

Facilitating Shareholder Engagement in Korea

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The active exercise of shareholder rights requires institutional investors to have their own engagement philosophies, strategies and know-how. As with Japan, collaboration with other shareholders including foreign pension funds (e.g., CalPERS) is necessary for Korean institutional investors to share the relevant philosophies, strategies and know-how, thereby boosting the capital markets. To this end, the following legal and regulatory efforts should be exerted: i) broadening the subject matter categories of shareholder proposals to include ESG issues, ii) enhancing the precatory nature of shareholder proposals, as in the US, to ensure that shareholder proposals take hold as a key tool for market discipline; and iii) rationalizing the proposal exclusion process through regulatory intervention. For proxy advisory firms that are expected to become part of the value chain and wield large influence over the markets, following the adoption of the stewardship code in Korea, investment adviser regulation and stringent conflict of interest regulation should be imposed to ensure that proxy advisers remain independent and have relevant expertise and skills. For nonprofit proxy advisers, it is worth considering the constructive application of the adviser regulation, and the establishment of an independent committee to deliberate on voting recommendations in order to ensure their independence.

Since the adoption of the Stewardship Code, the Korean government has been working on various measures to increase its adoption and acceptance by the market. It reduced legal

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uncertainties over the 5% rule (5% shareholding reporting requirement), use of nonpublic information, return of insider's short swing profit, and collaboration between institutional investors while pressing ahead with the introduction of the stewardship code for public pension funds. Also, it is expected that the National Pension Fund (NPF)'s adoption of the stewardship code will facilitate the exercise of shareholder rights by institutional investors. Learning from experiences or relevant laws and regulations in other countries, Korea has a long way to go before corporate engagement by institutional shareholders takes root. The pressing challenges facing the country are the lack of investor experience in shareholder engagement, the inflexibility of relevant laws and regulations, and the lack of infrastructure, which ensures impartiality as well as expertise and knowledge. This article examines current developments and issues regarding experience accumulation, shareholder proposal regime, and proxy advisory services, with the view that these three are important preconditions for the active exercise of shareholder rights. And it explores possible avenues for improvement.

1. Need to collaborate with overseas pension funds

The introduction of the stewardship code helped Korea establish the legal and regulatory basis for facilitating the exercise of shareholder rights, which is similar to those in developed countries. One remaining issue is the proper exercise of shareholder rights by institutional investors in a way that contributes to the value creation of investee companies in the mid- and long-term, and increases long-term investment returns for their clients. As witnessed in leveraged buyouts (LBO) peaked in the 1980s and shareholder activism by hedge funds over recent years, the exercise of shareholder rights driven by short-termism could undermine a company's long-term value. This means the failure of a fiduciary duty, which goes against the primary purpose of the code. With the aim of encouraging constructive shareholder engagement, the stewardship code embraces shareholder engagement through management-friendly, informal and private measures (e.g., written correspondence, private dialogue with the board of directors or management, and management-friendly shareholder proposals). Unfortunately, however, shareholder rights have never been used in Korea through any of the measures by any institutional investor or even the NPF. Given that, the collection of engagement experiences, strategies and know-how from foreign pension funds would provide some guidance and helps domestic institutional investors develop their own approaches. In the cases of the

US and other advanced countries, the diversification of corporate ownership and the increased ownership portion of institutional investors paved the way for institutional shareholders, mainly pension funds, to accumulate engagement experience in the 1990s. Furthermore, a rapid rise in the number of hostile M&As in the 1980s and hedge funds' shareholder activism in the 2000s also enabled institutional investors to engage in a broad spectrum of shareholder activities both friendly and hostile.

Public pension funds such as CalPERS have gained their engagement experience through informal private dialogues and shareholder coalitions, rather than formal shareholder proposals. Private pension funds have been more active in making shareholder proposals in collaboration with labor unions, instead of relying on private dialogue. Mutual funds, which are said to take a rather passive approach to exercising their shareholder rights, have actively engaged with investee companies by supporting pension funds' shareholder engagement or working with them since the global financial crisis. In terms of subject matters that shareholder proposals deal with, public pension funds and defined benefit (DB) pensions have superior experience and know-how on social or environmental issues, mutual funds on corporate governance matters, and hedge funds on financial or management strategies.

Overseas institutional investors: characteristics of shareholder engagement policies

Investor type	Key engagement tools	shareholder proposal matters
Public pension funds	Private dialogue, shareholder proposal, coalition, and litigation	Environmental, social and governance (ESG) issues
Private pension funds (DB)	Shareholder proposal, coalition, and private dialogue	ESG issues
Mutual funds (incl. DC)	Exercise of voting rights, coalition, and private dialogue	Governance issues
Hedge funds	Campaign, proxy contest, shareholder proposal, and litigation	Financial and corporate strategies, and governance issues

Note: DC refers to defined contribution pension plan.

Japan affords the best example of how to overcome the lack of experience in shareholder activities through coalition with overseas pension funds. Japan launched the Japan Stewardship Code in 2014, and successfully induced CalPERS to sign Japan's stewardship code in 2015. CalPERS whose exposure to Japan represents 9.9% of its total equity assets (reaching USD 72.7

billion) touted its adoption of Japan's stewardship code as an exemplary case of international collaborative shareholder engagement. CalPERS also extended the US "focus list" of targeted firms to Japanese firms. The public fund implemented "Japan Board Independence Initiative" for more than eight Japanese firms selected as part of the Focus List program. CalPERS expressed concerns over the lack of outside directors (i.e., board independence) at Japanese firms. In collaboration with other institutional investors, it strongly recommended that at least one-third of board members at Japanese firms should be outside directors. The public pension fund has reportedly voted against or engaged informally with companies without any independent director, for example, through written correspondence.

Breakdown of CalPERS's equity holdings in major countries (at June-end, 2015)

	Exposure as % of total	Market value (in billions of USD)
US	50.2	72.7
Japan	9.9	14.3
UK	6.9	10
Canada	3.3	4.7
France	3.0	4.4
Germany	2.9	4.3
Australia	2.0	3.0
Korea	1.7	2.5

Source: CalPERS

Korea should also proactively encourage CalPERS to sign up with Korea's Stewardship Code. The Focus List Program, which becomes synonymous with CalPERS's shareholder engagement policy, is the most widely known investment strategy linked to shareholder rights, which seeks to beat the market through constructive dialogue and consideration of non-financial factors including environmental, social, and governance (ESG) issues. Since there are a number of legal constraints on the Korean shareholder proposal regime, shareholder engagement through proposals would likely take place limitedly in Korea. Consequently, much attention will be drawn to CalPERS's investment strategy that pursues engagement on ESG issues through informal private dialogue with investee firms. Korea needs to actively induce national wealth funds and large pension funds as well as CalPERS whose exposure to Korea makes up nearly 1.7% of total equity investments, to adopt the Korean stewardship code. In addition, foreign pension funds

may fill the role of the NPF that cannot play in collaboration between institutional investors. The NPF owned 5% or more stake in many companies (approximately 35% of the total) as of 2016. This indicates that other institutional investors have little incentives to work with the NPF because of reporting burden and likely revelation of their investment strategies to the NPF, arising from share co-ownership. Moreover, the 5% rule would likely limit NPF to engage with companies through written correspondence or private dialogue when exercising its ownership rights. It is also not easy for the NPF to make a shareholder proposal. These circumstances greatly incentivize domestic institutional investors to work with foreign pension funds, which would enable them to share and accumulate experience and know-how on the exercise of shareholder rights.

2. Need to improve the shareholder proposal regime

The lack of flexibility in the shareholder proposal regime prescribed under the Commercial Act will become the biggest hindrance to promoting the exercise of shareholder rights by institutional investors to the US level. There are three possible avenues for improvement. First, the current shareholder proposal regime restricts the diversity of subject matters. The Commercial Act limits the scope of shareholder proposals to the matters described in the Commercial Act or a company's articles of incorporation. In such a case, shareholder proposals can hardly deal with matters relating to business strategies, or environmental or social issues, except corporate governance issues. The shareholder proposal regime under the Commercial Act contradicts the stewardship code, which incorporates ESG issues into the scope of shareholder engagement.

The shareholder proposal regime plays a critical role in making various means of constructive shareholder engagement more effective. Experience from other countries indicates that the shareholder proposal regime itself is important, and further affects the effectiveness of informal engagement such as private dialogue. A shareholder proposal is formal and legally binding, which may weigh heavily on the reputation of a company depending on the matter that the proposal deals with. The company thus prefers to address the issue raised through dialogue with its shareholder before the proposal is submitted or elevated to the general meeting of shareholders. In the US, as a result, roughly 30% of shareholder proposals are withdrawn before the general meeting after companies agree to tackle the issues raised by the proposal through

dialogue. Simply put, a well-designed regime for shareholder proposals enables constructive and effective shareholder engagement, for instance, through private dialogue. In this regard, Korea needs to improve the relevant legal and regulatory frameworks in order to broaden the subject matter categories of proposals. In the US, any subject matter can be submitted as a proposal unless the proposal falls into one of the 13 substantive bases for exclusion. In particular, shareholder proposals can touch on any issue that impacts a company's business operations generating more than 5% of total revenue.

Another area for improvement is the legal nature of shareholder proposals. The key lies in whether shareholder resolutions are binding or precatory (non-binding) on the company and its management. Shareholder proposals are precatory in the US, but they are binding in the UK. Also in Korea, shareholder proposals are legally binding. What is at issue is which regime is more desirable and useful in facilitating the exercise of shareholder rights and enhancing the effectiveness of shareholder rights as a tool for market discipline. A study¹⁾ found that despite the same legal tradition shared by the US and UK, precatory shareholder engagement in the US is far more active than binding one in the UK.²⁾ Such precatory nature of shareholder proposals has implications for Korea in which the exercise of shareholder rights by institutional investors is usually considered intervention in an investee firm's operations. When shareholder proposals are not legally binding but precatory in nature, they are more likely to be seen as business advice, not intervention, by companies. Especially, strengthening the precatory nature of shareholder proposals is an option worth considering in order to alleviate criticism towards the NPF that its exercise of shareholder rights is intervention in corporate management. At present, many agree that the independence of the NPF's governance from the government should be an integral part of institutional efforts to ameliorate the controversy over the intervention. However, precatory shareholder proposals could weaken concerns over the intervention issue arising from the NPF's shareholder engagement. It is necessary to consider allowing shareholder proposals of a precatory nature to be made, on top of the efforts to diversify shareholder proposal matters.

1) Bonnie Buchanan, Jeffry M. Netter, Annette B. Poulsen, Tina Yang (2009), Shareholder Proposal Rules and Practice: Evidence from a Comparison of the US and UK.

2) Of course, a shareholder resolution is treated as a legally binding decision in the US when a shareholder brings an unfriendly proposal to a shareholder vote for director appointment or other matters at his or her own expense, as seen in shareholder activism by hedge funds. In the US, even precatory shareholder proposals put heavy pressure on companies in that they may face persistent demand and litigation from shareholders if they do not adopt the proposals. Accordingly, precatory shareholder proposals as a means of disciplining the management may be just as effective as binding proposals.

Third, it is required to clarify exceptions allowing a company to exclude shareholder proposals from its proxy materials for a general meeting of shareholders, and to prevent the abuse of the exceptions. Compared to the 13 exceptions in the US, exceptions are not clearly defined in Korea. Furthermore, if the company excludes a shareholder proposal from its proxy materials, with the view that the proposal meets requirements for exclusion, the exclusion process should be transparent. As for the US, if the company intends to exclude a proposal from its proxy statement, it must submit its no-action request to the Securities Exchange Commission (SEC) no later than 80 calendar days before its general meeting is held, and also to the shareholder who has submitted the proposal. Then, the shareholder may decide whether to accept it or appeal. Both of the shareholder and the company are allowed to file their reasons with the SEC. If the company intends to make and file counterarguments, it must notify the shareholder of such intent no later than 30 calendar days before it files its statement in opposition. Such procedural transparency enables the shareholder proposal regime in the US to be used as a highly effective means for shareholders to exercise their rights by raising their voice actively and impartially to their investee companies.

3. Tightening proxy adviser regulation

The influence of proxy advisers has been growing, along with active shareholder engagement since the global financial crisis. Accordingly, demand for impartiality and independence of proxy advisers is also increasing. Many studies on the extent of their influence conclude that proxy advisers' advice has a meaningful influence on the way in which votes are cast.

There are two main regulatory approaches to proxy advisers discussed in the US. One is to apply the proxy solicitation rules to proxy advisory firms, and the other is to tighten the investment adviser regulation and impose stronger supervision. The first approach is that proxy advisory firms should be subject to the proxy solicitation rules, requiring that proxy advisers engaging in a proxy solicitation publicly disclose this activity to the SEC and general shareholders. Currently, proxy advisory firms are exempt from the filing and disclosure requirements of Rule 14(a)-2(b)(1) under the Securities Exchange Act when they do not seek a power to act as a proxy during their solicitation (communication). When proxy advisers become subject to the filing and disclosure requirements of the proxy rules without this exemption, they must file substantial information on their voting recommendations with the SEC, which would boost

the transparency and accuracy of proxy advisers' advice, and make the advice be free from conflicts of interest. The second regulatory approach is to strengthen the investment adviser regulation. The SEC has been taking this approach, bolstering regulation and supervision of proxy advisers since the global financial crisis. Proxy advisory firms in the US are regulated as investment advisers under the Investment Advisers Act because of their business nature. While proxy solicitation is regulated by the Securities and Exchange Act of 1934, the furnishing of proxy voting advice is governed by the Investment Advisers Act of 1934. Even if a proxy advisory firm is not registered as an investment adviser, it must abide by antifraud provisions of the Investment Advisers Act because proxy voting advice is considered the same as investment advisory service in light of its economic nature.

Current state of US regulation over proxy advisory firms (as of 2016)

Proxy adviser	Registration [Y/N]	Registered as
ISS	Y	Investment adviser
Glass Lewis	N	-
Egan-Jones	Y	Credit rating agency
Marco Consulting	Y	Investment adviser
ProxyVote Plus	Y	Investment adviser

The SEC tightened the regulation of proxy advisory firms in 2014, with a particular focus on conflicts of interest. The tougher regulation requires a proxy adviser to better disclose potential conflicts of interest, provided that the proxy adviser renders proxy advisory services to institutional investors while at the same time providing consulting services to corporate issuers in relation to proxy matters, or that any majority shareholder or executive of the proxy advisory firm also serves on the board of directors of its client company. Proxy advisory firms should disclose any material interest or significant relationships with institutional investors or companies, with sufficient information about policies and procedures regarding conflicts of interest to enable stakeholders understand the nature and scope of the conflict. Proxy advisers are also required to disclose a detailed and reasoned explanation for what they base their voting recommendations on.

Many institutional investors in Korea are also highly likely to use proxy advisory firms while they implement the stewardship code. To ensure that proxy advisers have their relevant



expertise and independence, they should be regulated as investment advisers given the nature of their business. Furthermore, proxy advisory firms should be subject to more stringent conflict of interest regulation and expertise requirements than investment advisory firms. As regards nonprofit advisory firms that cannot be registered as investment advisers due to their economic nature, the constructive application of the investment adviser regulation, as in the US, is worth considering. What is more, the problem of fairness or independence can arise from their corporate governance attributes. This warrants a different regulatory approach to nonprofit proxy advisers, for example, by establishing an independent committee to deliberate on voting recommendations.