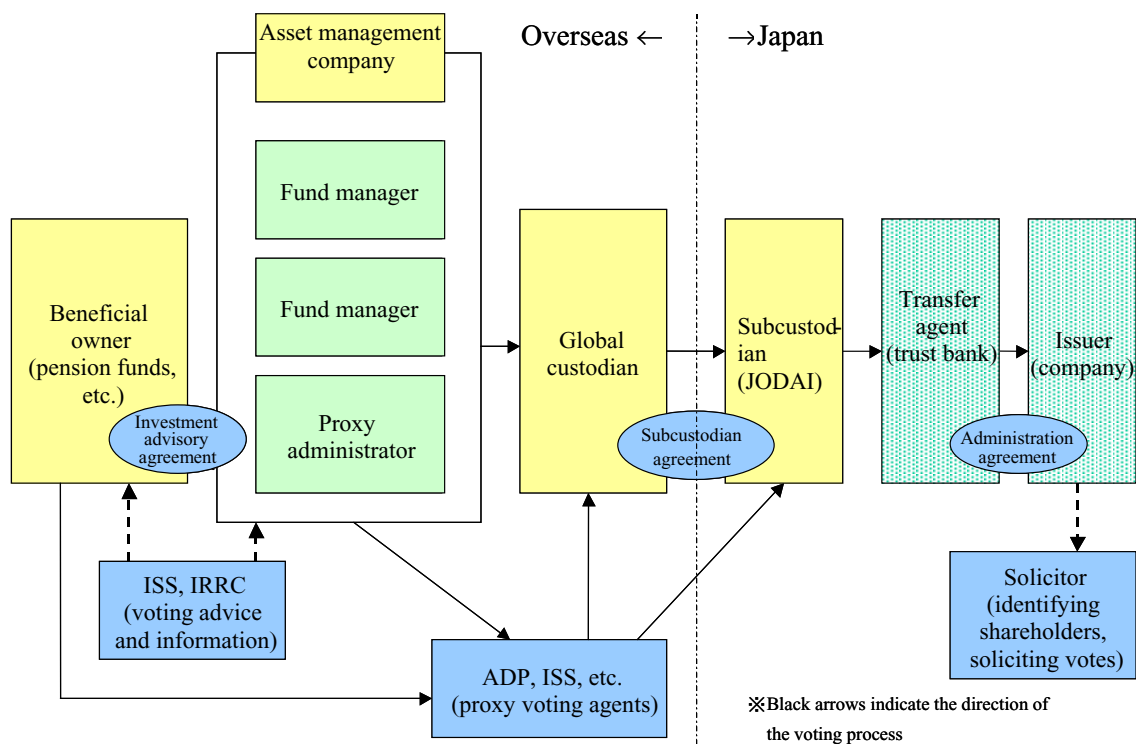
In all the markets for which they offer global custody services, global custodians appoint subcustodians, who are responsible for delivery, custody and settlement in accordance with local procedures. These subcustodians are also used to exercise voting rights in overseas companies. For example, Citibank offers to exercise voting rights on behalf of customers through its subcustodians in 47 markets. Although global custodians, with their global networks, often appoint their local subsidiaries as subcustodians, this is by no means always the case. Citibank, for example, has appointed its local subsidiaries as subcustodians in 39 of the 47 markets for which it offers global custody services.⁵

⁵ According to interviews held in November 2002.

In Japan, banks and securities companies have a role as subcustodians. They are called “JODAI.” Although there is no legal requirement to appoint a JODAI, the National Council of Corporate Affairs’ (ZENKABUKON) guidelines for foreign shareholders state that they should normally⁶ appoint a JODAI and delegate to him demands for name registration, votes at shareholder meetings, and receipt of notices and dividends. In fact, most foreign shareholders do appoint a JODAI in accordance with these guidelines.

These are the two reasons for the involvement of multiple intermediaries (i.e., global custodians and subcustodians) when foreign shareholders exercise their voting rights in Japanese companies.

Figure 5 Voting Process for Foreign Shareholders in Japanese Companies



Source: NRI, from Nomura Securities data.

⁶ This requirement does not apply if a foreign shareholder designates an address in Japan where mail can be sent.

2) The voting process and the role of custodians

(1) Relaying information about shareholder meetings

The transfer agent (i.e., trust bank) appointed by an issuer to do the administration relating to its shares sends notices of shareholder meetings and related documentation (e.g., copies of proposals) to the subcustodian, which will have signed a subcustodian agreement with the global custodian listed in the register of shareholders.

In some subcustodian agreements the global custodian only requires the subcustodian to enter the fund manager's voting instructions in the voting document and to send it to the transfer agent, while in other agreements the subcustodian is also required to send the global custodian information about proposals. The subcustodian is never responsible for deciding how to vote. When it informs the global custodian about any proposals, it will translate just the headings (e.g., "Directors' proposals") of the original proposals received from the transfer agent and send the translation by fax, SWIFT⁷ or mail. The subcustodian files the voting cards.

The global custodian then uses its data on its clients' positions to decide what information to forward to the persons responsible for voting on its clients' behalf.

Subcustodians are not the only source of information about proposals and other matters relating to shareholder meetings: sometimes fund managers refer to more detailed information in English prepared by proxy voting agents.

(2) Exercising voting rights

The global custodian receives its voting instructions by a cut-off date (decided by the subcustodian) from the persons who decide how a client's voting rights should be exercised. It then sorts all these decisions and sends them to the subcustodian by fax, SWIFT or mail.

The subcustodian sorts all the instructions it has received, enters them in the voting cards, which it posts to the transfer agent. All this is done manually. As most Japanese companies hold their annual general meetings in June, subcustodians face a formidable administrative task during the peak period. Some global custodians check whether subcustodians have actually sent the voting cards by the cut-off date.

⁷ An abbreviation for "The Society for Worldwide Interbank Financial Telecommunication." The Society provides services such as foreign exchange settlement by means of its telecommunications and settlement system linking banks all over the world.

3) Proxy Voting agents

(1) ADP

Most global custodians outsource all or, at least, some of the administrative work involved in exercising voting rights in overseas companies to agents. This is because such work is labor-intensive and it is more efficient for companies to outsource it than to use their own staff and equipment. As a result, the number one proxy voting agent in the United States, Automatic Data Processing, Inc. (ADP) has come to play a dominant role in this process. Listed on the New York Stock Exchange and with a 50-year history, ADP is also well known as the number one payroll processing company in the United States.

ADP first acted as a voting agent for US companies in 1993. This service, the fees the company can charge for it, and what the company may do are subject to US regulations: from the Securities and Exchange Commission, the New York Stock Exchange and the NASDAQ. Following a 1994 directive from the Department of Labor that US pension funds should endeavor to exercise their voting rights in overseas companies as much as possible in order to comply with their fiduciary duties, ADP began to offer global proxy services in 1996. The fees for this service are paid for not by issuers but by global custodians—partly because the service was originally intended to cater for fund managers, and partly because ADP has no direct connections with overseas issuers.

As of 2002, with 16 global custodians among its clients, including such major institutions as Citibank, Bank of New York and State Street, ADP was the dominant player in this market. Although Institutional Shareholder Services (ISS) offers a similar service only a relatively small number of global custodians, including Northern Trust and BNP Paribas, use the service.

(2) Issuing voting instructions via the Internet

In January 2002 ADP released ProxyEdge Lite, an Internet-based product enabling users to issue instructions via the Internet on how their voting rights in overseas companies should be exercised. The process by which this can be done is as follows:

(i) Client position data relayed by global custodians

Global custodians relay information on their client positions to ADP on a daily basis. This enables ADP to know which fund manager, etc. is responsible for voting on a client's behalf so that it can inform him about overseas companies' annual shareholder meetings.

(ii) Posting information about shareholder meetings on the Internet and informing the persons responsible for voting on a client's behalf

In the run-up to a shareholder meeting, ADP posts the information (proposals, etc. translated into English) it receives about the meeting from its subcustodian and local agent on its ProxyEdge Lite. It then sends an e-mail to the fund managers, etc. responsible for voting on behalf of the beneficial shareholders of that company (provided the fund managers have registered their intention to vote⁸), informing them that the information has been posted on its system.

(iii) Web site access

The fund managers, etc. responsible for voting access the Web site by entering a user name and password. Their screen will then display a list of items (similar to that in Figure 6), including the name of the company concerned, its country, the date of the shareholder meeting, the voting status, the date proxy materials were received, the type of meeting, the record date, and the vote deadline date.⁹

Figure 6 Information on Annual General Meetings Displayed by ProxyEdge Lite (schematic diagram)

Company Name	Country	Security ID	Meeting Date	Voting Status	Meeting Received Date	Meeting Type	Record Date Market	Vote Deadline Date
NTT	Japan	112233	6/26/02	Unvoted	6/14/02	annual	5/26/02	6/19/02
BT	United Kingdom	445566	6/15/02	completed	5/26/02	special	none	6/10/02

Source: NRI.

(iv) Issuing voting instructions

The person responsible for voting can display the proposals to be put to the shareholder meeting by clicking on the name of the company concerned. He can then vote by clicking one of the radio buttons (for "for," "against" or "abstain"). These instructions can be changed at any time up to the vote deadline date.

ProxyEdge Lite also allows users to issue standing instructions. Under this arrangement, it is assumed that the person responsible for voting will accept any proposals by the company concerned unless he issues instructions to the contrary. This arrangement is common in countries like Japan, where shareholder meetings tend to be held at the same time.

⁸ Fund managers will not necessarily choose to exercise their voting rights in all the companies whose shares they own.

⁹ In Japan the vote deadline date is always 8 working days before the annual general meeting is due to be held.

(v) Tabulating votes and informing subcustodians of results

After the vote deadline, ADP tabulates the votes and informs either the global custodian or (directly) the subcustodian by fax or SWIFT.

This online method of issuing voting instructions is more convenient than the traditional methods of mail, telephone or fax. It may also encourage more shareholders to vote. Nor is the system used only by US institutions: in recent years European institutions have also begun to use it.

4) Proxy solicitors

Japanese issuers sometimes use a "proxy solicitor" to encourage foreign shareholders to vote.

The first thing that a proxy solicitor does is to identify the fund manager behind the global custodian (i.e., the person responsible for exercising voting rights in the company concerned). It does this mainly by labor-intensive methods such as sending questionnaires to fund managers and carrying out telephone interviews.

Once the proxy solicitor has identified the fund manager responsible, it will send it a more detailed version of the proposals in English and try to persuade it to vote on them. In some cases, the proxy solicitor may even arrange for a management representative of the company concerned to visit the fund manager.

Many US companies (and particularly the larger ones) use a proxy solicitor both to identify the fund managers responsible for exercising their shareholders' voting rights and to carry out the administrative work involved in proxy voting. Proxy solicitors normally direct most of their efforts towards institutions (rather than retail investors), as these have larger shareholdings. In addition, if there is a proxy fight, they will often advise issuers—sometimes even shareholders. In order to ensure that the party they are advising wins, they will sometimes team up with lawyers, investment banks and public relations companies to carry out a major campaign or seek to gain a recommendation from ISS, which carries considerable weight with fund managers.

The biggest proxy solicitor in the United States is Georgeson Shareholder Communications Inc., followed by companies such as D.F. King & Co., MacKenzie Partners, Morrow & Co. and Innisfree M&A Incorporated, some of which have

offices in Japan. When two proxy fights occurred last year in Japan, both the companies involved and their shareholders were advised by their own proxy solicitors.

3. How Japanese Companies Should Respond

In view of the difficulties the existence of multiple intermediaries poses to companies trying to communicate with the persons responsible for exercising their shareholders' voting rights, Japanese companies need to ask themselves how they should respond to the increase in voting by foreign shareholders. The most unwelcome scenario for them would be if foreign investors voted either against or abstained from voting on a proposal at a shareholder meeting as a result of a misunderstanding caused, for example, by a lack of information. In order to prevent this and ensure that foreign shareholders fully understand a company's point of view and proposals when they vote, Japanese companies need both to improve the technology available to shareholders or their agents when they vote and to put more effort into cultivating good relations with foreign shareholders.

There are three specific steps that Japanese companies should take. First, they should translate proxy statements and proposals into English and provide their foreign shareholders with more detailed information.

Second, they should send out proxy statements as soon as possible. Japanese companies have long been criticized for holding their general meetings at the same time (i.e., at the end of June) and for sending out their proxy statements only a short time in advance. It would be in their own interests if they gave their foreign shareholders more time to consider their proposals by sending them out sooner.

Third, Japanese companies need to be prepared to send management representatives to meet the persons responsible for exercising the voting rights of foreign shareholders, especially in cases involving M&A or a proxy fight. As things stand at the moment, however, Japanese companies are rarely in a position to identify and meet face to face the persons who are responsible for exercising the voting rights of foreign shareholders. They should therefore consider using the services of proxy solicitors or Japanese securities companies, who number many of the fund managers responsible for exercising the voting rights of foreign shareholders among their clients. Moreover, in addition to such direct contacts, they should also consider making greater efforts to win the support of companies such as ISS whose views carry considerable weight with such fund managers.