CORPORATE GOVERNANCE PRINCIPLES

South Korea

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HERMES
INVESTMENT MANAGEMENT

COMPANY PURPOSE AND HERMES RESPONSIBLE OWNERSHIP PRINCIPLES

Companies aim to provide goods and services for customers and society at a competitive quality and price. This can only be achieved sustainably if they create and preserve value over time, not only for their shareholders but also for stakeholders, society and the environment. Our expectation, therefore, is that companies should be run not only for shareholders, but should also have a wider purpose that benefits society. In turn, this supports the needs of savers and pensioners, who rely on sustainable returns from their investments, to provide them and their families with a secure future.

This document should be read in conjunction with the Hermes Responsible Ownership Principles.1 They provide our views on corporate purpose and other issues that we believe are important for companies globally.

IMPLEMENTATION OF THE KOREA STEWARDSHIP CODE

We welcomed the launch of the Korea Stewardship Code in December 2016 and the publication of a list of Korean signatories to the code. In particular, we welcome the commitment to adopt the Code by key asset owners in South Korea, such as the National Pension Service and the Korea Investment Corporation. We encourage public companies in Korea to work closely with asset owners and fund managers to comply with both the spirit and practice of the code. Along with an increasing number of international investors and shareholder representatives, we support the implementation of the Code and the development of global best practice. This includes leveraging our significant stewardship experience around the world.

CORPORATE STRUCTURE

Korea is well known for its chaebols, family-controlled conglomerates which were established after the Korean War. They were instrumental to the rapid industrialisation of the country and its economic growth in the post-war era. Chaebols generally have a circular and interlocking ownership structure, which is still controlled by their founding families. We welcome initiatives from companies to simplify these structures and to engage more actively with minority shareholders. Although some chaebols have committed to increasing the independence of their boards and strengthening the role of their non-executive directors, much more needs to be done to improve corporate governance standards in Korea.

BOARD COMPOSITION AND EFFECTIVENESS

To improve board effectiveness, we encourage Korean companies to take concrete steps to evaluate the composition of their boards and their performance. This involves a number of actions, including but not limited to the following:

- Conducting an annual board evaluation to identify the attributes needed on the board, skill gaps and areas for improvement in board performance. At least every three years, this evaluation should be assisted by a credible, independent third party facilitator.
- Creating a policy on board diversity with a published plan on its development and implementation with targets.
- Developing a comprehensive programme for continuous dialogue between investors and independent non-executive directors on these and other governance-related matters.

We expect Korean companies to regularly assess the effectiveness of their boards to ensure that directors with a suitable mix of skills, experience and tenures work together optimally for the long-term benefit of shareholders, including for minority shareholders. As Korean boards are among the least gender diverse in major markets, we strongly encourage companies to appoint at least one woman to the board. Noting the global efforts to improve gender equality and emerging initiatives to promote wgreater female equality in other Asian countries, we plan to incorporate gender diversity in our voting policy for Korea. For companies that seek to grow internationally or depend on foreign markets, we expect board composition, also to reflect the geographical footprint of the business. Many independent directors on the boards of Korean companies have academic and local government backgrounds and we respect their experience. However, particularly as companies grow beyond their home market, we recommend that boards select their independent director candidates from a wider pool, with a focus on those with senior business experience including at non-Korean companies. We particularly welcome openness to the idea of minority shareholders nominating director candidates, although we expect them to go through the same robust selection process as other candidates.

We regard directors sitting on the boards of more than five listed companies as over-committed and unlikely to be able to play the role we expect of non-executive directors. Unless a company can demonstrate how any such individual is able to manage this workload or the director can explain how he or she is improving governance, we will recommend voting against the election of over-committed directors.

The Korean Commercial Act requires audit and nomination committees to be majority independent for companies whose assets exceed KRW 2 trillion. We recommend that the audit committee consists solely of independent directors, irrespective of the size of the company. We also advocate complete independence for the nomination committee and suggest that companies consider applying the same level of independence to remuneration committees, in line with global best practice. In addition, we urge companies to publish the board's and each committee's terms of reference to clarify their functions and responsibilities.

[1] https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2018/03/final-responsible-ownership-principles-2018.pdf

The positions of chair and CEO should be separated. An executive chair should be independent upon appointment and the company should explain where this is not the case. In cases where the roles of chair and CEO are combined or where there is a non-independent chair, we expect a strong lead independent director to be in place who can successfully organise the independent directors to act as a counterweight to management and large shareholders. The lead independent director should also be available to meet shareholders if they have governance concerns.

Efficient capital management

Companies should prudently manage their capital. They should aim to maximise long-term corporate value by implementing rigorous financial and strategic discipline. Optimal capital structure is different for each company and a decision for each board. However, we note that some Korean companies hold substantial cash balances for a considerable period of time, without providing a solid strategic plan or sufficient explanation for the use of this shareholder capital. Therefore, we expect companies to discuss their capital allocation with shareholders and justify the use of free cash. We expect more transparency on mergers and acquisitions, share buybacks, share cancellation programmes and dividend policies. Management should be able to explain the company's capital policy, demonstrating its strategy for using capital efficiently to create economic value and achieve sustainable growth.

Treasury shares are another concern for us. We acknowledge that the ability to move shares in and out of treasury may give companies greater flexibility in managing their share capital, especially for potential merger and acquisition opportunities. However, we are aware of the risk of conflict of interest and dilution that may harm the interests of minority shareholders if the company decides to release these treasury shares. This is particularly the case for companies that have controlling shareholders. We therefore recommend that companies cancel shares after a buyback.

Disclosure in English

With foreign investors increasingly participating in the Korean market, we welcome the decision by the Korean Stock Exchange (KRX) to encourage disclosure of important corporate and financial information in English as well as in Korean, thus allowing equal access to information for all investors. We expect companies to comply with this requirement and publish material in English at the same time as disclosure in Korean. We also encourage those companies not mandated to comply with the KRX's rules to follow the recommendation to disclose in English, to create a level playing field for all investors.

Annual General Meetings and reference materials

Listed companies are required to submit their annual reports to the Financial Supervisory Commission (FSC) and the KRX within 90 days of the end of their fiscal year, which, in most cases, falls on 31 March. The annual reports must include the audited financial statements approved by shareholders at AGMs, which tend to be held before the end of March, leading to a high concentration of meetings in a short period of time. We would like to see companies provide timely disclosure of audited financial statements and other reference documents well in advance of the AGM.

Bundled elections

A number of Korean companies continue to bundle the election of multiple directors under one proposal.
We strongly oppose bundled elections, because shareholders are forced to vote for or against a group of directors. We may have to oppose all the director candidates even if we have doubts about only one of them, which is unfair to both director candidates and shareholders. The power to elect directors is the most important shareholder right and shareholders should be able to vote on each director individually, taking account of his or her independence, skills, experience and performance.

Remuneration

In Korea, shareholders can approve the aggregate amount of fees to be paid to directors as remuneration for their services. The board has full discretion to allocate the amount among the board members. We encourage Korean companies to disclose details of their remuneration structure to ensure that remuneration schemes align management with strategic objectives, key drivers of business performance, long-term value creation, and important stakeholders. Following on from our pay principles[2], our current thinking on executive pay in Korea can be summarised as follows:

Simplicity: pay schemes should be clear and understandable for investors as well as executives. Pay structures should be simple, for example taking the form of a single incentive scheme and not be as leveraged as in many international markets.

Shareholding: the executive management team should make material investments in the company's shares and become long-term stakeholders in the company's success. Significant shareholding requirements for directors should remain in place for a specific period of time following departure from the company, with no share sales allowed for at least one year.

Alignment and quantum: pay should be aligned to the long-term success of the company and the desired corporate culture, and is likely to be best achieved through long-term share ownership. Pay can sometimes be too high, which may not be in line with many shareholders' and other stakeholders' views of performance. Boards should be able to justify to investors, the workforce and the public the rationale for the CEO's and the most senior management's pay, taking account of the pay of the wider workforce. Remuneration reports must explain how alignment with long-term shareholders is achieved.

[2] https://www.hermes-investment.com/wp-content/uploads/2017/09/Remuneration-Principles-Clarifying-Expectations.pdf

Accountability: the remuneration committee should ensure that pay properly reflects business performance and that pay reflects outcomes for long-term investors. The remuneration committee should take a robust view on pay, using their judgement and being accountable for their decisions. The potential outcomes of a pay policy should be rigorously scenario tested with a cap on the total possible pay published in advance, to help reduce the risk of unintended consequences.

Stewardship: companies and investors should regularly discuss strategy, long-term performance and the link to executive remuneration. Executives should be encouraged to achieve strategic goals and take account of the company's effect on key stakeholders.

We expect senior executives to willingly embrace these principles and, if they do not, for boards to consider the implications. Remuneration committees must take responsibility for the design, disclosure and dialogue on executive pay and we will hold them accountable for this.

SOCIAL, ETHICAL AND ENVIRONMENTAL RESPONSIBILITY

Companies should effectively manage environmental and social factors that are relevant to their business, with a view to enhancing long-term sustainability. They should also disclose to shareholders on a regular basis how they identify and manage the relevant risks and provide evidence that these structures are effective. In addition, companies should clearly define board and senior management responsibilities for environmental and social issues. We believe that directors of companies are accountable to shareholders for the management of social, ethical and environmental risks and opportunities in the same way that they are accountable for the company's financial performance.

Ethical leadership

We expect companies to have best practice anti-corruption and anti-bribery policies and processes in place and robust compliance mechanisms to enforce them. However, these are not enough on their own. We expect the board to oversee the anti-bribery and corruption controls and – just as importantly – to set the tone from the top, to encourage the highest ethical standards, to drive the expectations and values of the organisation. This is to ensure that the culture is one in which corruption cannot thrive, and that the necessary organisational measures exist to provide the best possible defence against corruption. We therefore seek to engage with companies where we judge the culture and values to be lacking or the effective oversight, management of, or reporting on anti-bribery and corruption to be insufficient.

Climate change

Climate change is a systemic risk to the value of the portfolios of our clients because of its economic and geopolitical consequences. We therefore support the goal of the 2015 Paris Agreement, which 195 countries signed up to, to limit global warming as a result of climate change, to well below 2°C. This historic commitment was helped by the intervention of companies globally, which publicly encouraged political action in the run-up to the Agreement.

Because of the systemic risk to the global economy, we expect every company to publicly support the Paris Agreement and to make this commitment a central tenet of its public policy and sustainability activity. In particular for companies whose value chain relies on significant energy usage or is exposed to the effects of climate change, the board should ensure that support for the Paris Agreement underpins the company's strategy. Every board should ensure that it has climate change on its board meeting schedules at least annually, and that it and senior management engage with experts who can advise them on the strategic risks and opportunities that climate change represents, and challenge the company's approach, if necessary.

We understand that companies may have different views on climate change from organisations of which they are members or from other organisations which they may be able to influence. Every board should make sure that the company uses all available avenues to influence these third parties, to encourage effective action on climate change in line with the Paris Agreement. Where a company and one of these third parties disagree on climate change, the company should explain publicly the action it has taken to argue for effective advocacy or action on climate change by that third party. It should also explain its reasons for continued participation in, funding or membership of the organisation despite this disagreement.

Task Force on Climate-related Financial Disclosures

We welcome the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures. We expect companies to adopt the recommendations in full. Companies should conduct scenario analysis to assess future transition and physical risks which will be brought about by climate change. As part of this scenario analysis, they should also identify and discuss their strategic options for a net zero emission world. In addition, we expect companies, especially those in sectors where climate risks are most material, to demonstrate clearly that they are managing both their current and possible future risks effectively. Furthermore, we expect companies to report on the opportunities presented by climate change. For instance, companies in the financial sector should report how they will help to finance the energy transition.

Human rights

Licences to operate are increasingly affected by the reputation of companies, including their performance on human rights. We support the UN Guiding Principles on Business and Human Rights and the UN Global Compact. We expect companies to use the reporting framework of the Guiding Principles to disclose how they manage human rights issues that are salient to their business.

Korea has a strong tradition of labour unions. They protect the rights of workers but, at times, can also present challenges for companies, especially when they are changing their business models or product requirements, or are responding to changing customer preferences. We therefore recommend that companies constructively manage their employee relations, provide a platform for regular dialogue and ensure union leaders have the opportunity to express the concerns of workers in a timely manner. Where appropriate, companies should involve shareholders in stakeholder discussions relating to labour practices. Companies should also leverage their influence within their supply chains to ensure that they are also committed to human rights best practice.

UN Sustainable Development Goals

We expect companies to assess the relevance of each UN Sustainable Development Goal (SDG) to their business and to consider how best to incorporate those that may be material into their business models and strategies. We encourage companies to report on how they support the SDGs and to engage with civil society to find out how best to respond to them.

Tax

We expect companies to:

- comply with all tax laws and regulations in all countries of operation;
- recognise the importance of taxation to the funding of good public services, on which they and their stakeholders rely, and the importance of their commitment to pay their fair contribution;
- ensure that their tax policies and practices do not damage their social licence to operate in all jurisdictions in which they have a presence; and
- disclose the taxes paid by or collected by them in each country.

HERMES
INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

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