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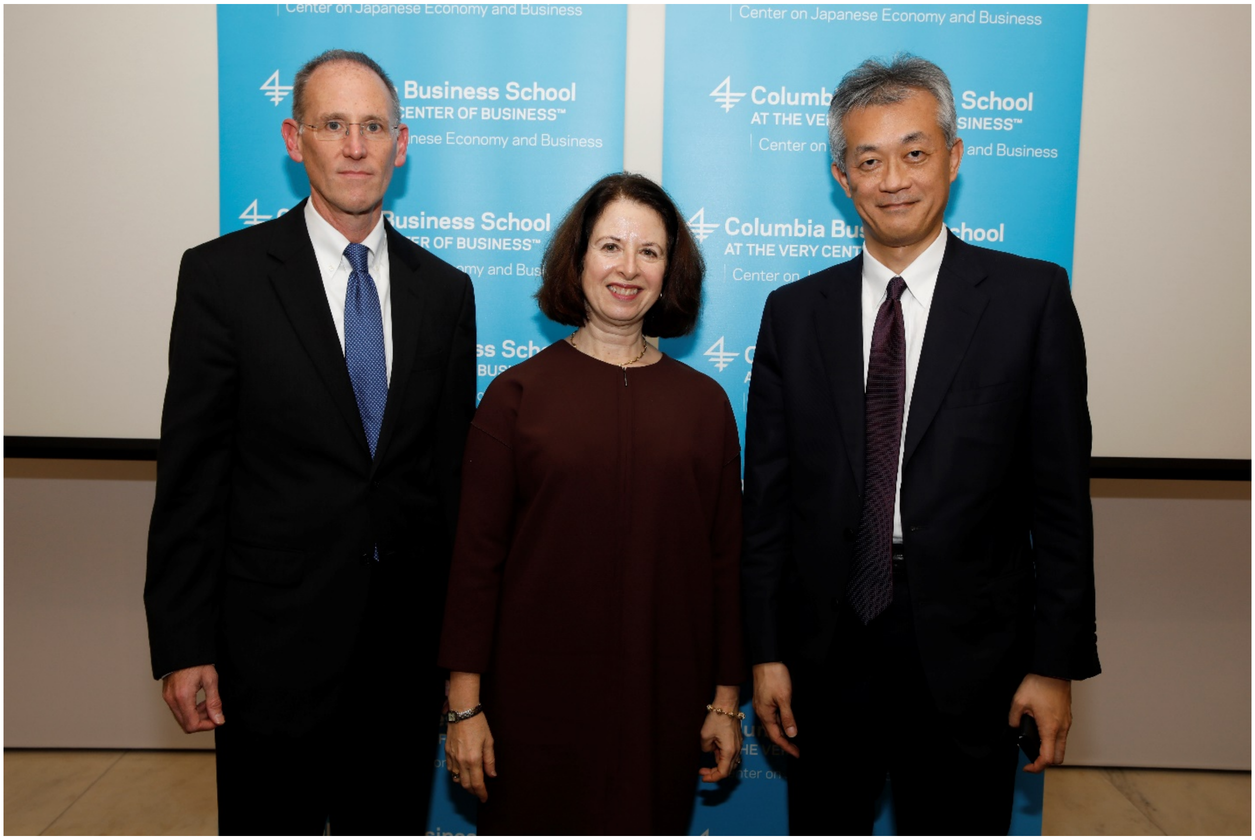
"Power to the Pensions! Japanese and NYC Pension Funds as a Force for Good Governance"

Thursday, November 9, 2017



Michael Garland, Alicia Ogawa, and Ken Hokugo

Featured Speakers:

Michael Garland – Assistant Comptroller, Corporate Governance and Responsible Investment, Office of the New York City Comptroller

Ken Hokugo '93 – Director, Head of Corporate Governance; Director, Hedge Fund Investments, Pension Fund Association of Japan

On November 9, 2017, the Center on Japanese Economy and Business (CJEB), Columbia Business School, hosted a public event bringing together experts to address the positive impact that institutional investors, particularly pension funds, provide for promoting good corporate governance in the United States and in Japan. This event was part of the CJEB's Corporate Governance and Stewardship Program, an initiative which seeks to analyze the governance structures of the most innovative Japanese companies and which aims to use this research to inspire more firms in Japan to adopt best practices in corporate governance.

Hugh Patrick, Director of CJEB, opened the event by introducing Alicia Ogawa, director of the Project on Japanese Corporate Governance and Stewardship. Professor Ogawa noted how the oversight of publicly traded companies has become a crucial topic given the increased number of "corporate shenanigans" lately. In addition to putting consumers at risk, she said, the conduct of these firms has cost their shareholders a lot of money, and the shareholders are the general public. She emphasized that how well institutional investors police the companies they invest in and how they put pressure on managements to fight corruption and waste has become a global topic of great urgency.

Hugh T. Patrick

Ultimately, what constitutes good corporate governance and how can we measure the effectiveness of good corporate governance? As Professor Ogawa observed, one of Prime Minister Shinzo Abe's objectives is in promoting good corporate governance in Japan is to push firms to invest more of the cash on their balance sheets into the domestic economy. Professor Ogawa believes that successful corporate governance is characterized by liquidity of management; that is, when Japanese companies are willing and able to hire the best person for a given role regardless of history or relationship.

To illustrate the reach and influence that public pension funds can have on shaping corporate governance practices, both Assistant Comptroller Michael Garland and the PFA Director of Corporate Governance Ken Hokugo respectively presented details on the structure and asset allocations of the New York City pension system and Japanese Pension Fund Association.

Alicia Ogawa

Michael Garland, the Assistant Comptroller for Corporate Governance and Responsible Investment from the Office of the New York City Comptroller, defined good corporate governance as practices that lead to value creation. Mr. Garland emphasized that, at a minimum, "good corporate governance is risk management and ensuring you have your rights when you need them." From the perspective of Ken Hokugo, the Director of Corporate Governance at the Pension Fund Association of Japan (PFA), good corporate governance is defined by holding a CEO accountable for the return a company earns, a scenario that he does not observe often in Japan.

Mr. Garland described how the New York City pension system is comprised of five retirement systems. With an aggregate value of $187 billion in assets, the New York City pension system is the fourth largest public pension fund in the United States.[1] According to him, approximately half of the assets are invested in public equity and are spread across nearly 10,000 portfolio companies globally. Investments in public equity include 3,500 public companies in the United States as well as approximately 1,500 public companies in Japan.

Michael Garland

Mr. Garland emphasized the importance of the New York City pension system being a long-term owner in all 10,000 portfolio firms. Nearly 80 percent of New York City Retirement Systems funds are invested through indexed strategies in order to minimize fees and increase portfolio diversification to meet obligations to pension holders. Due to this investment strategy, Mr. Garland believes the only way for the New York City pension system to increase the value of its portfolio is to meaningfully engage with

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[1] "Pension/Invesment Management: Asset Allocation." Office of the New York City Comptroller Scott M. Stringer, https://comptroller.nyc.gov/services/financial-matters/pension/asset-allocation (retrieved December 1, 2017).

its portfolio companies. This encompasses concerns about the board of a company, the environmental practices of a firm, workplace practices, or business strategies. Accordingly, the New York City pension system has been one of the most active filers of shareholder proposals aimed at helping firms change their practices through collaboration to better align with the interests of their shareholders.

Another tool Mr. Garland believes that institutional investors have that can be effective for encouraging compliance and good corporate governance is providing boards with the authority to claw back funds from firms or individual executives responsible for misconduct. Additionally, proxy access could be one of the most effective means for institutional investors to leverage moving forward. Proxy access, which is the right of long-term shareholders to nominate directors to the board of a company, is a difficult tool to use. Institutional investors must request proxy access from companies on a firm-by-firm basis. Furthermore, the tool can only be used by investors who have held at least 3 percent of the total shares of a company for at least three years. To put the limitations that this requirement imposes on the use of proxy access by shareholders into perspective, the New York City pension system owns at most half of one percent of any one of its publicly traded portfolio companies even though it is the fourth-largest pension system in the United States. As Mr. Garland explains, this is primarily an issue of changing the power dynamics of boardrooms, and resistance from firms in this area is to be expected. Nevertheless, change is

Ken Hokugo

underway. Since the Boardroom Accountability Project was launched by the New York City pension system in 2014, over 60 percent of the S&P 500 now offer proxy access to shareholders. Approximately one-third of these companies have offered proxy access in direct response to shareholder proposals submitted by New York City in collaboration with other investors.

Although public leaders working to promote good corporate governance practices in both the United States and Japan face many of the same challenges with regard to holding executives accountable for conduct, for achieving revenue targets, and aligning with the interests of shareholders, the cultural, regulatory, and legal environment in Japan presents different challenges related to Japanese corporate governance. Ken Hokugo, the Director of Corporate Governance at the Pension Fund Association of Japan (the third-largest pension fund in Japan and which manages approximately $102 billion in assets[2]), highlighted two main obstacles in the promotion of corporate governance practices in Japan.

According to Mr. Hokugo there is strong cultural resistance, as concepts such as "sustainable growth" and "corporate governance" are dismissed by large, traditional Japanese firms that have flourished for over two-hundred years. They have a significantly different perspective on the concept of managing corporations than young firms in the United States, for instance, and do not believe that pension funds have sufficient experience to provide them with guidance on management. The second obstacle for corporate governance in Japan is allegiant shareholders. Allegiant shareholders tend to be firms which have large stakes in other firms as strategic investments. These strategic investments are beneficial for the allegiant shareholders because they receive the benefits of a business relationship with the firm they are investing in. Reciprocally, they are expected to vote in alignment with the existing board. Allegiant shareholders are widespread and numerous; their investments are small, but the overall group is massive, which leads collectively to an irresponsible system.

[2] "Investments." Pension Fund Association, https://www.pfa.or.jp/english/about/investments/index.html (retrieved December 1, 2017).

To provide a sense of the influence of allegiant shareholders in preserving the status quo, Mr. Hokugo noted that approximately 10 to 20 percent of all publicly traded companies in the United States, the United Kingdom, and in continental Europe have strategic holdings. Comparatively, an average of 35 to 40 percent of all companies listed on the Japanese stock exchange are held by allegiant holders, with the number as high as 50 to 60 percent for certain firms. Given the historical importance of honoring relationships in Japanese business practices, Mr. Hokugo believes that engagement with Japanese firms on the topic of corporate governance will take decades and will require global coordination, such as the invitation to foreign investors to purchase some of the shares currently held by allegiant shareholders. The multiplicity of these shareholders makes this a difficult problem to solve, as it is deeply entrenched in the history of Japanese corporate culture. For Mr. Hokugo, promoting good corporate governance practices in Japan also means instituting more incentive systems to encourage more Japanese firms to take risks that increase returns on investment. Mr. Hokugo also pointed out the lack of encouragement for collective engagement in Japan’s Stewardship Code, which is in fact the only stewardship code in the world with this stance. Mr. Hokugo believes that this needs to be remedied because of the influence of allegiant shareholders.

Finally, Mr. Garland and Mr. Hokugo engaged in a panel discussion moderated by Professor Ogawa, which involved the audience Q&A. Regarding hiring independent board members as a potential solution for addressing corporate governance issues, there was a general consensus among Professor Ogawa, Mr. Garland, and Mr. Hokugo that a truly independent board member is not only difficult to find, but conditions for permitting the board member to conduct proper due diligence are often absent or difficult to maintain. In both the United States and Japan, Mr. Garland and Mr. Hokugo noted that independent board members are often selected by the CEO of the firm. Ultimately, it seems that the most effective measures at present are for institutional investors such as pension funds to continue to collaborate with each other to engage firms and implement measures that hold executives of firms accountable to compliance measures and the interests of their shareholders.