Korea Corporate Governance Service

# Proxy Review (2012 ~ 2018)

December 26, 2018
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## BACKGROUND

The Korea Corporate Governance Service (KCGS) has provided proxy advisory service since 2012 to help institutional investors make effective voting decisions. The subject report is prepared to provide a high-level summary of the proxy review the KCGS offered over the years, shedding light on a variety of cases to which investors need to pay heed. The report also aims to share desirable governance practices that are promoted by the agency's proxy voting guidelines, as a good reference point for capital market participants.

## DATA SOURCES

This summary report is based on the database of the KCGS's affirmative and negative vote recommendations issued in its proxy reports dating back to 2012. Readers are advised to take notice of the fact that companies and the KCGS differ in the way of counting the number of agenda items. That is, a company may have brought to the annual general meeting several agenda items bundled in a single proposal, but the KCGS looked at each individual item separately. For example, although a company put to a vote a slate of three director candidates in proposal no. 3, the agency issued an affirmative or negative vote recommendation against each of the three individual candidates. For this reason, the total number of proposals tabled by the companies may not match that of the proposals reviewed by the KCGS.

| | Companies | KCGS |
|---|---|---|
| Proposals tabled to AGMs | Proposal 2. Election of directors<br>Director nominee ○○○<br>Director nominee □□□<br>Director nominee △△△ | Proposal 2. Election of directors<br>2-1 Director nominee ○○○<br>2-2 Director nominee □□□<br>2-3 Director nominee △△△ |
| Proposals tallied(#) | 1 | 3 |

## PROXY REVIEW SUMMARY FOR 2012 ~ MARCH 2018

For the last seven years, the KCGS reviewed a total of 15,036 proposals tabled to 2,176 general meetings of shareholders held by 2,037 companies. As an annual average, the agency recommended voting against 17.3% of the proposals, and the rate remained steady over the years.

<Table 1> Proxy review details for 2012 ~ March 2018

| | | | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018[1] |
|---|---|---|---|---|---|---|---|---|---|
| Total | | Companies (#) | 237 | 394 | 396 | 283 | 237 | 253 | 237 |
| | | AGMs (#) | 237 | 399 | 448 | 316 | 267 | 272 | 237 |
| | | Proposals (#) | 1,892 | 2,856 | 3,030 | 2,003 | 1,747 | 1,902 | 1,606 |
| | | Against (%) | 18.2% | 16.4% | 18.7% | 17.6% | 18.2% | 18.1% | 14.1% |
| Financial statements | | Proposals (#) | 244 | 407 | 405 | 292 | 244 | 259 | 242 |
| | | Against (%) | 0.8% | 0.7% | 2.5% | 4.5% | 3.7% | 3.1% | 2.1% |
| Articles of incorporation | | Proposals (#) | 190 | 215 | 212 | 127 | 142 | 124 | 92 |
| | | Against (%) | 41.6% | 16.7% | 11.8% | 19.7% | 18.3% | 8.9% | 13.0% |
| Executives | | Executives total | 1,101 | 1,620 | 1,759 | 1,127 | 1,000 | 1,096 | 882 |
| | | Against (%) | 22.1% | 24.6% | 26.5% | 24.8% | 25.4% | 26.5% | 20.0% |
| | Directors | Directors total | 804 | 1,179 | 1,275 | 835 | 725 | 750 | 648 |
| | | Against (%) | 17.7% | 19.6% | 19.4% | 18.8% | 19.9% | 20.8% | 16.7% |
| | | Inside directors | 371 | 526 | 583 | 375 | 319 | 334 | 298 |
| | | Against (%) | 3.2% | 3.4% | 4.3% | 5.3% | 6.3% | 4.5% | 4.7% |
| | | Directors not engaged in regular business | 38 | 72 | 101 | 66 | 44 | 55 | 37 |
| | | Against (%) | 7.9% | 5.6% | 3.0% | 3.0% | 4.5% | 1.8% | 0.0% |
| | | Outside directors | 395 | 581 | 591 | 394 | 362 | 361 | 313 |
| | | Against (%) | 32.2% | 36.0% | 37.1% | 34.3% | 33.7% | 38.8% | 30.0% |
| | Auditing body | Auditing body total | 297 | 441 | 484 | 292 | 275 | 346 | 234 |
| | | Against (%) | 34.0% | 38.1% | 45.5% | 41.8% | 40.0% | 38.7% | 29.1% |
| | | Audit committee members | 268 | 362 | 403 | 258 | 246 | 307 | 208 |
| | | Against (%) | 32.1% | 39.0% | 42.7% | 40.7% | 40.2% | 38.8% | 28.4% |
| | | (Non-)standing auditor | 29 | 79 | 81 | 34 | 29 | 39 | 26 |
| | | Against (%) | 51.7% | 34.2% | 59.3% | 50.0% | 37.9% | 38.5% | 34.6% |
| Remuneration cap | | Proposals (#) | 312 | 562 | 555 | 397 | 315 | 342 | 327 |
| | | Against (%) | 2.9% | 1.6% | 4.1% | 3.0% | 3.8% | 2.6% | 1.5% |
| Stock options | | Proposals (#) | 12 | 15 | 24 | 18 | 15 | 25 | 35 |
| | | Against (%) | 91.7% | 86.7% | 83.3% | 94.4% | 86.7% | 60.0% | 71.4% |
| Executive severance pay policy | | Proposals (#) | 22 | 17 | 38 | 24 | 17 | 29 | 17 |
| | | Against (%) | 0.0% | 29.4% | 39.5% | 20.8% | 23.5% | 20.7% | 17.6% |
| Merger, etc[2] | | Proposals (#) | 1 | 10 | 24 | 11 | 7 | 14 | 1 |
| | | Against (%) | 0.0% | 30.0% | 4.2% | 9.1% | 0.0% | 35.7% | 0.0% |
| Others[3] | | Proposals (#) | 10 | 10 | 13 | 7 | 7 | 13 | 10 |
| | | Against (%) | 0.0% | 10.0% | 38.5% | 0.0% | 0.0% | 7.7% | 10.0% |

[1] Due to shareholder proposals, the data above have a discrepancy with the figures distributed in April 2018「Proxy Review of Q1 2018 Annual General Meetings」.

[2] "Merger, etc." include mergers, divisions, and transfers of business and/or assets.

[3] "Others" include capital reduction/increase, stock split, dismissal of directors, conditional de-listing, and reduction in reserve funds.

## Financial Statements and Dividends

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**KCGS Proxy Voting Guidelines**

IV-1.1 **(Adoption of Financial Statements)** We recommend voting AGAINST proposals of adopting a financial statement if it failed to receive a 'qualified' opinion from an external auditor.

IV-3.1 **(Dividend Payout)** We recommend voting FOR proposals of paying dividends on condition that the payout value is not too low or high to destroy shareholder value in full consideration of the profit size, financial position and investment plan of the company, and the payout level of the industry peer groups.

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Dividends serve as a way of returning profits to investors and a corporate governance tool that deters agency costs by reducing surplus cash flows in the company. Under the Commercial Act of Korea, financial statements are subject to approval by a general shareholder meeting. With the amendment to the Act in 2011, a board may resolve to adopt the financial statements without general shareholders' approval if certain requirements are met[1].

Over the period of 2012 through March 2018, the KCGS reviewed 2,093 proposals covering financial statements and dividend payouts, which accounted for 13.9% of the total proposals reviewed (15,036 proposals). Out of these proposals, 77 were tabled for reporting purposes but the agency issued an affirmative or negative vote recommendation against them as well. Thus, the figures below include the agenda items for reporting purposes only.

1) 1. That an external auditor presents an opinion that each of the documents listed in Article 447 appropriately represents the company's financial conditions and performance of management in accordance with statutes and the articles of incorporation; 2. That all the auditors (in cases of a company which has established an audit committee, referring to the members of the audit committee) give consent thereto.

<Table 2> Negative vote recommendations against financial statements and dividends

<table>
<tr><th colspan="2"></th><th>2012</th><th>2013</th><th>2014</th><th>2015</th><th>2016</th><th>2017</th><th>2018</th></tr>
<tr><td colspan="2">Firms(#)</td><td>236</td><td>394</td><td>394</td><td>281</td><td>237</td><td>252</td><td>237</td></tr>
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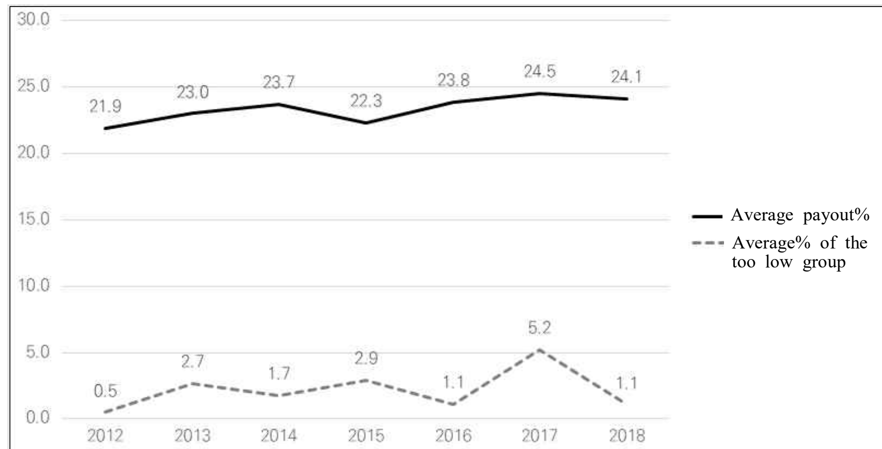
<tr><td colspan="2">Oppositions(#)</td><td>2</td><td>3</td><td>10</td><td>13</td><td>9</td><td>6</td><td>5</td></tr>
<tr><td rowspan="3">Reason for opposition</td><td>Too little dividend</td><td>1</td><td>1</td><td>9</td><td>12</td><td>7</td><td>4</td><td>5</td></tr>
<tr><td>Too much dividend</td><td>1</td><td>1</td><td>1</td><td>1</td><td>2</td><td>2</td><td>0</td></tr>
<tr><td>Others</td><td>0</td><td>1</td><td>0</td><td>0</td><td>0</td><td>0</td><td>0</td></tr>
<tr><td colspan="2">Oppositions(%)</td><td>0.82%</td><td>0.74%</td><td>2.47%</td><td>4.45%</td><td>3.69%</td><td>2.32%</td><td>2.07%</td></tr>
</table>

Of the proposals reviewed by the KCGS, 2.29% or 48 proposals received a negative review opinion. The reasons are either ‘excessively low’ or ‘excessively high’ dividends, with the former taking up 81%. The average payout ratio[2] of the 39 proposals categorized as paying ‘excessively low’ dividends is 2.2%, far lower than the entire population’s average 23.4%. Even with the exclusion of the 19 no-dividend cases, the payout ratio for the group is still low at 4.6%.

In the meantime, the average payout ratio of the eight proposals that paid out ‘excessively high’ dividends stands at 209.9%. As an example worth sharing in this report, the KCGS issued a negative vote recommendation against the shareholder proposal that the largest shareholder be paid a markedly low dividend, citing breach of the ‘equal treatment of shareholders’ principle specified in the agency’s guidelines on proxy voting.

2) The total dividends of quarterly, interim and year-end dividends divided by consolidated net profit for the period

[Figure 1] Payout ratio of companies paying excessively low dividends




At the company level, over the period, at least one negative vote recommendation was issued to 33 firms, with 10 of them receiving more than one such recommendation - a total of 25 recommendations, which account for 52% of the entire negative vote recommendations. The 10 companies mentioned above received negative vote recommendations repeatedly for the same and only reason: excessively low or high dividends. Although the population is small, they testify to a repeated trend of inappropriate decisions on dividends. In this regard, investors are advised to pay close attention to the firms with a too-little-dividend review.

In the example shared below, the company paid out dividends but at a lower rate compared to its ratio of earnings to dividends and the industry average. Moreover, a concern was raised that the company’s reserve funds might not be spent for proper usages considering the history of embezzlement and negligence of the largest shareholder and management and unjust supports provided for an affiliated company 100% owned by the largest shareholder’s family.

**[Case 1] Potential misuse of retained earnings**

- Company A is a chemical textile manufacturer and listed on KOSPI.
- This firm brought a proposal to pay KRW1,750 a share to its 2012 AGM.
- The company's payout ratio stood at 0.65% with an annual yield at 0.1%.
- The largest shareholder was convicted on charges of negligence and embezzlement of more than KRW20bn by the court of first instance in February 2012.
- The Korea Fair Trade Commission fined KRW460m against nine affiliated companies including the subject firm on charges of providing unjust supports for company D 100% owned by the largest shareholder.
- Based on this information, it was determined that the largest shareholder and management were highly likely to misuse the retained earnings for their own benefit, instead of spending them enhancing firm value such as in investing.

With regards to Case 2 below, the KCGS issued a negative review opinion on grounds of the potential erosion of management's trustworthiness and destruction of shareholders rights. The company in question stuck to a zero dividend policy publicizing that it would reinvest the earned surplus in alternative ways of enhancing firm value. The company, however, acted out of sync with what it disclosed, in the process of buying back and selling its treasury shares.

**[Case 2] Inconsistent return policy**

- Company C is in the advertising business and listed on KOSPI.
- This firm resolved not to pay out dividends in 2014 and 2015.
- The zero dividend policy continued since FY 2012. In its business report issued back then, the company disclosed that it would shift from cash dividends-centered shareholder return to re-investment of earned surplus for increased firm value.
- From February 2012 until April 2014, however, the firm repurchased its shares worth KRW299.8bn in four rounds. The value was more than 17 times the total payout KRW17.5bn from 2011, the year preceding zero dividend policy.
- If the repurchased shares were canceled, the end effect would have remained the same as cash dividends. The company, however, sold most of them (89.84%) to its affiliates in November 2014.
- The company sold the treasury stock for KRW19,200 per share, lower than the average per-share price of KRW23,419 it paid when repurchasing shares, incurring a huge loss to the firm (KRW48.5bn in the difference between the two figures).
- This company announced a zero dividend policy citing re-investment of earned surplus, but it caused a large cash leakage by selling the repurchased shares to affiliates instead of canceling them, damaging consistency of the zero dividend policy it proclaimed.

## Amendments to Articles of Incorporation

Articles of incorporation is a company's internal rules that must be established before a corporation is incepted covering the organization and operation of the corporation. They are the rules that must be followed by the company and the directors entrusted to perform business activities on behalf of the company. In this light, depending on how the rules are written, they may act as an effective tool to build a desirable corporate governance structure or an installation aggravating the agency problem. Articles of incorporation may be amended by the special resolution of the general meeting of shareholders, so much so that the local commercial law allows firms to adopt and change many of their practices by amending the articles of incorporation.

Articles of incorporation deal with a variety of matters including the issuance of stocks and/or corporate bonds and the size and composition of the board of directors, to name a few. For this reason, the KCGS has not set up separate guidelines with regards to the amendments of articles of incorporation.

From 2012 through March 2018, the KCGS reviewed 1,102 proposals of amending articles of incorporation, which accounted for 7.3% of the total proposals reviewed over the period (15,036 proposals).

<Table 3> Negative vote recommendations against amendments of articles of incorporation

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| Firms(#) | 186 | 205 | 204 | 110 | 116 | 111 | 77 |
| Proposals(#) | 190 | 215 | 212 | 127 | 142 | 124 | 92 |
| Oppositions(#) | 79 | 36 | 25 | 25 | 26 | 11 | 12 |
| Oppositions(%) | 41.6% | 16.7% | 11.8% | 19.7% | 18.3% | 8.9% | 13.0% |

Of the proposals reviewed, 214 proposals or 19.4% were opposed by the KCGS with a drastic fluctuation of the opposition rates from year to year. 2012 showed the highest opposition rate of 41.6%, due to the amendments to the commercial law in 2011, which triggered amendments of articles of incorporation to introduce an indemnification clause for executives and empower the board of directions to approve financial statements.

**Frequently cited rationals for negative vote recommendations**

(Diminished shareholder rights) Along with the commercial law, articles of incorporation stipulate a company's important decision-making matters subject to approval by the general shareholder meeting. Some of the matters may be delegated to the board of directors with an amendment to articles of incorporation. When this happens, the general meeting of shareholders is deprived of its authority regarding the matters concerned. Thus, amendments of articles of incorporation need a careful approach. Prime examples include the approval of financial statements and indemnification for executives.

As for the former, in overseas markets, the size of the dividends is decided by the board of directors and the general shareholders' meeting cannot perform the role of auditing financial statements effectively. Considering these facts, a board of directors may be a right party who can perform the role efficiently. However, the decision-making for dividend payouts in Korea is not as transparent a process as it is in overseas markets; the size of the payouts is smaller; and it is difficult to voice opinions about dividends[3]. In recognition of these circumstances in Korea, it is deemed that amending articles of incorporation without a rational dividend policy in place diminishes shareholder rights.

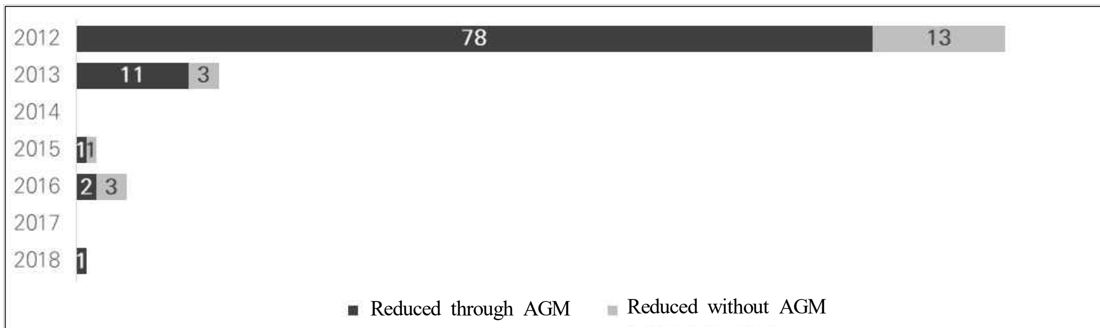
[Figure 2] # of proposals to amend articles of incorporation to authorize BOD to approve financial statements

Previously, indemnification of executives was only possible with a full agreement by all the shareholders. With the amendment to the commercial law, however, the board of directors or general meeting of shareholders are given the authority to reduce the liabilities of executives. Taking into account the local market circumstances where shareholders have difficulty in seeking a remedy ex post facto, it is desirable from the perspective of protecting

3) The Financial Investment Services and Capital Markets Act sees the act of asking for dividends as participating in management activities. When an investor is recognized as holding ownership for the purpose of participating in management activities, he/she is subject to far stricter disclosure requirements.

shareholder rights that the general shareholders' meeting is provided with the ultimate authority to reduce the scope of executives' liabilities.

[Figure 3] # of proposals to amend articles of incorporation to reduce liabilities of executives




(Voting by mail) Voting by mail is an important tool to protect minority shareholders' rights in the sense that one can exercise voting rights without attending shareholders' general meeting in person. When voting in writing is allowed in the articles of incorporation, it must be made available in practice without fail. In this light, the abolishment of mail-in voting without a proper alternative to protect shareholders' rights may act against the interests of shareholders. Whereas no firm proposed to adopt voting by mail in the articles of incorporation, six companies proposed the removal of the voting method.

(Cumulative voting) Cumulative voting is a representative tool to protect minority shareholders' rights especially when multiple directors are to be appointed through a contested election. Unless a company opts out of the tool in its articles of incorporation, cumulative voting may be employed. Limited to listed firms with KRW2tn or more in assets, the Commercial Act restricts largest shareholders' voting rights to 3% when a company seeks to opt out of cumulative voting in its articles of incorporation or remove the opt-out clause itself. The Act also requires that the item be proposed separately from other items of amending articles of incorporation, in recognition of the importance of cumulative voting. Of the proposals reviewed, two proposals sought to opt out of cumulative voting.

(Diminished board rights) A number of proposals tried to (potentially) reduce the

rights of the board of directors specified in the articles of incorporation. A typical example is to shorten the notice period for a board meeting. When the notice period is reduced excessively, it is difficult for the directors without full-time responsibilities, outside directors in particular, to attend the board meeting. Moreover, it is likely that they are deprived of the time needed to study and review the concerned proposal in a sufficient manner prior to the meeting. The KCGS found that nine companies proposed to shorten the notice period of a board meeting, on average by 5.6 days. Six of them moved the notice deadline to one day prior to the meeting and the remaining three to three days prior.

| Before | 14 days prior | 10 days prior | 7 days prior | | 5 days prior | 2 days prior | Total |
|---|---|---|---|---|---|---|---|
| After | 1 day prior | 1 day prior | 3 days prior | 1 day prior | 3 days prior | 1 day prior | |
| Firms(#) | 1 | 1 | 2 | 3 | 1 | 1 | 9 |

Another example of diminishing the rights of the board is as follows:

**[Case 3] Amendment of articles of incorporation likely to reduce board rights**

As for an emergency matter, in case there is no time to call a board meeting, the chief executive officer may execute with the consent from all the other directors. In case of an accident with the CEO, the person in the order of the listing in Article 37(2) may do the same. Still, a board meeting must be called ***without delay*** and the details of the matter and execution shall be reported for approval.

As for an emergency matter, in case there is no time to call a board meeting, the chief executive officer may execute with the consent from all the other directors. In case of an accident with the CEO, the person in the order of the listing in Article 37(2) may do the same. Still, the details of the matter and execution shall be reported to the ***next*** board meeting for approval.

- Even with the consent from the full board, execution by CEO alone without the process of discussion in a meeting does potential harm to the authority of the board, whose role is to act as a meeting body.
- The clause demanded a board meeting be called ‘without delay’ to mitigate such a concern.
- The board met every six months tops.
- In this light, the above-mentioned proposal was likely to heighten the concern over reduced board authority.

(Defending management control) 27 proposals were found to have a likelihood of being manipulated for defending management control. All the proposals were to issue convertible shares where the company could decide conversion, except for one proposal seeking super majority voting.

Convertible shares refer to the shares entitled to the right to be converted to another class of shares, mostly to common shares. An amendment to the Commercial Act in 2011 made it possible to convert such shares to common shares without a request from a shareholder if there is a clause in the articles of incorporation allowing to do so. Then, convertible shares may be issued and converted for the purpose of defending management control. In line with this, if defense of management control was cited as a reason for conversion or there was not a clear reason stated, negative voting was recommended.

Six of the proposals reviewed stated that they were converting shares for defending management control, and 20 of them said that the board of directors made the decision.

When super majority voting is adopted into the articles of incorporation, it means that the company wishes to make it harder for a matter to pass through by setting in stricter requirements than those required by the Commercial Act. A company tabled a proposal to add the below to its articles of incorporation:

| **[Case 4] Amendment to articles of incorporation to defend management control** |
|---|
| Method of resolution by a general meeting of shareholders<br>① A resolution may be made by a general meeting of shareholders with a majority of affirmative votes by the shareholders present in the meeting unless it is stated otherwise by law. In this case, it should be at least a quarter of the total number of shares issued.<br>***② Notwithstanding paragraph 1 above, a proposal falling under any of the following sub-paragraphs requires at least two-thirds of the shareholders present and at least two-thirds of the total number of shares issued:***<br>***1. When an existing director is to be dismissed following a hostile M&A***<br>***2. When a new director and/or auditor is to be elected following a hostile M&A***<br>***3. When a revision to the articles of incorporation is to be made with regards to the matter specified in this paragraph.*** |

In the meantime, the articles of incorporation of a company cover a variety of themes, so much so that amendments may be sought for a variety of issues.

When several clauses are to be amended at the same time, making multiple proposals considering different characteristics of the individual items, rather than making a blanket proposal, can help shareholders make rational decisions.

In most cases, however, a number of items are bundled into one proposal. Then, the company shall take the risk of having the proposal in whole is aborted due to a few negative elements. Conversely, if the proposal is supported in entirety, there may come a case where shareholder rights are violated.

In this sense, it is advised that if an amendment is sought against multiple items, they are separated into independent proposals. If it is too much of a bother to separate all the individual items, they could be grouped by category. Of the proposals reviewed by the KCGS, 26 of them or 20 companies sought to amend articles of incorporation in individual items.

## Election of Directors

A listed company has too large a number of shareholders and it is hardly likely that all of the shareholders are competent enough and equipped with expertise. Thus, directors are elected and authorized to undertake the business activities of the company on behalf of general shareholders. A board of directors, a meeting body comprising multiple directors, is a representative governance tool. That is, the board acts as the most senior-level decision-making body of the company and plays the role of overseeing management at the same time.

Over the past seven years, 6,216 proposals were tabled to elect directors and the KCGS issued negative vote recommendations against 1,185 or 19% of them. The opposition rate reached the highest level of over 20% in 2017. It dipped again to the lowest in 2018 to 16.7%. The companies who received at least one negative vote recommendation accounted for about 50% of the companies who tabled proposals of electing directors every year, and the ratio trended down.

<Table 4> Negative vote recommendations against election of directors

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| Firms(#) | 207 | 345 | 357 | 259 | 214 | 230 | 203 |
| Proposals(#) | 804 | 1179 | 1275 | 835 | 725 | 750 | 648 |
| Oppositions(#) | 142 | 231 | 247 | 157 | 144 | 156 | 108 |
| Oppositions(%) | 17.7% | 19.6% | 19.4% | 18.8% | 19.9% | 20.8% | 16.7% |
| Firms opposed(#)[1] | 102 | 167 | 167 | 108 | 99 | 104 | 82 |
| Firms opposed(%) | 49.3% | 48.4% | 46.8% | 41.7% | 46.3% | 45.2% | 40.4% |

[1] The number of firms who received at least one negative vote recommendation against their director election proposals.

In the following section, the trends of the KCGS recommendations over the past seven years are discussed by director type[4].

4) Article 317 of the Commercial Act requires that a company register inside directors, outside directors, and other directors not engaged in the regular business of the company when establishing a corporation. In line with this requirement, most of the companies classify directors into inside directors, outside directors, and other directors not engaged in the regular business of the company. The subject report also follows this categorization.

## Inside Directors

**KCGS Proxy Voting Guidelines**

II-1.1 (Disqualifications of Inside Director Candidates) We recommend voting AGAINST proposals of appointing an inside director with one or more disqualifications below:

- · A person who received administrative or judicial sanctions due to the violation of law, or who has been exempted from the execution of such sanctions;
- · A person who has not executed shareholder proposals approved at the general meeting of shareholders without a valid reason;
- · A person who has intentionally distorted or concealed important information that needs to be considered by shareholders before making voting decisions, such as the company's financial status or matters related to the resolution of the board;
- · A person who holds multiple positions and thus is not expected to be able to fulfill duties as a director in a faithful manner.
- · A person who is responsible for destroying the company's value or violating shareholder rights.

II-3.1 (CEO Nominees' Professional Experience and Qualifications) We recommend voting FOR proposals of approving the CEO nominee if it is determined that there are no issues challenging his/her performing duties by considering his/her expertise, experience, reputation, professional ethics, and whether he/she is holding multiple positions and the degree of the same.

Inside directors are the ones engaged in the regular business of the company. In most cases, senior-ranking executives including CEO double-hat as an inside director.

Over the period of 2012 through March 2018, 2,806 proposals seeking to elect inside directors were reviewed by the KCGS, which accounted for 18.7% of the total proposals for review (15,036 proposals) and 45.1% of the proposals of electing directors (6,216). The fact that almost half the total director election items were to elect inside directors is a testament to the high ratio of inside directors in the composition of the board of directors.

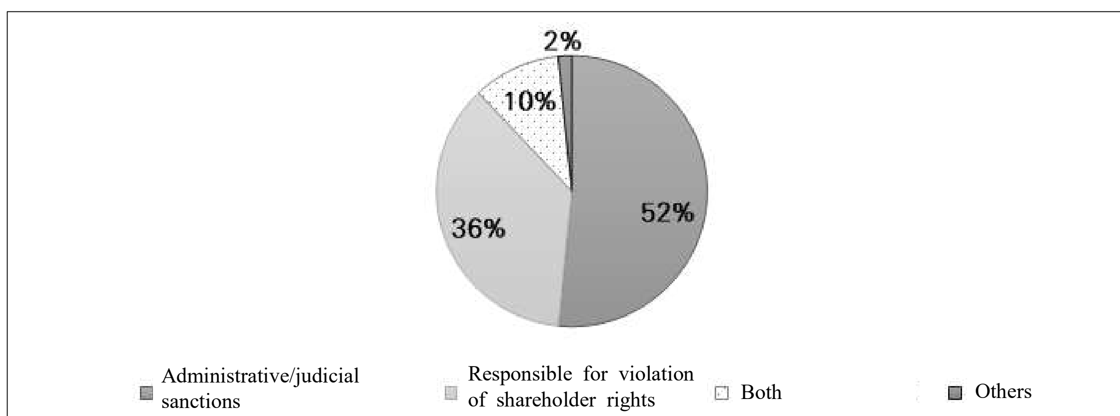
<Table 5> Negative vote recommendations against inside directors

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| Firms(#) | 176 | 278 | 297 | 207 | 182 | 185 | 163 |
| Proposals(#) | 371 | 526 | 583 | 375 | 319 | 334 | 298 |
| Oppositions(#) | 12 | 18 | 25 | 20 | 20 | 15 | 14 |
| Oppositions(%) | 3.2% | 3.4% | 4.3% | 5.3% | 6.3% | 4.5% | 4.7% |

The KCGS advised against 4.4% or 124 of the proposals of electing inside directors. The rate is far lower than the rate of negative vote recommendations issued against the entire group of director candidates.

Inside directors are the ones involved in the regular business of the company. Hence, unlike outside directors, independence is not a prerequisite for inside directors, which is a reason behind the lower negative vote recommendation ratio. Most commonly cited reasons for opposition (approx. 98.4%) included the cases where i) the candidate received administrative or judicial sanctions or was still in the cooling-off period after such a sanction and ii) the candidate was responsible for the violation of shareholder rights.

[Figure 4] Reasons for negative vote recommendations against inside director candidates




1 "Others" include the cases where the candidate intentionally distorted/concealed key information or the company he/she served was marked for unfaithful disclosure.

2 One case fell under two categories: "responsible for violation of shareholder rights" and "others." This case was counted under the former.

## Case Study

In Korea, it is not uncommon that controlling shareholders take advantage of their

management control and misappropriate the company's resources, receiving a criminal punishment as a consequence, or cause damage to shareholder rights. Examples of such cases are described below:

**[Case 5] A candidate who received administrative/judicial sanctions**

- Candidate A standing for company A's inside directorship was a controlling shareholder of the business group to which company A belongs.
- The candidate had been sentenced for imprisonment twice on charges of embezzling an affiliated company's funds. The execution of the sentence was terminated only recently.
- He abused his status as a controlling shareholder of the business group and directed an affiliated company's funds for personal usages in several instances. In this sense, it was significantly doubtful whether he could fulfill his responsibility as a faithful director.

**[Case 6] A candidate responsible for damaging firm value**

- Candidate B standing for company B's inside directorship was a controlling shareholder of the business group to which company B belongs.
- He purchased assets for non-business usages by misappropriating funds from several companies affiliated with the business group.
- When the candidate was serving as CEO, company B directed over 77% of recent three years of dividends and R&D costs for purchasing assets.
- He did not attend the board meeting to decide the asset purchase, and the board was only provided with extremely limited information.
- Upon the announcement of the asset purchase, company B's stock price continued dropping along with a drop in the foreign investment ratio. The company announced a variety of shareholder return policies but they could not prevent the stock price from falling.
- It was significantly doubtful whether the candidate, as a controlling shareholder of the business group and chief executive officer of company B, faithfully discharged his responsibility as a director prescribed by the Commercial Act in the best interests of the company's mid- to long-term benefit when he was making a massive investment decision.

**Other Directors Not Engaged in Regular Business**

As indicated in the term, 'other directors not engaged in regular business' are the ones who are not involved in the everyday business activities of the company. Unlike outside directors, however, independence is not required in this position.

Other directors not engaged in regular business are a new type of directors added to

the Commercial Act with its amendment in 2009. As they are not involved in the everyday business of the company, one may expect that they will play the role of advising to or monitoring management. In practice, however, the distinction between other directors not engaged in regular business and inside directors is not clear, except for the fact that the latter work full-time while the former don’t. This is because largest shareholders or a party related to them serve as a director not engaged in regular business in some cases.

Over the past seven years, 413 proposals were tabled to elect other directors not engaged in regular business, and 3.6% or 15 of the proposals received a negative vote recommendation by the KCGS.
As with inside directors, the most common reasons for negative advice were administrative and/or judicial sanctions and violation of shareholder rights: 5 cases each.
While it is not that other directors not engaged in regular business cannot work full-time, they normally work part-time. Thus, attendance in the board meeting may function as a qualification indicator. In four cases, the candidates were opposed on the ground of low attendance. In a separate case, a candidate received a negative vote recommendation on the ground of holding an excessively large number of positions concurrently. Specifically, he was holding director positions in seven different companies not belonging to the same business group.

**Outside Directors**

An outside director refers to a director who is not involved in the regular business of the company and remains independent from the firm. Due to the independent nature of this position[5], an outside director is expected to play an ever more important role in recent days when an added emphasis is placed on the board of directors' role as a supervising body.

The Commercial Act prescribes that listed firms with KRW2tn or more in assets appoint at least three outside directors to form a majority of the board. A board where outside directors take the leading role is increasingly recognized as an international best practice[6].

The KCGS applies the same qualifications required for inside directors to an outside director, along with the following separate criteria of independence:

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**KCGS Proxy Voting Guidelines**

II-2.1 **(Disqualifications of Independent Director Candidates)**

We recommend voting AGAINST proposals of appointing an independent director with one or more disqualifications below:

- omission -

**<Disqualifications such as undermining independence>**

- If the nominee has been a largest or substantial shareholder himself/herself or has been a related party to such a shareholder in the last five years;
- If the company is a related party to a company that is its largest or substantial shareholder or it has been such a party in the last five years;
- If the nominee has been a related party to the individual or corporation that has had an important business relationship, a competitive relationship or a cooperative relationship with the largest shareholder, affiliated company or the company in the last three years.
- An executive/employee who has worked in the company or its affiliated company/non-profit organization other than in an independent director position in the last five years; his/her spouse; or direct ancestors and descendants.
- If the nominee has served in the company as an independent director for more than seven consecutive years including the new term (five years for financial industry) (when calculating the term that the director served, the tenure at an affiliated company is included, and when an independent director is re-elected within the two year period after the prior term ended, the term is counted as on a continual basis)
- If the nominee has attended less than 75 percent of the board meetings as an average over the last three years.

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5) In overseas markets, they call this position an independent director stressing the importance of independence.

6) The New York Stock Exchange stipulates that any listed firm shall comprise a majority independent board. The same rule is found in the Corporate Governance Code of the United Kingdom.

There were 2,997 proposals to elect outside directors in the past seven years, and the KCGS recommended voting against 34.9% of them. Over the same period, 2,806 proposals were brought to the general shareholders' meeting to elect inside directors, a similar number to that of the proposals of electing outside directors. However, the proposals nominating outside directors had a far higher opposition rate, a testament to a significant number of candidates failing to meet independence criteria.

<Table 6> Negative vote recommendations against outside director nomination

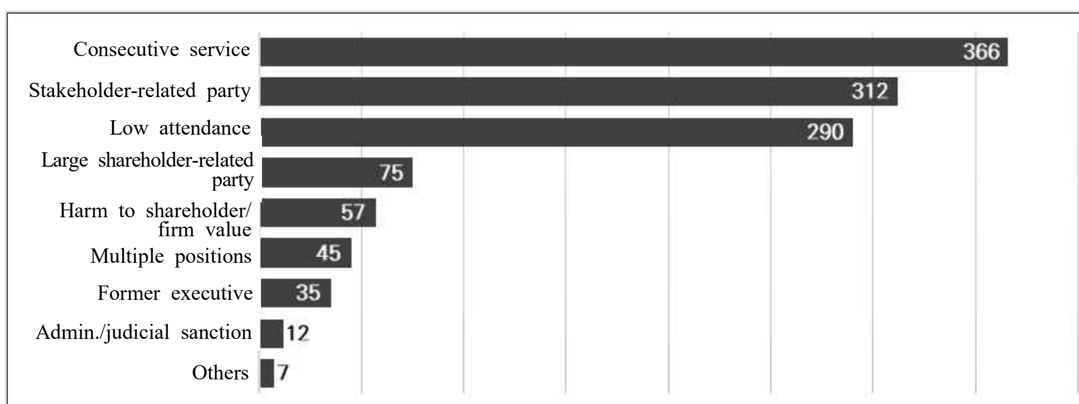
| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| Firms(#) | 169 | 282 | 268 | 185 | 176 | 172 | 156 |
| Proposals(#) | 395 | 581 | 591 | 394 | 362 | 361 | 313 |
| Oppositions(#) | 127 | 209 | 219 | 135 | 122 | 140 | 94 |
| Oppositions(%) | 32.2% | 36.0% | 37.1% | 34.3% | 33.7% | 38.8% | 30.0% |
| Firms opposed(#)[1] | 94 | 155 | 155 | 95 | 92 | 96 | 78 |
| Firms opposed(%) | 55.6% | 55.0% | 57.8% | 51.4% | 52.3% | 55.8% | 50.0% |

[1] The number of firms with at least one negative vote recommendation on the proposals of electing a director.

Every year, more than a half of the firms reviewed for outside director nomination received at least one negative vote recommendation. Of the total number of general shareholders' meetings reviewed (2,176 of them), 1,435 meetings put to a vote the proposals to elect outside directors. Of these meetings, 772 meetings received at least one negative recommendation (53.8%).

The most cited reason was a long and consecutive service (30.5%), followed by being a party related to a stakeholder and low attendance in board meetings.

[Figure 5] Reasons for oppositions to outside directors



## Case Study

As described in the previous section, the KCGS found a number of cases where a candidate was not independent enough as an outside director and his/her capability to fulfill responsibilities in a faithful manner was doubted. The following shows a few such cases:

**[Case 7] Formerly served as an executive/employee**

- Candidate C worked for company C for 36 years and was nominated as an outside director three years after his previous employment at the firm ended.
- Before leaving the company, he was heading the accounting team, in charge of disclosure documents of the company.
- Most of the firm's inside directors were serving the company as an inside director when the candidate was still with the company. It was determined that he was not independent enough to fulfill his duty of monitoring and supervising the activities performed by his former superiors and/or colleagues.

**[Case 8] Zero attendance in board meetings**

- Candidate D formerly served company D as an outside director for two years.
- This candidate did not attend any of the 15 board meetings held during his service at the company.
- The most important and basic responsibility of an outside director, whose main task is monitoring management, is to listen to and carefully review the matters reported to the board, and present opinions. It was significantly doubtful whether this candidate could perform his duty as an outside director in a faithful manner.

**[Case 9] Involvement in litigation brought against controlling shareholder**

- Candidate E for company E is an attorney working with law firm K. He stood for re-election at the pertinent general meeting of shareholders.
- Candidate E participated in the preparation for a hearing of a criminal case against the controlling shareholder of company E, even when he was serving an inside director term at the firm.
- Besides, law firm K candidate E worked with had represented the companies affiliated with the business group company E belonged to and the controlling shareholder's family in multiple instances of legal advisory services and litigations.
- It was determined that candidate E was not independent enough to monitor and keep in check management of company E and the controlling shareholder when he shared an interest with the pertinent business group and the controlling shareholder both directly and indirectly.

## Auditors and Audit Committee Members

A member of an auditing body has the responsibility to monitor and supervise the activities executed by management and the board of directors. To ensure that they fulfill such responsibility in a faithful manner from an independent standpoint, far stricter qualifications are required for them than those for board members.
The Commercial Act recognizes two types of auditing body, an audit committee and an auditor, and requires that a company install one of the two types depending on the asset size or by choice. Audit committee members and auditors are discerned from each other in whether they are a board member or not and in the qualifications required in them. Due to the difference in how they are composed and operated, discussions are still underway on the merits and demerits of each type. What is expected of them as an auditing body, however, is essentially the same.

Thus, the KCGS Proxy Voting Guidelines does not distinguish an auditor from an audit committee member and whether he/she is a full-time auditor, and requires that they have added qualifications as a member of the auditing body, along with the qualifications expected in an outside auditor.

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**KCGS Proxy Voting Guidelines**

II-4.1 (Disqualifications of Auditors and Audit Committee Members)

We recommend voting AGAINST proposals of appointing an auditor or audit committee member with one or more disqualifications below:

- If falling under the disqualifications applied to independent directors.
- If the nominee was previously serving a company as an auditor or audit committee member and the non-audit service fee paid to the external auditor by the company was larger than the audit service fee paid to the same external auditor in the last five years. For this purpose, the non-audit service fee does not include the fees for an initial public offering, bankruptcy, restructuring, tax adjustment, or any other equivalent occasions.
- If the nominee was previously serving a company as an auditor or audit committee member and the company received an opinion other than “qualified,” or received material administrative or judicial sanctions in connection with external audit during his/her service in the last five years
- If the nominee was chairing an audit committee and fewer than four audit committee meetings were held in any financial year during his/her service in the last five years.

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Over the last seven years, 2,368 proposals were made for the election of an auditor or audit committee member, and the KCGS recommended voting against 55.4% of them. The rate is significantly higher than the opposition rate against the outside director nominees (34.9%). Part of the reason stems from the fact that stricter qualifications are required for an auditing body member. It also means, however, that a significantly large number of candidates are short of independence and expertise required in an auditor or audit committee member. An upside is that the opposition rate against an auditor/audit committee member candidate trended down since 2014.

<Table 7> Negative vote recommendations against auditor/audit committee member nominees

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| Firms(#) | 150 | 240 | 252 | 156 | 153 | 175 | 131 |
| Proposals(#) | 296 | 441 | 484 | 292 | 275 | 346 | 234 |
| Oppositions(#) | 101 | 168 | 220 | 122 | 110 | 134 | 68 |
| Oppositions(%) | 34.1% | 38.1% | 45.5% | 41.8% | 40.0% | 38.7% | 29.1% |
| Firms opposed[1](#) | 75 | 128 | 160 | 94 | 81 | 102 | 57 |
| Firms opposed(%) | 50.0% | 53.3% | 63.5% | 60.3% | 52.9% | 58.3% | 43.5% |

[1] The number of companies with at least one opposition to an auditor or audit committee member nominee

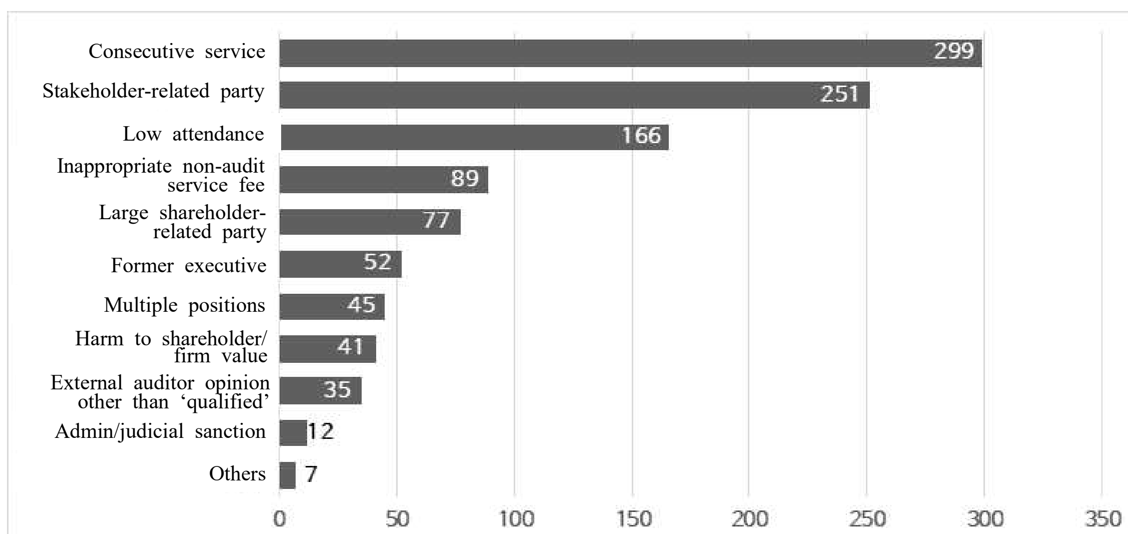
Except for 2018, every year saw half the reviewed companies receive at least one negative vote recommendation against their proposals of electing auditors/audit committee members. Specifically, of the 2,176 general meetings reviewed, 1,284 meetings put to a vote the proposals of electing auditor/audit committee members and 704 of them (54.8%) received at least one negative vote recommendation.

The reasons for opposition included consecutive service terms, followed by being a party to a stakeholder and low attendance, the same reasons as for outside director candidates. There were a significant number of nominees whose qualifications were questionable in terms of their ability to monitor the appropriateness of the fees for non-audit service and deal with an external auditor, which are important credentials required for an auditing body.

Separately, two of the nominees failed to meet the annual frequency criteria of holding an audit committee meeting. The KCGS Proxy Voting Guidelines revised in 2018 requires that the chairperson of the audit committee member call an

audit committee meeting at least four times a year[7]).

[Figure 6] Reasons for opposition to auditor/audit committee member nominees




**Case Study**

Most of the auditor/audit committee member nominees were opposed for the same reasons cited against outside director candidates. The following are the cases of two candidates lacking the qualifications especially required for an auditing body member:

**[Case 7] A candidate responsible for a large amount of non-audit service fee**

- Candidate F served company F for two years as an audit committee member.
- During his service, the company paid an external auditor non-audit service fee exceeding the audit service fee paid for the same period.
- An audit committee member has a duty to ensure an independent and faithful audit on the firm's books, and he also has an authority to appoint an external auditor. In this light, it was determined that the candidate was accountable for a non-audit service fee large enough to put the external auditor's independence at risk.

7) As per the Financial Investment Services and Capital Markets Act, a listed company has a duty to submit four periodic reports a year. To ensure the reliability of these reports, audit committee meetings need to be held at least four times a year.

**[Case 8] A standing auditor candidate involved in regular business of multiple firms**

- Candidate G served company G as a standing auditor for about two years.
- Other than G, this candidate was then working for firm X and Y as executive director and vice-president respectively.
- A listed firm exceeding a certain level in assets is legally obligated to appoint a standing auditor, and the position is there to perform auditing activities effectively working full-time in-house. From this perspective, it was determined that the candidate would not be able to perform his duty faithfully as a standing auditor at company G when he was involved in the regular business of other firms.

## Stock Options

In the local capital markets where pay-for-performance is not established, stock options serve as a means to align the interests of management with those of shareholders. Advanced markets such as the United States, however, use stock options less, citing management's short-termism and excessive risk-taking[8]. In this sense, it is desirable that stock options are designed in a way they may be exercised when long-term goals are achieved. Further, considering that the exercise of stock options may cause dilution of existing shareholders' rights, it is desirable to check the level of dilution of existing shareholders' rights and whether the vesting conditions of the stock options are linked with performance.

Over the last seven years, the KCGS reviewed 144 proposals of granting stock options that were tabled to 126 annual meetings. Of these, 114 proposals were opposed by the agency mostly on the grounds of a weak linkage with performance or little incentive for long-term performance.

<Table 8> Negative vote recommendations against proposals granting stock options

| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|
| Firms(#) | 9 | 13 | 23 | 16 | 13 | 22 | 28 |
| Proposals(#) | 12 | 15 | 24 | 18 | 15 | 25 | 35 |
| Oppositions(#) | 11 | 13 | 20 | 17 | 13 | 15 | 25 |
| Oppositions(%) | 79.6% | 87.2% | 76.1% | 87.5% | 85.7% | 56.5% | 66.1% |

### Case Study

Before stock options are granted, the name of the grantee, method and quantity of the granting, exercise price, vesting period, among others, must be approved by the general shareholders' meetings[9]. Nonetheless, some of the companies stated only the fact that stock options would be granted, without disclosing specific details.

8) Dylan Minor, CEOs with Lots of Stock Options Are More Likely to Break Laws, 2016.5.26., Harvard Business Review

9) Article 340(3) of the Commercial Act

**[Case 9] Omission of important information necessary for approving stock options grants**

- Company H is listed on KOSDAQ as an electronics manufacturer.
- This company brought a proposal of granting stock options to its general shareholders' meeting, omitting most of the details that were essential for the meeting to approve the proposal (please see the box below).
- Without being able to confirm linkage with performance, whether market elements were controlled, etc., it was determined that this proposal violated shareholders' rights.

A. The need for issuing stock options

- Pursuant to Article 12 of the articles of incorporation of the company, stock options shall be granted to the executives and/or employees who have contributed or are capable of contributing to the management, business, and technological innovation of the company, among others.

B. Names of the persons granted stock options

| Name | Title | Position | # of shares | |
|---|---|---|---|---|
| | | | Type | # of shares |
| - No person eligible as of the date of disclosure | | | - | - |
| ( - ) person(s) in total | | | - | ( - ) |

※ While no one is eligible for the subject stock option grant as of the date of this notice for the 14th annual general meeting, stock options may be granted during the approval process of the meeting.

C. Method of granting stock options, type/number of the shares, exercise price, vesting period, and other conditions

| | Details | Note |
|---|---|---|
| Granting method | - While no one is eligible for the subject stock option grant as of the date of this notice for the 14th annual general meeting, stock options may be granted during the approval process of the meeting. | - |
| Type/number of shares | | - |
| Exercise price & vesting period | | - |
| Other conditions | | - |

As shown in the above case, most of the listed companies tabled a proposal to grant stock options without due elements required by the KCGS guidelines for proxy voting. A few firms, however, presented performance targets and controlled market influence.

**[Case 10] Stock options linked with target performance & market elements controlled**

- Company I manufactures chemical substances and products as a KOSPI-listed firm.
- The firm tabled to its 2016 annual meeting a stock option plan of granting 40,000 registered common shares to its CEO and six others.
- The size was around 0.35% the total shares issued, not an excessive level.
- While the exercise price was fixed, the shares were designed to vest after two years from granting and within eight years.
- Moreover, performance targets were presented in EBITDA cumulative growth over 2016 through 2018 against that of 2015. By adopting share price increase rates against Korea Composite Stock Price Index 200, the market influence was controlled.
- By setting performance targets and making the options exercisable for a different number of shares subject to target achievement, the plan was designed to be linked with long-term performance.

| EBITDA cumulative growth (%)<br>Market indicators | 20% ≤ | 15%~20% | 10%~15% | 10% > |
|---|---|---|---|---|
| 100% ≤ | 100% | 80% | 50% | - |
| 90%~100% | 80% | 50% | - | - |
| 90% > | 50% | - | - | - |

## Severance Pay Policy For Executives

The nature of the severance pay for executives is different from that for ordinary employees and judicial precedents also see it as a type of remuneration[10]. Thus, it is reasonable that the procedures for approving remuneration are applied to severance pay for executives. Considering that it is hard to predict the timing of the payout and the size of the pay is different case by case, however, it is difficult to seek approval of severance pay on an annual basis, unlike the case for remuneration cap. For this reason, many of the local companies have established a severance pay policy for executives and refer to this policy to pay severance to an outgoing executive subject to approval from the general shareholders' meeting[11].

The KCGS reviewed 164 proposals of approving the adoption and revision of a severance pay policy for executives over the past seven-year period, and opposed 23.2% or 38 such proposals. As the policy deals with remuneration for directors that requires approval from a general meeting of shareholders, it is desirable that the specific details are disclosed to shareholders in a transparent manner. Nonetheless, concrete details before and after the approval and execution of the proposal were not disclosed in many cases.
In another case, a far higher accrual rate was set for severance beyond a normally accepted range - for executives, severance is typically calculated by multiplying the salary for the immediately prior month by the number of service years and the accrual rate. Yet another proposal tried to adopt the so-called 'golden parachute rule' into the severance pay policy applicable to executives so that a large amount of severance is payable to an executive leaving the company involuntarily.

### Case Study

In the case below, shareholder value was likely to be violated due to a potential payout of a massive amount of severance. It also reduced responsibility imposed on the controlling shareholder involved in the management of the company.

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10) Sentence "97다38930" dated February 24, 1999 by the Supreme Court
11) See the 『Standard Articles of Incorporation for Listed Firms』 published by the Korea Listed Companies Association dated December 27, 2013

**[Case 11] Controlling shareholder's family becoming a non-board member and paid an excessive severance**

- Company J is a KOSPI-listed manufacturer of food products.
- At the time when the proposal was tabled, family members of the controlling shareholder were serving the company as chairman and vice-chairman. As per the disclosure requirement under the Financial Investment Services and Capital Markets Act, the company disclosed the total remuneration for the chairman and the vice-chairman, which amounted to KRW5.4bn and 4.4bn respectively for the business year of 2013.
- In Q1 2014, the chairman and the vice-chairman resigned from directorship. In the 2014 annual meeting, the company proposed to expand the scope of severance pay eligibility from a certain executive level to the entire executive group.
- In the following year, an accrual rate for the severance payable to the chairman and vice-chairman roles was newly adopted in the annual general meeting, at six times.
- Considering the purpose of a legal amendment to ensure detailed disclosure of individual executives' remuneration and enable shareholders to evaluate the appropriateness of the remuneration and the fact that severance pay is part of the executive remuneration package, a concern was raised over inappropriate compensation for the controlling shareholder's family who evaded the law by removing themselves from the board and adopted an accrual rate off a normally-accepted range for their severance.

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