

Practical Guidelines for Investment of Pension Assets

The Practical Guidelines were developed to complement the Principal Policy for Investment of Pension Assets and the investment guidelines provided to individual investment managers. The purposes of the Practical Guidelines are to make the contents of the Principal Policy for Investment of Pension Assets and the investment guidelines more concrete by adding necessary explanations needed for practical operations and to deepen understanding of the reasons for and background to instructions made and reports requested, among other matters.

These Practical Guidelines set forth what Pension Fund Association (“PFA”) considers to be fundamental principles. Actions that differ from the fundamental principles of the Practical Guidelines may be taken, depending on the investment styles and approaches and organizational structure of individual investment managers. In such cases, if such actions are approved upon consultation with PFA, their details will be set out in the individual investment guidelines agreed on with the individual investment manager. Accordingly, the contents of the Principal Policy for Investment of Pension Assets and investment guidelines set out for individual investment managers shall prevail, and the Practical Guidelines shall be followed for matters that are not clearly stated in either or matters that are unclear.

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I. Practical Guidelines for Trading Orders for Securities and Other Instruments

1. Best execution

The choice of which securities firm to trade with when buying and selling securities and other instruments is basically left to the investment manager. However, from the viewpoint of fiduciary responsibility, the investment manager is not permitted to take advantage of its position as an ordering party (position with the power to determine the allocation of tangible and intangible benefits to securities firms arising from trading, such as securities trading commissions) for its own benefit or for the benefit of a third party. For the sole purpose of being faithful to the interests of PFA as the entrusting party, in other words, for the sole purpose of improving the performance (substantive performance after consideration of costs) of the subject fund, the manager should conduct transactions with the securities firm that would be expected to achieve the best possible results upon the comparison of various conditions.

Best execution means that the investment manager executes securities trades that are the most beneficial to PFA as the entrusting party, in light of the perspectives described above, in order to achieve the maximum return on investment while minimizing total trading costs. To ensure best execution, the investment manager will clarify the evaluation criteria for best execution according to the type and other attributes of the entrusted assets, in the selection and evaluation of securities firms and, on the basis of the evaluation results, the investment manager will require the securities firm to establish a structure for placing trading orders.

2. Handling of inquiries to securities firms

In over-the-counter (“OTC”) transactions, even if the time and method of placing an order are the same, it is common for terms such as trading value and rate to vary among securities firms, differences in transaction terms may also occur in entrusted transactions. Therefore, if such a difference in transaction terms occurs, the investment manager should make inquiries of at least three securities firms and, in principle, deal with the securities firm that offers the most favorable terms in the current market conditions at the time of the transaction.

On the other hand, the investment manager may choose other reasonable transaction terms if it determines that making inquiries to multiple securities companies would not necessarily be effective in obtaining favorable transaction terms, such as, for example, there is a lack of liquidity or a sudden change in market conditions. The investment manager should clarify its method of handling such cases in its criteria for the selection of securities firms in advance.

When making inquiries to multiple securities firms, the investment manager shall retain not only normal trading value records, but also the names of the multiple securities firms that the investment manager has asked to present transaction terms and documents indicating the process of determining the terms, such as the time of the inquiry, the trading conditions presented, and the trading value conditions, for at least one year as internal records, and the investment manager should make them available for disclosure at any time when requested by PFA.

3. Placing orders with affiliated securities firms

Although the investment manager is not necessarily prohibited from placing orders with its parent company, an affiliated securities firm of its parent company, or its own affiliated securities firm (hereinafter referred to as the “affiliated securities firms”), in principle, the investment manager should refrain from dealing with the affiliated securities firms to avoid conducting more transactions than necessary for the sake of providing benefits to the affiliated securities firms. Nevertheless, from the perspective of best execution, the investment manager may conduct transactions with the affiliated securities firms only if such a transaction is considered to be most advantageous to PFA and to achieve maximum return on investment while minimizing total trading costs. However, even in such cases, the ratio of orders placed with the affiliated securities firms must not be excessive, e.g., such a ratio significantly exceeding the trading share held by the affiliated securities firms in the market.

The placement of orders with the affiliated securities firms shall be prohibited for the following transactions unless approved by PFA upon prior consultation.

- “Principal transactions” concerning equities
 - A transaction in which any of the affiliated securities firms subscribes to an initial public offering of securities for which said firm is the lead managing underwriter
 - Purchase of said securities from the affiliated securities firms within three months from the date of the new issuance (excluding government bonds)
- Scope of the affiliated securities firms

A parent company is a corporation that substantially controls the management of the investment manager in accordance with the criteria set forth in Article 8, paragraph 3 (a)-(4) of the Order for Enforcement of the Act on Regulation, etc. of Investment Advisory Business Pertaining to Securities, or other corporation that substantially controls the management of said corporation.

An affiliated securities firm is a securities firm that has a close capital, financial or personnel relationship with the parent company or with a specified group of shareholders that includes the investment manager (specified shareholder group). Specifically, it refers to a securities firm in which a specified shareholder group holds a 15% or larger share in total or a securities firm or other entity whose representative directors include a person or persons from a specified shareholder group.

In this context, a specified shareholder group refers to “a group consisting of shareholders (shareholders deemed to be core members of the group, hereinafter referred to as “specified shareholders”), shareholders who have a special interest in the specified shareholders, and shareholders equivalent thereto.” “Shareholders equivalent thereto” includes the companies of members of the board of presidents belonging to a specified shareholder, its subsidiaries, and companies in which a majority of the issued shares are held by such companies. They also include companies invested in by a specified shareholder that has a close relationship with a specified

shareholder group in terms of the background of their establishment and their financial and personnel relationships.

4. Soft dollar arrangements

Soft dollars (soft commissions) are a service other than the purchase and sale of securities provided by a securities firm or a third party in exchange for the placement of orders for securities trades with the securities firm. However, research services, e.g., research reports, provided by a securities firm or a third party that are necessary for investment decision-making but that have not been commercialized (referring to the sale of services to a large number of unspecified people for a separate fee; the same shall apply hereinafter) are not defined as soft dollars because there is actually no realistic way to receive such services by making payment for them separately from trading orders. Examples of research services include written research reports, information, analysis and consultation services provided by analysts and other professionals, seminars and workshops, and corporate research (such as company visits, meetings with staff, and IR activities).

In principle, the investment manager shall not conduct transactions that involve such soft dollars (hereinafter referred to as “soft dollar arrangements”) as it is difficult to accurately control execution costs and identify the advantages and disadvantages of adopting soft dollar arrangements, and there is a risk of conflicts of interest on the part of the investment manager. However, soft dollar arrangements may be conducted where best execution is deemed to be secured, where the primary purpose of use of the service or other benefit in question is clear, and where it is deemed to be in PFA’s direct interest. In such cases, however, the investment manager must obtain the approval of PFA in advance and is required to report the arrangement to PFA promptly upon its execution. If approval has been obtained, the details of such soft dollar arrangements will be clearly set out in the investment guidelines.

Because research service costs are potentially included in commission fees, even when receiving research services that are not considered soft dollars, the investment manager is to fully consider whether the amount of the commission fee is commensurate with the value of the combined use of trade execution services and research services from the perspective of ensuring best execution.

5. Clarifying policy and establishing structure regarding trading orders

To ensure best execution, the investment manager is to develop and establish a framework for the trading order execution process and clarify the criteria for the selection and evaluation of counterparty securities firms.

In selecting a securities firm, the investment manager is to clarify the evaluation criteria according to the type and other attributes of entrusted investment assets (securities firm selection criteria) and place trading orders with securities firms on the basis of the evaluation results.

In over-the-counter transactions, the securities firm’s profit margin is usually included in the price. Therefore, from the viewpoint of ensuring best execution, special consideration must be given to the method of identifying trading costs. When conducting multiple trades simultaneously (e.g., basket

trading), the investment manager should choose terms that are the most advantageous for the series of trades as a whole, without necessarily focusing on the superiority or inferiority of the terms of each trade.

Execution costs must be considered, including less visible costs such as market impact cost (cost arising from negative price movement due to the trader's own transaction), timing cost (cost arising from price movements between making the investment decision and placing the order), and loss of opportunity cost (cost arising from failure of contract despite an investment decision being made), as well as costs that can be easily identified, such as commission fees. However, as the method of identifying specific costs varies depending on the type and other attributes of entrusted investment assets, the investment manager is to determine the method and strive to identify the costs in the best possible way.

6. Particulars to be registered and reported pertaining to trading orders

(1) Particulars to be registered

The investment manager is to register the following particulars with PFA in advance and promptly re-register any change in the registered particulars.

1) Policy and structure for trading orders

- Trading execution process

Explain the flow of trading orders in an easy-to-understand way with a flow chart.

- Distinctive features of policy and structure for trading orders

- Existence or otherwise of a trader system

If adopting a trader system, matters such as the roles of the fund managers and traders who are involved in securities trading orders, the name and number of traders and their years of experience, methods for evaluation of traders, etc.

- Definition and evaluation method of execution costs

2) Securities firm selection criteria

- Particulars of selection and evaluation criteria (trade execution capabilities, credibility, information provision capabilities, administrative capabilities, etc.)

- Checkpoints for each particular

- Specific evaluation methods, such as scoring and weighting of each particular

- Evaluation procedures (evaluation organization, personnel structure, frequency of meetings, etc.)

- Method for feedback of evaluation results

3) Criteria concerning trading orders

- Selection criteria for entrusted trading and OTC trading (for equities and foreign-currency-denominated shares only)

- Criteria for basket trading (for equities and foreign currency-denominated shares only)

4) Names and other information about affiliated securities firms

(2) Reports on the status of trading orders

The investment manager shall report monthly to PFA on the status of trading orders in each asset class.

II. Practical Guidelines for the Use of Derivatives

1. Use of derivatives

In principle, derivatives shall be used only when they complement investment in the underlying assets, when they are effective for smooth transaction execution, transaction cost reduction, improvement of transaction conditions, and other similar purposes in investing in the underlying assets, and when there is no significant deviation from the risk and return of investment in the underlying assets (the total portfolio, including derivatives, is within the expected risk and return).

The use of derivatives in overlay strategies (portfolio overlay, currency overlay) and portable alpha strategy shall be prescribed in the investment guidelines to be presented to each investment manager to whom such strategy is entrusted, regardless of these Practical Guidelines.

2. Important notes for the use of derivatives

The following points are to be carefully considered when using derivatives in the management and investment of entrusted assets. These points are fundamental principles, and in the event that questions arise in their interpretation or obstacles arise in the style and methods of investments as derivative instruments and investment techniques develop in the future, the investment manager may consult with PFA on an individual basis. If approved by PFA upon consultation, the content of such action will be set out in the investment guidelines.

(1) Purpose of using derivatives

Investment managers must only use derivatives for the purpose of increasing efficiency in risk management, and their use for speculative trading is prohibited.

From the perspective of efficient risk management, typical purposes of the use of derivatives are for hedging portfolios (hedging purpose) and for substituting underlying assets (substitution purpose). Specifically, this includes the kinds of cases described below. However, even in other cases, if the use of derivatives is in line with the principle of supplementing the investment in underlying assets, the investment manager may implement such use upon prior consultation with PFA and if PFA's approval is obtained. If approval has been obtained, the details of such use of derivatives will be clearly set out in the investment guidelines.

- When adjusting portfolio sensitivity (duration for bonds, beta value for equities) on the assumption that asset prices will fluctuate temporarily and abruptly, the investment manager will use derivatives to adjust the sensitivity of the portfolio temporarily due to the large cost burden (commission, market impact, etc.) of trading the underlying assets.
- As market impact would be large if underlying assets trading were to be conducted all at once at the time of inflow/outflow of funds, derivatives are temporarily used to adjust exposures and replaced with underlying assets or cash while avoiding market impact.
- Derivatives are used to gain exposure in advance in anticipation of fixed future inflows.

- For dry powder, derivatives are used to achieve substantively full investment.

If a call option commensurate with the underlying asset is sold in order to sell the underlying asset on favorable terms, or a put option commensurate with the underlying asset is sold in order to purchase the underlying asset on favorable terms, such sale will be considered to be in line with the substituting purpose in its broad sense.

In addition to the hedging or substitution purposes described above, arbitrage and speculation are also considered to be purposes of the use of derivatives. However, the use of derivatives for these purposes is not permitted in principle because they may deviate significantly from the risk/return of the underlying asset, and they are inappropriate for the investment of pension funds whose primary focus is long-term investment.

The use of derivatives may make it possible to substantively change the allocation between the underlying asset and cash at will. In principle, however, full investment is to be carried out on the asset class specified in the investment guidelines, so the use of derivatives for allocation purposes is not permitted.

(2) Limit of use of derivatives

In the use of derivatives, the balance of sell positions and buy positions (net notional principal) shall not exceed the following range to avoid a leverage effect.

- 1) If the sell position exceeds the buy position, the notional principal of the exceeding sell position is within the scope of the underlying assets currently held or confirmed will be held.
- 2) If the buy position exceeds the sell position, the notional principal of the exceeding buy position is within the scope of the surplus funds currently held. Accrued income that is expected to be certain and bonds with a maturity of less than one year shall be included in the surplus funds.

It is possible to conduct a buy position beyond the scope of the surplus funds based on the assumption of the future amount of a deposit, but in this case, PFA should be consulted in advance.

- 3) Even within the scope of 1) and 2) above, the use of derivatives will not be permitted if, as a result of the use of derivatives, the portfolio differs from the risk/return assumed from the investment style and approach, or if the substantive duration or beta value of the portfolio including derivatives becomes negative.

(3) Scope of derivatives to be used

There are no restrictions on the types of derivatives to be used as long as they include listed instruments (futures, options, etc.) that are generally liquid and whose prices are publicly announced. As it is difficult for PFA to understand the contents of unlisted instruments whose trading terms are decided on an over-the-counter basis, investments can be made only in unlisted instruments for which PFA has granted approval upon prior consultation. In such cases, due

attention should be paid to the creditworthiness of the counterparty and liquidity (possibility of cancellation) in the event of emergency. If approval has been granted, the details will be clearly set out in the investment guidelines.

3. Report and check of the status of use of derivatives

As the status of the use of derivatives is not provided on the balance sheet, making it difficult to identify exposure, they are to be clearly distinguished from the underlying assets and reported in such a way that the notional principal can be identified.

In principle, such reports are to be made in conjunction with the regular monthly reports, and their contents are to include the purpose or method of use of derivatives, notional principal and unrealized gains/losses, delta value (preferably gamma value), portfolio risk management indicators that factor in the derivatives (such as duration), and cost of use.

Given these reports, PFA will check the particulars necessary for managing the risk of the use of derivatives from time to time or through opportunities such as meetings, as appropriate.

III. Practical Guidelines for the Handling of Local Withholding Tax on Overseas Assets

Interest and dividends on overseas assets may be subject to withholding tax at the domestic legal tax rate of the country in question. If a tax treaty has been concluded between the Government of Japan and the country in question for the purpose of avoiding double taxation, this local withholding tax will be partly or wholly exempted. Regarding methods of exemption, there are two types of country: countries that collect the tax amount at the time of receipt of interest and dividends at the restrictive tax rate specified in a tax treaty with submission of certain documents in advance by the taxpayer; and countries that withhold tax on interest and dividends at the rate set forth in the domestic law of the country in question at the time of receipt of the interest and dividends and then refunds the excess of the restricted tax rate through certain procedures at a later date.

Refunds of local withholding taxes on overseas assets can take a considerable amount of time, but withholding tax refunds are also part of the interest and dividends accruing from investments and are part of pension assets. Therefore, the possibility of loss of opportunity for reinvestment cannot be denied as a result of the time required for the refund procedures.

The party entrusted with the custody of pension assets is required to familiarize itself with local tax affairs, take appropriate and prompt procedures for claiming withholding tax refunds, understand the status of such refunds, and report them to PFA.

1. Important notes for refund claim procedures for local withholding tax

The party entrusted with the custody of pension assets (custodian) shall pay attention to the following matters with regard to refund claim procedures for local withholding tax on overseas assets.

(1) Understanding of the local taxation system

The custodian shall constantly conduct research of the tax systems of individual countries, establish systems for responding properly and promptly, and make efforts to collect information. The custodian is to promptly provide the collected information to investment instructors.

(2) Selection of sub-custodians

In the selection of sub-custodians, due consideration is to be given to the administrative capabilities of candidates. This includes knowledge of tax systems and the ability to properly and promptly carry out prior procedures and refund claim procedures with the authorities.

(3) Procedures for local withholding tax

If it is necessary to notify the tax authority in advance, the custodian is to take procedures promptly so as not to interfere with investment actions. In doing so, if there are necessary procedures to be taken by PFA, the custodian is to notify PFA of that fact, accompanied by a written explanation and,

if the original documents for the procedures are written in a foreign language, a Japanese translation of such documents.

(4) Refund claim procedures for local withholding tax

If local withholding tax has been deducted and it is necessary to claim a refund based on a tax treaty at a later date, procedures are to be taken promptly. If there are procedures required of PFA, they are to be handled in the same way as for (3) above.

(5) Confirmation of unrefunded local withholding tax

If withholding tax is not refunded after a certain period of time (about half a year) has passed since the refund claim was made, the custodian is to check with the local authority to understand why the refund has not been made and take appropriate measures.

As refunds of withholding tax form part of investment results, from the perspective of efficient investment, the investment manager is to strive to identify whether the custodian is undertaking the necessary procedures properly and promptly.

When investing in overseas assets, the investment manager is to make constant efforts to research the tax systems of individual countries and to identify real after-tax revenue and the time required for refunds of withholding tax, in order to avoid unexpected cost burdens.

2. Regular reports and particulars to be reported to PFA

The custodian is to provide regular reports on the status of local withholding tax on overseas assets as follows:

(1) Monthly report

The status of local withholding tax for the relevant period is to be reported on a monthly basis, taking into account the following points:

1) Details of interest and dividends

Details of interest and dividend payments are to be recorded to clearly indicate non-refundable and refundable local withholding tax separately.

2) Details of receipt of refunds

If refunds are received in the relevant period, the dates of receipt of refunds, dates of receipt of interest and dividends, and dates of refund claims are also to be stated in the details of receipt of refund.

(2) Annual report

Regarding the status of local withholding tax on overseas assets for each business year, the following particulars are to be reported by the end of April of the following business year.

1) Details of receipt of refunds

Regarding the receipt of refunds of the relevant business year, details of such refunds, including

the names of relevant securities, names of relevant countries, names of custodians, total amounts of dividends or interest, total amounts of withholding tax, amounts of claims for refunds, dates of refund claims, and dates of receipt of refund, are to be stated.

2) Details of unrefunded amounts

Regarding unrefunded amounts as of the end of the relevant business year, the names of the relevant securities, dates of initial claims for refunds, dates of renewed refund claims (latest date), and reasons for and responses to unrefunded claims are to be stated.

IV. Practical Guidelines for the Handling of Shareholder Incentives Related to Equity Investments

1. Purpose of the Principal Policy

Given their economic value, shareholder benefits are the fruits of equity investments and form part of pension assets. Therefore, the custodian is required to be responsible for converting to cash the shareholder incentives as much as possible that are considered highly redeemable, and returning them to the fund.

2. Judgment criteria for redeemability of shareholder incentives

Shareholder incentives are provided by companies in various forms, such as discount coupons and products made by the company. By rights, it is preferable that all such benefits be redeemed for cash and returned to the fund, but in reality, there are many cases in which they are difficult to redeem. For this reason, redeemable shareholder incentives are to be redeemed for cash if such shareholder benefits are generally distributed and there is an open market, such as a discount ticket/ voucher shop, for them. However, the custodian is to pay due attention to the possibility that the social credibility of the market itself may be in doubt to avoid unforeseen problems.

The asset custodian is to set forth certain rules, such as criteria for judging whether or not shareholder incentives shall be redeemed, and methods of handling such shareholder incentives, including how to store them, if they are not redeemed.

3. Important notes for the redemption of shareholder incentives

As redemptions of shareholder incentives are over-the-counter transactions, paying due attention to the social credibility of the market itself, inquiries are to be made to multiple business operators to understand actual market conditions and to deal with the business operator that offers the most advantageous terms.

Version history

1) Practical Guidelines for Trading Orders for Securities and Other Instruments

Formulated: Nov. 15, 1996; Revised: Jun. 12, 2000; Revised: Apr. 1, 2006

2) Practical Guidelines for the Use of Derivatives

Formulated on Mar. 12, 1997; Revised on Apr. 1, 2000; Revised on Apr. 1, 2006; Revised on Nov. 2, 2011

3) Practical Guidelines for the Management and Investment of Real Estate

Formulated on Mar. 19, 1998; Revised on Apr. 1, 2000; Abolished on Mar. 11, 2005

4) Practical Guidelines for the Handling of Shareholder Benefits Related to Equity Investments

Formulated on Mar. 19, 1998; Revised on Apr. 1, 2000; Revised on Apr. 1, 2006

5) Practical Guidelines for the Handling of Local Withholding Tax on Overseas Assets

Formulated on Apr. 8, 1999; Revised on Apr. 1, 2000; Revised on Apr. 1, 2006

6) Practical Guidelines for Soft Dollar Arrangements

Formulated on Jun. 12, 2000; Abolished on Apr. 1, 2006 (Integrated into “Practical Guidelines for Trading Orders for Securities and Other Instruments”)

7) Practical Guidelines for the Exercise of Shareholder Voting Rights

Formulated on Oct. 5, 2001; Revised on Apr. 1, 2006; Abolished on May 22, 2014 (Abolished due to the establishment of “Pension Fund Association Policy for the Fulfillment of Stewardship Responsibilities”)