Introduction of the Stewardship Code in Korea

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I. Adoption of the Stewardship Code

The introduction of the stewardship code in Korea was initially pursued by the Financial Services Commission (“FSC”)\(^1\) back in 2015. The initial Stewardship Code Council set up by the FSC prepared a draft Stewardship Code in December 2015. Regretfully, this draft was not adopted due to a strong opposition from the business community. At that time, the business circle expressed a concern that the Code would lead to excessive intervention by institutional investors adversely affecting their business autonomy.

The second attempt to introduce the stewardship code was made last year. Instead of the FSC, the Korea Corporate Governance Service (the “KCGS”)\(^2\), a private organization, took the lead this time. Under the auspice of KCGS, the Stewardship Code Council was set up for the second time in August 2016, all the council members being appointed from private sectors\(^3\). By the end of 2016, due to the Choi Soon-sil gate\(^4\) which put the country in such

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\(^1\) The Financial Services Commission is a central government body in Korea responsible for financial policy and financial supervision.

\(^2\) KCGS was launched in 2002, the major founding members being the Korea Exchange, the Korea Financial Investment Association, the Korea Listed Companies Association and the KOSDAQ Listed Companies Association. Main activities of KCGS consist of conducting corporate governance assessment, providing advisory services on sustainability reports prepared by domestic firms, offering proxy advisory services and researching on corporate governance and corporate social responsibility issues.

\(^3\) There were 11 members: 2 from academic circles, one from the Korea Capital Market Institute, 1 from Korea Financial Investment Association, 3 representing asset management business and 4 from Korea Corporate Governance Service.

\(^4\) The political scandal broke in 2016 which eventually led to the impeachment of President Park Geun-hye Park in 2017.
a great turmoil, the social demand for more transparent corporate management became stronger than ever. Against this backdrop, the draft Stewardship Code prepared by this second Stewardship Code Council was successfully adopted in December 16, 2016 and became effective from December 19, 2016.5

II. Overview of the Korean Stewardship Code

The official title for the Korean Stewardship Code is “Principles on the Stewardship Responsibilities of Institutional Investors” (hereinafter referred to as the “Code”). The Code aims to propose key principles that are crucial for institutional investors who manage other people’s assets to effectively exercise their stewardship responsibilities, and concrete details for these principles. For investors, stewardship is more than just voting. Engagement activities of institutional investors include a wide spectrum of shareholder activities geared towards “clear and constructive goals” in conducting a dialogue with investee companies. Thus, the stewardship activities range from monitoring key management issues such as an investee company’s business strategy and outcome, risk management, and corporate governance, to consultation with the board of directors, etc., as well as more proactive activities concerning shareholder proposals, litigations, etc..

The Code is directed in the first instance to institutional investors, which are divided into two categories, i.e. asset managers and the asset owners. There is a division of duties between asset managers and asset owners. Broadly speaking, asset managers include asset-management companies, which manage investments in various asset classes for various investors and communicate with portfolio companies. Asset managers, with day-to-day responsibility for managing investments, are well positioned to influence investee companies’ long-term performance through stewardship. Given these, asset managers are required to routinely exercise stewardship responsibilities through investment management and purposeful dialogue with investee companies. On the other hand,

5 For the preparation of the draft, a round-table conference was held four times to collect opinions from the related business, and the public comment process went on from November 18 through December 11.
asset owners’ responsibilities are rather indirect. Asset owners, as the provider of capital, are required to set the tone for stewardship and influence behavioral changes that lead to better stewardship by asset managers and companies they utilize by providing the specific guidance or general principles and evaluating their performance. "Asset owners" include pension funds and insurance companies.

Institutional investors take on ultimate stewardship responsibilities even when they entrust all or part of their stewardship activities to external investors or other (advisory) service providers. This means, even when institutional investors choose to outsource to external service providers some of the activities associated with stewardship, they cannot delegate their responsibility for stewardship. They remain responsible for ensuring those activities are carried out in a manner consistent with their own approach to stewardship. Accordingly, institutional investors should monitor and supervise to ensure that outsourced activities are executed in accordance with their own stewardship policy. Hence, the Code applies, by extension, to proxy advisors, investment advisors, etc. that provide (advisory) services related to the detailed contents of the Code.

The Code is not a rigid set of rules. It is based on principle-based approach consisting of basic principles and detailed guidelines thereon. It is true that the language of some guidelines are rather too specific so that it looks as if they are based on the rule-based approach. This is to narrow the scope of activities so as to assist an easy decision by the institutional investors on the relevant matters considering that the Korean institutional investors in general are not accustomed to principle-based approach and they lack experience on active shareholder engagement. Overall, the Code can still be regarded as taking a principle-based approach.

The Code sets out the seven principles of effective stewardship by

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7 Brief description of these 7 Principles are as follows:

1. publicly disclose their policy on how they will discharge their stewardship responsibilities;
investors, which are quite similar to those of UK Stewardship Code. The Code applies to institutional investors (whether domestic or foreign) holding shares in Korean listed companies only if they voluntarily commit to accept and abide by the principles of the Code. It adopts the "comply or explain" approach, which requires that subject institutional investors either comply with its principles or explain why they have not done so. In providing an explanation, they should provide a clear rationale for their approach and sufficiently explain alternatives to stewardship activities.

The Code expressly recognizes that ensuring an appropriate level of remuneration in fulfilling stewardship responsibilities is essential and states that investors, asset owners, asset managers, and relevant authorities, etc. should share a common understanding on this point. This is in response to the voices of the asset management companies. Currently, in the Korean capital market, even the asset management companies are not very active in shareholder engagement and do little more than rubber-stamping in most instances. One of the main causes for such phenomenon is thought to be the low service commissions in the market. Considering that additional costs will be involved in carrying out the stewardship responsibilities, unless appropriate level of service commissions is ensured, imposing mandatory requirement to engage in corporate governance of the investee companies would be ineffective.

To address the concerns of the business community that the implementation of the Code might adversely affect business autonomy, the Code states that stewardship activities do not signify any undue intervention in day-to-day operations of investee companies. Moreover, institutional investors may consider selling their shares in the event if it is

2. have a robust policy on managing conflicts of interest in relation to stewardship, and this policy should be disclosed;

3. monitor their investee companies on a regular basis;

4. establish clear guidelines on when and how they will escalate their steward activities as a method of securing/enhancing investment value;

5. have a clear policy on voting, and the disclosure of such activity;

6. report periodically on their voting and stewardship activities to investors; and

7. enhance their relevant expertise and competence to effectively/actively carry out stewardship activities.
deemed that selling the shares is in the best interests of their clients and beneficiaries. So, the Code would not prevent institutions choosing to exercise their ‘exit’ rather than ‘voice’ and indeed it may even reinforce a preference for that action.

Also, to allay the concern on any legal uncertainties that institutional investors may face during the course of their stewardship activities, the Code recognizes the need to make collaborative efforts among institutional investors, relevant authorities, etc. to categorize shareholder activities and clarify the application of the relevant laws and regulations in each case.

The Code designates the KCGS as the responsible authorities to periodically examine trends in participation in and implementation of the Code in order to gauge the overall level of stewardship activities in the capital markets. The Code also requires KCGS to publicly disclose on its own website the list of participating institutional investors, etc. and the website of each investor. This will provide capital market participants, etc. with information necessary for selecting institutional investors that fit their investment preferences and enable them to monitor how well the institutional investors implement stewardship responsibilities.

III. Guidance for Implementation of the Code

(1) The First Manual on the Korean Stewardship Code (the “First Manual”)

To promote understanding of the Code by the participating institutional investors, the KCGS published the First Manual on June 9, 2017. The Stewardship Code Development Committee set up by the KCSG was in charge of drafting the manual. The First Manual interprets the Code in detail and includes concrete examples so as to provide practical guidance on the implementation of the Code.

(2) Legal Guidance from the FSC

To eliminate the legal uncertainties involved in the course of carrying out
stewardship responsibilities pursuant to the Code, the FSC set up the Stewardship Code Working-level Council (the “Working-level Council”)\(^8\). The Working-level Council deliberated various legal issues raised in the market and the outcome thereof is included in the Legal Guidance on the Stewardship Code (the “FSC Guidance”) published by the FSC on June 9, 2017.

The major issues dealt in the FSC Guidance include:

- **Use of Non-public Information**: Article 174 of the Capital Markets Act regulates trade by insiders on the basis of Material Non-public Information during the period Material Non-public Information remains undisclosed to public. For the purposes of this Article, “insiders” include the initial tippees who obtain their information from a primary insider\(^9\). Thus, if the institutional investor, during their dialogue with the management of the investee company, obtains Material Non-public Information from the company, they may be subject to this rule. Also, even if the institutional investors are not initial tippees, in certain instances, trading shares based on the Material Non-public Information may still constitute market disturbance using Material Non-public Information under Article 178-2(1). Hence, the FSC Guidance urge caution on dealing with Material Non-public Information by the institutional investors and recommend suspending the trade until the relevant information is disclosed to the public.

- **5% Rule**: Article 147 of the Capital Market Act requires the shareholders holding 5% or more of the total outstanding shares of a company (shares held by specially related persons aggregated for this purpose) to make certain reports when they first reach 5% and thereafter, when more than 1% of their shareholding ratio is changed. In doing so, the level of reporting required is different depending on the purpose of acquiring the shares. If the purpose of share acquisition is

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\(^8\) The council consisted of officials from the FSC, Financial Supervisory Service of Korea, the Korea Exchange as well as legal experts from private sectors.

\(^9\) Primary insiders are those who have their information through being a director, employee, a major shareholder of an issuer of securities or have access to the information by virtue of their employment, office or profession, such as professional advisers to the company.
to influence the management of the company, more detailed report is
required. According to the FSC Guidance, the purpose of share
acquisition shall not automatically be regarded as “to influence the
management of the company” solely because the acquirer is
participating in the stewardship code. Also, the FSC Guidance
provides in-depth description of what is meant by the term “to
influence the management of the company”.

IV. Effects of the Code

(1) Current Status

Although more than 30 asset-management companies (including PEF
firms) have expressed their intent to participate, only three PEF firms\(^\text{10}\) have actually committed to participate as of June 16, 2017. At the
moment, keen attention is being paid to National Pension Service, the
nation’s largest institutional investor with $500 billion under management,
as they started reviewing whether to participate in the Code in May
2017.\(^\text{11}\)

NPS holds shares in around 750 listed companies in South Korea, and
owns more than 5% stakes in 350 firms. It is the single largest
shareholder in Samsung Electronics Co. Ltd. with a 9.22% stake at end-
2016. Given such immense influence in the market, it is quite likely that
NPS’s action will have a ripple effect in the industry. In the event NPS
elects to participate in the Code, most asset management companies,
other pension funds, and insurance companies would be expected to
participate as well.

\(^\text{10}\) They are JKL Partners, IDEAL Partners and STIC Investments.

\(^\text{11}\) The review process focuses on finding the obstacles to introducing the Stewardship Code and measures to tackle them, taking into consideration the characteristic if the NPS as a financial investor. Ilgye Kim, “NPS studies stewardship code adoption in 2017”, “The Korea Economic Daily”, May 10, 2017.
(2) Future Prospects

Poor corporate governance have been pointed out to be a chronic problem of many Korean companies as this caused South Korea’s historical discount to other Asian markets that have haunted local stocks to be undervalued for decades. Since the Asian Financial Crisis in 1997, a number of measures are taken to improve corporate governance and Korean companies have undoubtedly taken steps to become more shareholder-friendly. Nevertheless, many people still feel that without reforming family-run conglomerates, known as chaebol, chronic poor corporate governance practices would not be completely cured as they have been criticized for ignoring the interests of minority shareholders at best, and corruption, at worst.

The July 2015 merger between Samsung C&T and Cheil Industries\textsuperscript{12} vented the social demand for chaebol reform and improvements in corporate governance standards. Under these circumstances, recent election of President Moon, an advocate of better corporate governance, would definitely bring about in a near future a notable change in corporate culture. As implementation of stewardship code is regarded as a proper step toward achieving the goal\textsuperscript{13}, it is quite likely that sooner or later the government will actively push for the broad adoption of the Korean Stewardship Code by institutional investor. Additionally, Korean companies are expected to form a more shareholder-friendly environment and take various measures to rewarding shareholders.

Further, KCGS is currently considering a free disclosure of the outcome of the proxy-advisory service provided by KCGS to its clients in connection with the major agenda of shareholders meeting such as mergers, appointment of directors and auditors, distribution of dividends and so on.

\textsuperscript{12} It is alleged that this merger was exploited as a tool to implement the management control succession plan solely for the benefit of Lee Jae-yong, the leader of Samsung Group’s ruling family at the expense the minority shareholders.

\textsuperscript{13} Implementation of stewardship code was included in Moon’s presidential election pledge. It should also be noted not a few people are skeptical to such optimism and there is a considerable amount of opposition to the broad implementation of the Code.
If done, this is expected to encourage participation in the Code by the small-and-medium-sized asset management companies which could not afford proxy-advisory services.

V. Final Remarks

The stewardship code was first released in UK in 2010. The Korean Stewardship Code was adopted in Korea December 2017 in form and substance quite similar to that of UK. Both aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship is believed to benefit companies, investors and the economy as a whole.

However, the nature of the problems the stewardship code tries to address in these countries is slightly different. The traditional model of a UK public company is one with widely dispersed share ownership. Where shareholder ownership is widely dispersed, there is a widespread ‘rational apathy’ amongst shareholders. Dispersed ownership, combined with shareholder passivity, leads to a separation of ownership and control of the company, with control substantially residing in the managers. This phenomenon called ‘managerialism’ often leads to so called agency problem, i.e. management would rather avoid the profit maximization objective required by the shareholders in favor of goals of their own. The UK Stewardship Code was adopted against this backdrop. In other words, the social disease UK Stewardship Code mainly aims to cure is the agency problem caused by managerialism in public companies.

The situation in Korea is slightly different. Korean economy is dominated by chaebol. Large blocks of shares are held by chaebol families and their affiliates under cross-holding arrangements and these chaebol related shareholders (the “leading shareholders”) are often in a position to exercise quite direct control over management. Thus, agency problem in its traditional meaning is rather rare in Korean public companies. In most

14 In UK, the percentage of listed company shares in the hands of private investors has declined over the last fifty years or so, from well over 60 per cent in the late 1950s to less than 20 per cent in 2006.
cases, the remaining shares not held by the leading shareholders are widely dispersed and among these minority shareholders, there is widespread ‘rational apathy’ just like UK. So the real problem in Korea is the abuse of shareholder’s influence on the management by these leading shareholders at the expense of minority shareholders. Gains resulting from shareholder activism are generally expensive to produce and it becomes more expensive and difficult if it involves a battle against the leading shareholders. Then, when you win after bearing all these costs and efforts, other shareholders take a free pro rata share in the benefits created. Accordingly it is rational for small retail investors to utilize their ‘exit’ rights rather than ‘voice’ rights if they are unhappy with the direction the company is taking. As a result, even institutional investors have not performed a significant governance role in Korea so far.

There is no doubt that a wide adoption of the Code in Korea will have certain positive effects in enhancing institutional investors’ governance role so as to keep the leading shareholders in check to certain extent. This will lead to an improvement of the corporate governance standard of Korean companies. Still, we should also bear in mind that stewardship code is not a cure-all solution and its efficacy will depend on economic reality which it is to be implemented. Unlike UK where there is no leading shareholder in most public companies, many Korean public companies are actually run by the leading shareholders. This means the disease Korean public companies are suffering from is different from the one UK companies confront. Then, we may need a different medicine to cure our own disease.

Despite many side-effects of chaebol’s dominance, we cannot deny that there are also many advantages of having a leading shareholder actively managing the company. Where there is a leading shareholder engaged in active management of the company, an active shareholder engagement by institutional investors may bring about shareholder vs. shareholder confrontation. When it comes to making an important business judgement, a leading shareholder who has a great stake in the company and put a lot of time and efforts to review and analyze the specific issue in question may be in a better position to make a judgment more fit to the long-term success of the company than institutional investors. Thus, there is a need to ensure that these advantages are not seriously undermined by active shareholder engagement by institutional investors contemplated by the Code. As this is a matter rather unique in Korea, the solution can only be found through our own trial and error while
implementing the Code. So how successful the Code will be still remains to be seen.