Tasks for Effective Application of Stewardship Code in Korea

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Summary: In a bid to strengthen institutional investors' fiduciary duty and urge more active engagement as shareholders, Stewardship Code was introduced in Korea last year, and it is poised to be adopted by many institutional investors including National Pension Fund. However, obstacles to its effective application abound, including complex ownership structure and business relationships of companies, conflicts of interest among different shareholders, weak binding power of the Code, legal uncertainties over institutional investors' collective action and engagement. These would need to be resolved or mitigated with greater policy efforts to ensure effective implementation of Stewardship Code in Korea.

Stewardship Code was first established in the UK 2010 amid a recognition that institutional investors, as major shareholders of companies, had to act more responsibly and proactively during the time of the global financial crisis. Recently, many Asian countries have enacted similar codes including Japan, Hong Kong, and Taiwan; in Japan, it was introduced in 2014 as part of governance reform efforts under the Abenomics. In Korea, Stewardship Code was introduced for institutional investors last year, and its application has expanded to eight asset management companies this year, and expected to be adopted by more companies—a plan for introduction has been submitted by 46 asset management companies (possibly three more), two insurance firms, one (or possibly two) investment advisory firms, three securities firms, and one bank. The list might get longer as the National Pension Fund also decided to adopt the Code recently. Its adoption has been encouraged because it is expected to facilitate companies' growth and long-term profitability by encouraging institutional investors to engage in business management more actively—e.g. through a practice of voting rights—and pay greater attention to enhancing corporate value. The Code is also expected to contribute to increasing stock values by improving governance structure of the companies and raising dividend yield ratio.

However, it needs to be noted that a mere introduction of Stewardship Code would hardly help to enhance corporate or shareholder values. As Tirole (2006) pointed out, institutional investors are also exposed to an agent problem as their interests could conflict with ultimate beneficiaries. It would always remain a challenging task to decide whose interests should be primarily served in making decisions. Moreover institutional investors might be reluctant to actively participate if they are pursuing short-term profits, or biased heavily toward passive investment or extensively diversified investment, or if a company has a complex ownership structure like funds of funds. Meanwhile, few empirical research have been conducted on the effect of Stewardship Code of UK. One of the most widely quoted cases in discussing the effect of institutional investors' engagement is CalPERS (California Public Employees' Retirement System), and even studies on this case have produced a mixed result regarding excess returns of companies in the "Focus List."

Other barriers to effective implementation of Stewardship Code in Korea include the followings. First, domestic institutional investors are hardly free from influence of large conglomerates or holding companies due to a complex ownership structure and business relationships, and thus might not be able to practice voting right in an unbiased manner. Even if there are independent institutional investors in terms of ownership structure, their volume is too small to have a significant influence. Noting this, the domestic Stewardship Code urges institutional investors to disclose their policies on different cases of conflicts of interests, but unless they step forward voluntarily, it is hard to thoroughly grasp complex ownership structures and business relationships of involved companies that might dampen institutional investors' independent decision-making and actions.

Second, regarding the expected adoption of the Code by the National Pension Fund, the fund may be relatively free from the binds of competition, ownership or business relationships, but at the same time, it might trigger both "shareholder activism" and "social activism." It needs to be noted that, in case of CalPERS, some criticized that its "Focus List" sparked social activism that compromised interests of ultimate investors.

Third, another important issue is who enacts and applies Stewardship Code. the private self-regulation may lack the enforcibility. For instance, the UK where began with the private self-regulation system has moved to the regulator-led system as the concern for its effectiveness and enforcibility has arisen. However, as in US where the mega asset management firms such as Blackrock or Vanguard actively participates, the private self-regulation system may work effectively. In Korea, large foreign institutional investors might be able to play this role as active shareholders given their relatively independent status, but then, such actions might be met with public resistance.

The party that enacts and applies the stewardship codes may also be an important factor to consider where the private self-regulation may lack the forcibility. For instance, England where began with the private self-regulation system has gradually moved to the regulator-led system as the concern for its effectiveness and forcibility has arisen. the However, as in US where the mega asset management firms such as Blackrock or Vanguard actively participates, the private self-regulation system may work effectively.

Fourth, to promote influence of institutional investors, Kay Review (2012) in the UK recommends foaming investor forums this is also reflected in the Korean Stewardship Code—but such activity could possibly collide with a regulatory framework that restricts shareholders' collective action or engagement for takeover protection. (Note: For this reason, Japan's Stewardship Code excludes recommendation on institutional investors' collective engagement.)

Lastly, proxy services are broadly used by foreign institutional investors abroad for analyzing shareholder voting agendas, but the domestic market for the service remains in a nascent stage in Korea. Its global market is currently dominated by a few firms—e.g., ISS, Glass-Lewis—whose service greatly affects outcomes of shareholder meetings. Due to the mono·oligopolistic supply by a few firms, some raise concerns over the inaccuracy or the bias of the analysis because of conflict of interest from providing other services to the firm they analyze. Noting such concern, a bill was proposed in the US in 2016 to step up regulations on proxy advisory firms.

As for the institutional investors' engagement in companies in Korea, data on voting by about 90 domestic institutional investors throughout 2016 (1,687 individual reporting cases plus 78 collective reporting cases) showed quite passive in engagement and action. Among 27 institutional investors who have cast an objecting vote once at least, most of them were foreign asset management companies or independent asset management companies if domestic.

Given this, the following tasks need to be tackled to ensure effectiveness of Stewardship Code in Korea. First, disclosure requirements may be strengthened to provide greater information on the ownership structure and business relationships of the companies, and the reason for practicing or forgoing voting rights by institutional investors. Second, greater efforts are needed to form a competitive market for proxy advisory services within the country. Third, the supervisory authority needs to play a stronger role in adopting and managing Stewardship Code, as private-sector efforts and the 'comply or explain' basis may be too weak to ensure its effectiveness. In this regard, 'tiering of signatories' in the UK may provide a useful reference whereby the supervisory authority periodically assesses the quality of the Code statements.