APEC Symposium on

Emerging Enterprises and Corporate Governance:

New Economy and Old Rules

SECOND ANNOUNCEMENT

October 16 – 17, 2000
The Westin Taipei

Chinese Taipei

RATIONALE FOR THE SYMPOSIUM

This symposium is intended to explore the relationship between emerging companies and corporate governance in the backdrop of the new economy. The APEC initiative on corporate governance was launched at Finance Ministers' Meeting in Canada 1998, in which it was declared to be a long term and on-going project.

Recognizing the importance of venture capital for SME growth, Chinese Taipei put forward a proposal on "Economic Revitalization Through Start-up Companies and Venture Capital" (99/AMM/021), which recommended APEC to put concerted efforts in policy setting, educational reform, entrepreneurship cultivation, SME development, industrial innovation and corporate governance for economic revitalization. Chinese Taipei's proposal was recognized and endorsed by APEC Ministers. In the Eleventh APEC Ministerial Meeting Joint Statement, APEC ministers stressed that they welcomed the proposal and looked forward to further work in this area in 2000.

Pursuant to the Ministers' Joint Statement, a few activities have taken place. First, the "APEC Start-up Companies and Venture Capital Survey" was conducted for planning the work to be carried out in 2000. A work report was submitted to the First Senior Officials' Meeting held in February 2000 in Brunei Darussalam. Under the title of "Economic Revitalization Through Start-up Companies and Venture Capital: Report on Activities for 2000" (057/SOM I), Chinese Taipei sketched out a series of activities for the year of 2000, including this symposium. In May this year, the APEC Seminar on “Securing Initial Equity Funding for Start-up Companies—The Birth and Growth of SMEs in a Knowledge-based Economy” was successfully held in Taipei and received positive responses from the participants. **(http://www.apecsec.org.sg/workgroup/policy.html)**

OBJECTIVES

In light of the global trend of knowledge-based economy, APEC has to positively take initiatives to adapt to it. Apparently, it will be one of the main challenges facing APEC in this century. The establishment of good corporate governance practice in APEC should be one of the priorities that we deliberate.

The new economy stresses the development of human capital, and allows knowledge to be the driver of economic growth. Incentives are more important when this approach is followed. An APEC economy wishing to capitalize on knowledge-based economic input should encourage corporate governance. Specifically, unhindered capital formation, such as venture capital investment, should be encouraged. In addition, the usual corporate governance requirements such as accountability, transparency, proactive board, shareholder protection, and the market for corporate control should be emphasized. In short, the new economy cannot get away from the good old corporate governance rules. The symposium also wishes to explore whether best practice principles can be set or adopted for the APEC region.

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---Agenda---

Day 1, Monday, October 16th 2000

Registration
09:00~9:30

Opening Remarks

09:30~09:40	**Mr. Andrew L. Y. Hsia** **Director General, Chinese Taipei APEC Senior Official**
Session One	Corporate Governance and Emerging Enterprises in the APEC Region **Moderator: Mr. Jamie Allen, Secretary General, Asian Corporate Governance Association Ltd., Hong Kong, China**
09:40~10:30	●Corporate Governance and Economic Recovery **Mr. Pisit Leeahtam, Deputy Finance Minister, Ministry of Finance, Thailand** ●Corporate Governance in Asia: Are Global Principles and Practices Sufficient? **Mr. Jamie Allen, Secretary General, Asian Corporate Governance Association Ltd., Hong Kong, China**
10:30~10:50	Coffee Break

10:50~11:40	●The Role of Capital Markets in Corporate Governance **Mr. Frederic Hu, Executive Director of Asia Economic Research, Goldman Sachs & Co., Hong Kong, China** ●Improving the Legal Environment for Emerging Enterprises **Mr. Hideki Kanda, Professor of Law, University of Tokyo, Japan**
11:40~12:00	Q&A
Luncheon 12:00~13:30	
Session Two	Planting Corporate Governance Culture in Start-ups **Moderator: Mr. Ta-Lin Hsu, Chairman, H & Q Taiwan Co. Ltd., Chinese Taipei**
13:30~14:20	●**A** Legal Perspectives on Venture Capital and Growth Firm Governance: What We Know and Don't Know **Professor Curtis J. Milhaupt, Fuyo Professor of Law and Director of Center for Japanese Legal Studies, Columbia Law School, U. S. A.** ●How Venture Capital is Reshaping the New Asia Economy? **Mr. Ta-Lin Hsu, Chairman, H & Q Taiwan Co. Ltd., Chinese Taipei**
14:20~14:40	Coffee Break
14:40~15:30	●Public Policies Fostering Entrepreneurship **Mr. Mitsuru Taniuchi, Chairman, APEC Economic Committee, Japan** ●Accounting Transparency and Related Issues

	Mr. Kiattisak Jelatianranat, Chairman, Board of Directors, Institute of Internal Auditors of Thailand, Thailand
15:30~16:00	Q&A

Day 2, Tuesday, October 17th, 2000

Session Three	Post-IPO Corporate Governance Practice for Emerging Companies **Moderator: Mr. Lawrence S. Liu, Partner, Lee & Li, Attorneys-at-Law; Professor of Law, Soochow University, Chinese Taipei**
09:30~10:20	●Board Structure and Corporate Development after IPO **Professor Chen-en Ko, Dean, College of Management, National Taiwan University, Chinese Taipei** ●Changes in Corporate Governance Practices after the Economic Crisis **Professor Hasung Jang, Professor of Finance, and Director of Center for Finance and Banking Research, Korea University, Korea**
10:20~10:40	Coffee Break
10:40~11:30	●Competition, Alliance and Corporate Governance **Mr. Lawrence S. Liu, Partner, Lee & Li, Attorneys-at-Law; Professor of Law, Soochow University, Chinese Taipei** ●Governance in the Financial Sector **Mr. Ken Waller, Group Economic Advisor, Asia, Commonwealth Bank of Australia, Australia**

11:30~12:00	Q&A
Luncheon 12:00~13:30	
Session Four 13:30~16:00 (Coffee Break at 14:20~14:40)	Panel Discussions on Experiences and Policy Implications **Moderator: Mr. Paul S. P. Hsu, Senior Partner, Lee & Li, Attorneys-at-Law; Professor of Law, National Taiwan University, Chinese Taipei** **●Mr. Jamie Allen, Secretary General, Asian Corporate Governance Association Ltd., Hong Kong, China** **●Mr. Lawrence S. Liu, Partner, Lee & Li, Attorneys-at-Law; Professor of Law, Soochow University, Chinese Taipei** **●Mr. Mitsuru Taniuchi, Chairman, APEC Economic Committee, Japan** **●Professor Curtis Milhaupt, Fuyo Professor of Law and Director of Center for Japanese Legal Studies, Columbia Law School, U. S. A.**
15:30~16:00	Q&A
Concluding Session 16:00~16:15	**Mr. Paul S. P. Hsu, Senior Partner, Lee & Li, Attorneys-at-Law; Professor of Law, National Taiwan University, Chinese Taipei**

APEC Symposium
on

Corporate Governance and Economic Recovery

by

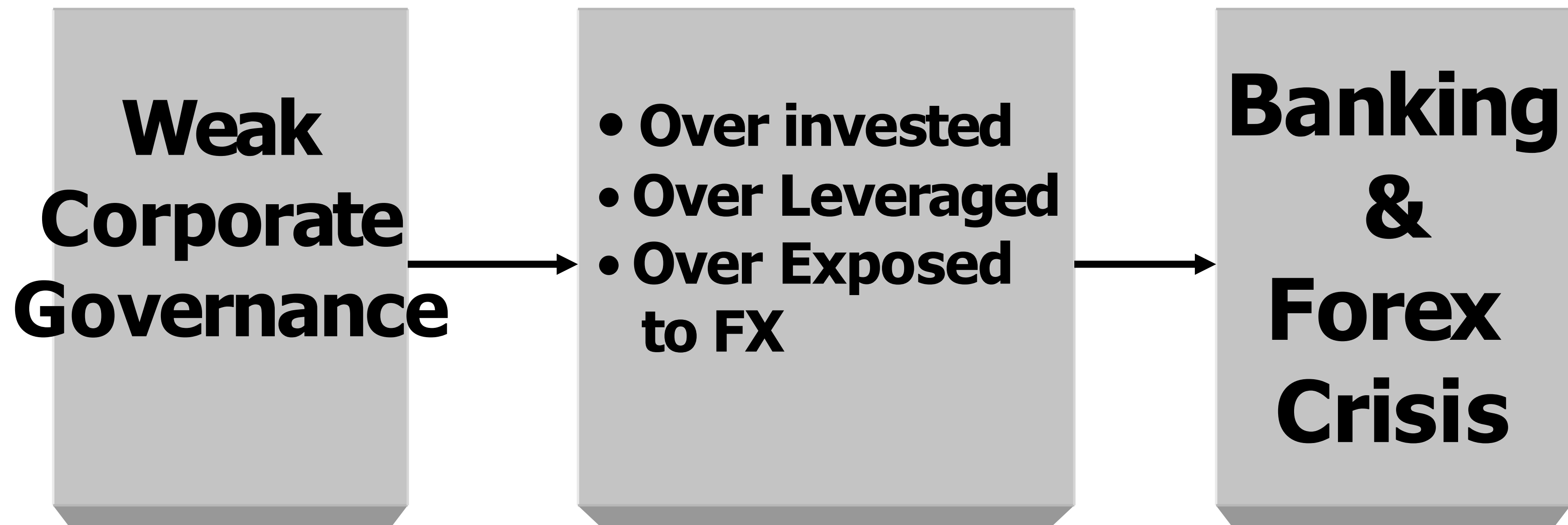
Dr. Pisit Leeahtam

Deputy Finance Minister of Thailand

16 October 2000, Taipei

Crisis and Corporate Governance

Weak corporate governance caused the Crisis in 1997



Capital market vs Banking sector

- Savers put money into banking system as deposits are insured.
- Less funds are available in the capital market, both the equity and fixed income markets.
- Banking system is over liquid while capital market activity is sluggish.

Necessity to improve corporate governance

- Transparency and reliable information for investors to accurately assess risks and make sound decision.
- Investors’ confidence.
- Increased liberalization and deregulation requires corporate governance.

Promoting corporate governance

*Emphasis on " **Conflict of Interests** "*

- –Legal framework
- –SEC's supervision
- –Roles and responsibilities of board of directors
- –Financial system reform

Legal framework

- Appropriate legal framework is crucial to foster corporate governance.
- This should include legal provisions, sufficient supervision and strong legal enforcement, which aim to provide investors' protection.

Legal framework

4 main issues to be focused:

(1) Protection of shareholder’s voting rights

(2) Protection of creditor interest

(3) Roles and responsibilities of directors

(4) Law enforcement

Legal framework

- Amendment of Bankruptcy Act and related laws help expedite law enforcement procedure (less time consumed for court procedure and less cost).
- Adoption of new accounting standard.
- Amendment of Security and Exchange Act (SEA) and Public Company Act (PCA).

SEA and PCA amendments

- increase shareholders’ right to call a shareholders meeting
- require company to disclose more information to shareholders
- provide additional protection for minority shareholders in case the resolution has strong impact on shareholders
- strengthen and modify director’s duties

Legal framework

- clearer and extensive definitions about directors’ conflict of interests
- insider trading
- accountability of the management for fraud or misconduct

SEC supervision:

*To press on with "**disclosure and transparency**"*

- SEC be more stringent to monitor and enforce companies in submitting financial statements.
- New accounting standard with more coverage, including standard on consolidation of financial statements, conforming with General Accepted Accounting Principle (GAAP).
- Audit committees.

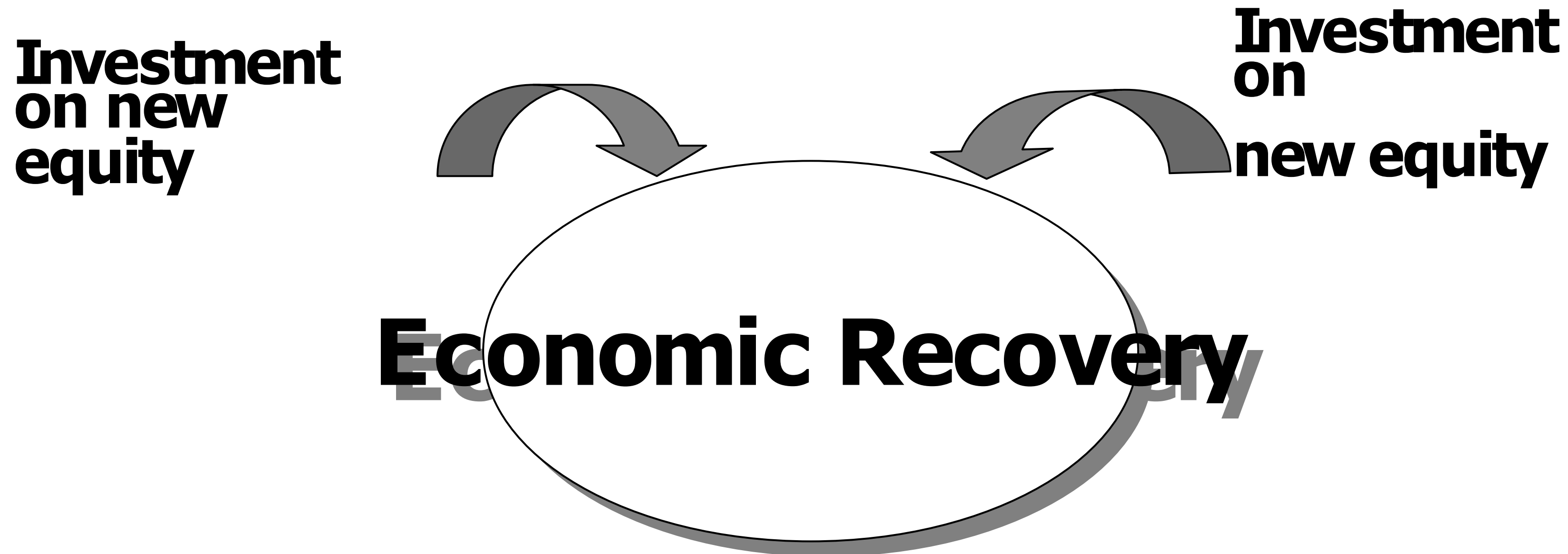
Roles and responsibilities of board of directors

- Stock Exchange of Thailand (SET) issued the **code of best practices** for directors of listed companies.
- Roles of independent directors
- As the **Code of best practices** is not legally compulsory, a scheme to building up management’s awareness is necessary.

Financial system reform

- Financial Institutions' Recapitalization
- Support for Merger of Financial Institutions
- Privatization of Intervened Commercial Banks
- Establishment of the Asset Management Companies
- Strengthening the Operation of Public Specialized Financial Institutions
- Amendment of Financial Sector Laws

Corporate governance and recovery



- Investment is crucial factor for economic recovery.
- With inadequate corporate governance, investors are reluctance to make new investment, thereby retarding economic recovery.

Conclusions

- Cultivating corporate governance requires changes in legal framework and business culture.
- With corporate governance, growth could be sustainable: quality growth.
- Without corporate governance, growth could be short-lived and the economy is prone to repeated crisis.

"Corporate Governance in Asia: Are Global Principles and Practices Sufficient?"

Jamie Allen
Secretary General
Asian Corporate Governance Association
Hong Kong

Outline of presentation to the

APEC Symposium on
Emerging Enterprises and Corporate Governance:
New Economy and Old Rules

Taipei, October 16-17, 2000

Summary
This presentation will examine whether the current convergence across Asia towards a minimum set of "global" corporate governance principles and practices—widely seen as an inevitable part of globalisation—will produce significantly higher levels of transparency and accountability in Asian companies over the short to medium term? With some exceptions, the answer is probably no. Reasons include: the existence of dominant shareholders (families or the state) in most Asian companies; the historic absence of director training and a shortage of competent independent directors; a tendency towards form rather than substance; government ownership; regulatory weakness; and fragmented market pressure.

I will argue that while global standards provide a sound basis on which to begin reforming domestic corporate governance regimes in Asia, they should not in all cases be seen as a final answer. Today's global standards are based largely upon "Anglo-American" concepts of corporate governance, which is itself a reflection of the strength of the US economy during the 1990s, the influence of the US as a provider of capital, and the leadership shown by the UK in developing new standards of corporate governance (starting with the Cadbury Report in 1992). While it would be fair to say that the Anglo-American model is the most robust and workable system of corporate governance available, it is also true that it was devised for a different corporate system than exists in Asia. The danger is that simply trying to graft these ideas on to national company and securities laws will produce the appearance of improved governance, but not a great deal of tangible change. The imperative is for national authorities, market players and related parties to think through how best to adapt and implement global principles and practices creatively in order to achieve real improvements in Asian corporate governance. Some suggestions will be offered.

Convergence around global standards
While Asian countries are not moving towards identical systems of governance, there is a striking agreement among the proponents of reform in each country—market regulators,

central banks, institutional investors, professional associations, non-governmental organisations, the media and academics—on the centrality of certain principles (see table 1). These include:

- Enhancing shareholder value as *the* or *a* primary focus of companies, and upholding or extending shareholder rights. (This is accepted, even in places like China, as a fundamental prerequisite for the development of capital markets.)

- The need for non-executive and independent non-executive directors to provide an "outside" view on strategic direction and to counterbalance the executives on the board (or to help strengthen the supervisory board vis-à-vis the management board in two-tier systems).

- The usefulness of board committees responsible for audit, nomination and compensation and comprising a majority of independent or non-executive directors.

- The importance of higher levels of financial disclosure from listed companies and much improved auditing practices.

- Allowing or encouraging institutional investors to act as a check against management and a lever for enhancing board independence.

Why is convergence occurring? First, globalisation is driving standardisation and there is a worldwide trend towards adopting Anglo-American corporate governance concepts. Second, this approach offers an efficient solution for emerging markets that quickly need to reform their financial systems and regain credibility. Third, foreign institutional investors have a stake in promoting higher standards of corporate governance (and many of the larger ones are based in the US). Fourth, domestic pressure for greater corporate accountability and transparency is rising and many of the participants in this process are either Western trained or accept the logic of Anglo-American corporate governance principles.

Points of divergence also exist and will influence domestic corporate governance systems in the years ahead (see table 2). These include:

- The degree of emphasis placed on "stakeholders"(a broader group of interested parties including employees, customers, creditors, environmentalists, consumer rights groups, and so on).
- The two-tier versus single tier board system.
- The impact that legal culture has on how governments write and enforce new codes of best practice.

But convergence remains the dominant trend in Asia at present.

Local implementation of global principles
How best to implement the new corporate governance principles is a question that each government is grappling with. Some countries have quickly incorporated global principles into their company and securities laws, while others have preferred to strengthen their listing rules. Most countries have developed new codes of best practice over the past two years, but the extent to which these are mandatory varies considerably. This process is not carried out in isolation, but usually involves negotiation with domestic corporations, local investors and foreign institutional investors. Depending on the economy, it may also involve the IMF, World Bank and the Asian Development Bank.

The issues can be quite complex. What is the right balance between mandatory rules, self-regulation by companies and market mechanisms (eg, pressure from institutional investors)? Should the new rules be applied to all companies or, at least initially, just the largest listed ones? What social obligations can legitimately be imposed on companies? Should best practices like world-class financial disclosure, independent directors and audit committees be implemented all at once or phased in? What are the implications for national competitiveness if reform occurs too slowly and investors lose confidence? What complementary institutional building is required to ensure that best practices do not become mere window dressing (eg, a new institute of directors to train directors and inculcate the meaning of "independence")?

These questions represent just the tip of the iceberg and indicate the difficulties involved. Differences in priority are already apparent at the national level following the recent spate of reforms. China expects its overseas-listed state enterprises to meet a much higher standard of governance than domestically listed companies. In March 1999 the China Securities Regulatory Commission released a new set of measures designed to "deepen reform" among the former. Korea sets a higher standard for the proportion of independent directors on the boards of its largest listed companies and banks than other listed companies, and has made audit committees mandatory for the largest listed firms. Hong Kong is bucking a regional trend by not making audit committees mandatory (except for GEM companies). It does, however, use a mixture of official arm-twisting and peer pressure to persuade listed firms to implement them. Thailand, which produced a new code of best practice in March 2000, echoes Hong Kong-style pragmatism by stating that governance reform must be practical and take into consideration the "Thai operating context".

The really interesting question is whether Asian countries will develop original ideas in the process of adapting international best practice to their specific circumstances. Although reform has just begun, it is already apparent that some Anglo-American solutions, designed as they are for a different corporate system, may not function effectively in Asia—at least over the short term. Can we realistically expect relatively young and inexperienced independent directors to monitor incumbent management in the average Asian company? Will audit committees, made up of such people, provide adequate checks and balances? The problem is not that the concept of independent directors is inapplicable to Asia—without them how would most minority shareholders

be represented on a board?—but that the Anglo-American way of nominating and electing such directors (the board nominates, the shareholders "elect" at the annual general meeting) may be insufficient to ensure the system works in the family controlled Asian firm. Perhaps minority shareholders need to be given a greater say in the nomination of their representatives?

There are also complaints that the "one share, one vote" system does not allow minority shareholders to influence management decision-making because they can easily be outvoted by controlling blockholders. There is criticism that audit committees are not receiving real information about corporate accounts. And there is a broader concern that corporate governance reform in many Asian countries will be stymied by the undeveloped nature of domestic legal systems and public institutions responsible for regulatory and financial oversight.

If these legitimate issues are not addressed, the danger is that corporate governance reform in Asia will result in more form than substance—at least over the short to medium term. It will create new formal structures within companies (and impose new costs), while producing inadequate substantive improvements in accountability and transparency. Pockets of improvement will undoubtedly appear in a small percentage of companies with strong incentives to become more open (eg, those accessing international capital markets), but the average level of governance will only improve incrementally.

The logical conclusion of this argument is not that Asia needs an entirely original system of corporate governance (which would defeat the reason for and purpose of much of the current reform effort). Instead, global principles and practices need to be sensibly implemented so that the objectives of greater accountability and transparency are met in practice, not merely in appearance. My talk will go on to suggest some ways in which this might be done.

ASIAN CORPORATE GOVERNANCE ASSOCIATION (ACGA)

"Corporate Governance in Asia: Are Global Principles and Practices Sufficient?"

Presentation by Jamie Allen, Secretary General, ACGA
to the
APEC Symposium on
Emerging Enterprises and Corporate Governance:
New Economy and Old Rules
Taipei, October 16, 2000

ACGA Background

- **Founded:** In August 1999 by David Chiang, Chairman, Lombard/APIC and a group of Asian business leaders from 8 countries.
- **Aim:** To promote the commercial and practical benefits of corporate governance to Asian companies, and to assist them in implementing it.
- **Achievements**: Regional report (1--updated), major articles (2), seminars (1), conference speaking engagements (14), policy commentary (3), information conduit (database of >500 contacts, many of them outside Asia), awards judging (2).
- **Future:** Website, membership services, training, further publications and advocacy.

The issue: a global perspective

"The global economy necessitates global corporate governance standards."

Investment manager of "the world's largest pension fund", quoted in

Governance, September 2000.

The issue: a regional perspective

"For Asian firms and economies to compete successfully for funds in the years ahead, their corporate governance practices must *at least match* those of the new international standards. And they must be clearly seen to have achieved those standards."

Report to APEC Finance Ministers, May 1999.

The challenge

- Although global principles are indeed valid for Asia, simply transplanting them to the region is likely to produce disappointing results--in *most* cases.

- There is a danger that in five years time we will look back and find we've built a hollow framework. Form rather than substance.

- The challenge is to find creative ways to localize global principles, while ensuring that the spirit of those principles--greater transparency, accountability and fair treatment of all shareholders--is upheld.

Some qualifications

- "Best-practice" approaches are valid for Asia.
- Localization means finding ways to root global principles in each country, not to dilute them.
- Corporate governance reform is a gradual process. I do not expect rapid change. But the starting point is critical: a weak foundation will mean a weak structure later on.
- There is no perfect system of corporate governance. Trail and error is inherent in this process.

Sources of "global principles"

- The UK Combined Code (1992-98)
- CalPERS Global Principles (1997)
- OECD Principles (1999)
- ICGN Statement on OECD (1999)
- CACG Principles (1999)

CalPERS: California Public Employees' Retirement System
ICGN: International Corporate Governance Network

CACG: Commonwealth Association for Corporate Governance

ICGN Statement: Main points

- "Optimize returns to shareholders/manage relationships with stakeholders".

- One-share, one-vote.

- Independent non-executive directors (INEDs): at least 3, at most a "substantial majority".

- INEDS should "monitor" management and "contribute effectively to strategy".

- Board committees: audit, compensation, nomination. Composed "wholly or predominantly" of INEDs.

ICGN Statement: continued

- Compensation of directors and key executives should be aligned with interests of shareholders.
- Disclose compensation of individual directors and key executives.
- Major strategic shifts require shareholder approval.
- Active cooperation between corporations and stakeholders.
- Institutional investors have a fiduciary responsibility to vote.

Impact on Asia

Since the crisis:

- New or upgraded codes of best practice in most major economies.
- Changes to listing rules and some legislation.
- New regional initiatives
  - APEC Initiative, including report on “Strengthening Corporate Governance in the APEC Region”.
  - PECC PARNet
  - ACGA
- New institutional development at the national level
  - New Institutes of Directors: Philippines, Singapore, Thailand
  - New NGOs: Indonesia, Japan, Korea

Convergence in Asia

- Convergence around best-practice principles:
  - Shareholder value
  - Board independence and monitoring
  - Equal voting rights
  - Minority shareholder access to management
  - Greater financial disclosure
  - Greater "non-financial" disclosure
  - Rationalization of executive compensation
  - Enhanced auditing
  - Greater role for institutional investors

Points of convergence

	Shareholder value	Independent directors	Higher levels of financial disclosure	Independent committees	Codes of Best Practice	Institutional investor importance
China	Note 1	Note 1	Y	Note 1		Y
Hong Kong	Y	Y	Y	Y	Y	Y
India	Y	Y	Y	Y	Y	Y
Indonesia	Y	Y	Y	Y	Y	
Japan	Y	Y	Y	Y	Y	Y
Korea	Y	Y	Y	Y	Y	Y
Malaysia	Y	Y	Y	Y	Y	Y
Philippines	Y	Note 2	Y	Note 2	Note 3	Y
Singapore	Y	Y	Y	Y	Y	Y
Chinese Taipei	Y		Y			
Thailand	Y	Y	Y	Y	Y	Y

Note 1: These principles have been recognised as important by the China Securities Regulatory Commission, especially for large state-owned enterprises listed overseas.

Note 2: Banks in the Philippines are required to have independent committees for remuneration and audit.

Note 3: A code of best practice is being proposed to the government in the Philippines.

.... and divergence

- **While convergence is the dominant trend at present, differences remain in principle ...**
  – Stakeholder focus
  – Single- vs two-tier board
  – Size and scope of code of best practice (level of detail, range of situations covered, underlying philosophy).

- **…and practice**
  – Implementation in phases: China, HK, M'sia, Sing, Thai
  – Implementation in leaps: India, Korea
  – Focus first on bigger companies:China, India, Korea
  – Voluntary vs mandatory rules: all countries use a mixture of regulation and self-regulation.

However ...

The focus of reform across the region is largely about injecting global best-practice into domestic company and securities law--mainly to satisfy the pressures of globalization--while giving relatively little attention to developing new ideas for localizing best-practice.

This is understandable, since it is still early days in the process of corporate reform. But with economic recovery upon us, has the political will to do more begun to subside?

Obstacles to global best practice in Asia over the near term (1)

Obstacles	Typical consequences
Dominant blockholders, entrepreneurial CEOs and "family style"	•Negates one-share, one-vote and creates investor passivity. •Undermines INEDs, hence board committees as well. Inadequate information flows. Shortage of potential INEDs. •Skews compensation. •Impedes proper disclosure and auditing.
Cross/pyramid shareholdings	Ubiquitous related-party transactions. Information opacity.

Obstacles to global best practice in Asia over the near term (2)

Obstacles	Typical consequences
State ownership	•Adds a political and often non-commercial dimension to board decision-making. •Can also undermine INEDs and board committees. •Shareholders may lose at the expense of stakeholders.
Weak regulatory system	Existing regulations cannot be enforced; may not be appropriate.

Obstacles to global best practice in Asia over the near term (3)

Obstacles	Typical consequences
Partially developed legal system	•Minority shareholders are limited in their ability to seek redress through the courts. •Derivative suits allowed, but not class action. •Often high costs imposed on minorities pursuing a civil action.
Restrained media	•Less public debate •Less information flow

Clash of historic contexts

Today's "global" principles are mostly based on Anglo-American concepts of corporate governance. They are a pragmatic solution to the problem of "agency conflict" in publicly listed companies with a diversified ownership base, and which are operating in stable legal systems and mature democracies.

Should we expect these principles to work in each Asian country in the same way as they do in the US or the UK?

Solutions: “Soft” mechanisms

- Emphasize the positive, commercial benefits of corporate governance. So many Asian companies see it just as new regulation or cost. But this need not be a zero-sum game.
- Recognize the apprehension that exists about imported “alien” concepts. Discuss them in “market”, not “cultural”, terms.
- Translate jargon like “fiduciary responsibility” by using terms that make sense locally (eg, duty, obligation, trust, loyalty, honesty).
- Find positive translations for the term “corporate governance” in local languages.

Solutions: Empower minorities so as to balance blockholders

- Give priority to raising accounting and auditing standards: most shareholders put a higher value on good financial disclosure than board reform.
- Allow cumulative voting (as Korea has done), but do not allow companies to exclude or postpone it.
- Allow class-action suits, or lower the entry hurdles for derivative suits (as Korea has also done).
- Allow minorities a role in the nomination, not just the election, of new directors.
- Permit online voting.

Solutions: Make use of market mechanisms

Currently, there is a very strong reliance on governments to drive reforms. Much institutional investor activism is “invisible” (investor-to-company), while retail activism is extremely limited.

- More of the onus to drive change should be on investors--institutions and retail. New organisations representing investor interests need to be created, like the PSPD in Korea, or the Council of Institutional Investors in the US. Even Hong Kong lacks an organization representing investors, something which the SFC has commented upon.

Solutions: Share information

- Information sharing can be a substitute for weak legal and regulatory institutions (ie, investors use data from each other to make decisions rather than rely on the implicit guarantee of enforcement by state agencies). Eg, Webb-site.com in Hong Kong.
- Shift away from “merit-based” selection towards “disclosure-based regimes” in many of the new second boards should encourage better use of information and more self-reliance.
- The Internet will become an increasingly efficient facilitator of this (eg, GEM board in Hong Kong).

Solutions: Education

- Require all directors, including the chairman and CEO, to undergo some training each year?
- Require owners and senior managers of companies undergoing IPOs to sit a test?

Solutions: Keep the big picture in the frame

- Focus on outcomes and objectives--real improvements in transparency, accountability and fair treatment of shareholders--and keep “process” issues in perspective. Be flexible.

- Best-practice principles are only a means to an end. The danger is that they may become an end in themselves.

Innovation

"As Korea considers further corporate governance reforms, it must recognize that the approaches used in other jurisdictions may be inadequate to deal with the entrenched intra-group relationships which characterize the chaebol.

"The government should be prepared to consider a limited number of reforms for which there is limited precedent elsewhere.

"Innovation always carries with it uncertainty, but it is also the means by which the leading edge of corporate governance reform is redefined and advanced."

Coudert Brothers, Shin & Kim, Bernard Black (June 2000)

Goldman Sachs

The Role of Capital Markets In Corporate Governance

Fred Hu
Asia Pacific Economics Research
October , 2000
Taipei

1

Corporate Governance: Why Does it Matter?

- Separation of ownership (financing) and control (management) is a key feature of modern corporations
- Mis-aligned incentives, moral hazard, information asymmetry, etc lead to the **principle-agent** problem
  - appropriation of investors (pyramid schemes, transfer pricing)
  - perks, corporate jets, pet projects, empire-building
  - pursuing high-risk, low return projects and other value-reducing activities

How to ensure managers act in the interest of investors (both shareholders and creditors) ?

- **The CORE of CORPORATE GOVERNANCE**

2

Lessons from the Asian Economic Crisis

Serious Weaknesses in Corporate Governance in Asia

- Family-controlled conglomerates
- Cross-shareholding
- Excessive leverage
- Disregard for minority investor interests
- Lack of transparency and information disclosure
- Poor return on investment

3 Common Sense: Good Corporate Governance Requires a Good Legal System

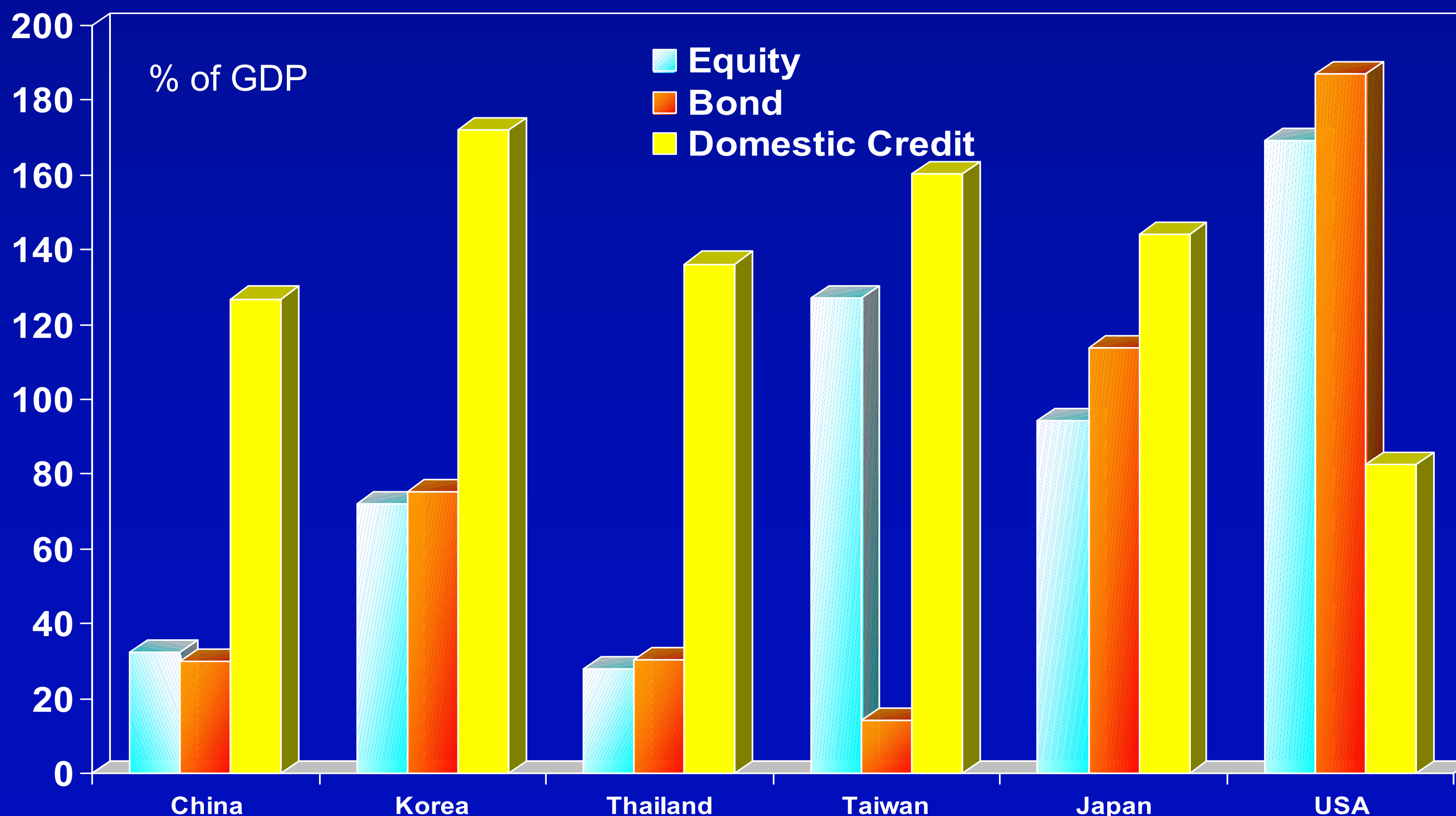
- Protection of investors (especially minority shareholder) rights
- Legal prohibitions against managerial self-dealing
- Well-functioning courts to effectively enforce contracts and settle disputes

4 But It Takes More Than Law to Achieve Good Governance

- Laws do not automatically eliminate value-reducing or sub-optimal managerial behavior
- Capital markets can play a critical role in efficient allocation of resources
- Capital markets reduce information costs & moral hazard, monitor managerial performance, and mitigate principal-agent problems

5 Asian Financial System not Conducive to Good Corporate Governance

- Deposit-taking banks are dominant financial intermediaries
- Capital markets are far less developed



6 Banks Are Ineffective in Improving Corporate Governance

Banks themselves are firms facing daunting corporate governance challenges.

- Vulnerable to moral hazard (explicit deposit insurance or implicit government guarantees)Protection of investors （especially minority shareholder）rights
- Taking excessive credit risks and failure to monitor borrowers
- Proprietary as opposed to public information

Capital Market Solutions: Information Devices

- Companies raising financing in public markets are required to disclose
- In an efficient capital market, stock prices reflect all relevant information
- Stock prices serve as guide for firm’s capital spending decisions and a yardstick for managerial performance

8

Capital Market Solutions: Altering the Capital Structure

- Shift from equity financing to debt financing to decrease information costs & increase financial discipline
- Change debt/equity ratio to maximize the firm's market value

Capital Market Solutions: Large Shareholders

Concentrated ownership to mitigate agency problems

- Large investors have both the incentive and power to monitor managerial behavior, hence reduce agency & information costs

Examples:

- State-owned enterprises (SOEs) in China (free-rider problems)
- Hutchison-Whampoa in Hong Kong (K.S. Li’s controlling rights)
- Venture capital firms in US

- Risks: for mature firms, potential rip-off of small investors and other stakeholders in the firm (can be mitigated by a stronger legal system), less so for emerging enterprises

Example:

Executive Stock Option Schemes

11

Capital Market Solutions: Market for Corporate Control

Hostile takeovers/LBOs/MBOs

Benefits: Strengthened corporate governance, increased operating efficiency and market value

Example:

Corporate restructuring in the US in the 1980s and early 1990s

Requirement: Liquid capital markets

Barriers: Family or state-controlled enterprises with small free float; cultural, legal & political risks for corporate raiders, e.g., in Japan and Korea

12 CASE STUDY : PetroChina 中国石油

	Before	After
Principal Businesses	13	4
Employees	1.5 million	480,000
Corporate Governance	Government Unit	Board of Directors 3 Independents
Management	Government Targets	Return-based
Accounting Standards	PRC GAAP	IAS/US GAAP
Incentive Program	None	1st approved in PRC

Conclusions:

To improve corporate governance in Asia, countries in the region MUST:

- ✓ **Build up legal institutions**
- ✓ **Develop capital markets**

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Improving the Legal Environment for Emerging Enterprises

Preliminary Draft

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1. Introduction

In this paper, I discuss how to improve the legal environment for emerging enterprises in the Asia-Pacific region. I discuss both private law and public regulation. Each economy has its own history and experiences of laws and regulations, and thus any change from the present state must be "path dependent." Also, while it is common that emerging enterprises will have a positive effect on the economy in any place, the way in which such enterprises operate may take different forms, depending upon laws, regulations, business customs and culture in any given economy. Thus, there seems no single solution to the problem of how to improve the legal environment. Nevertheless, I try to emphasize factors that should be common, rather than those that should be different among various economies in the region.

In Section 2, I identify the basic legal issues concerning emerging enterprises. In Section 3, I examine corporate governance. In Section 4, I examine financial law, particularly securities regulation. In Section 5, I discuss corporate law. Section 6 is my preliminary conclusion. From time to time, I refer to Japanese experiences, not only because I know Japan better than other economies, but also because Japanese experiences might be of interest to policy makers in other economies in the region.

2. Basic Legal Issues on Emerging Enterprises

A variety of laws and regulations relate to emerging enterprises. For example, contract law, property law, corporate law, financial law, insolvency law, intellectual property law, and tort law are all what matter. In addition to these basic laws, the enforcement of these laws is also important, and in that sense there must be a well-functioning and reliable court system and private bar. In the following, however, I assume that these basic laws and the basic judicial

system exist, and focus on corporate governance first, and then two areas of law that in my judgment are important in encouraging startup, small businesses: financial law and organization law.

Unless a business is conducted by one person, a legal or organizational "form" of business is required. For example, suppose that a person created a small business using his or her own website and it becomes somewhat successful. He or she now wants to move the business to a corporate form to expand by introducing more capital from outside. This often happens in Japan today. In this situation, first, corporate law at the entry level is very important. Because the cost of incorporation is the key to the decision on whether to move the business in the corporate form. Second, corporate law, especially the law governing financing, is important, because the entrepreneur usually wants outside capital to expand. Third, the law governing the supply-side of capital is also very important. Because no one would invest money in such startup business unless he or she is sure that his or her money is secured and that his or her money will not disappear by theft or in the way he or she does not expect. The first two issues are mostly governed by corporate law, and the third issue by financial law, particularly securities regulation.

Of course, it is usual in any economy that the state provides special assistance in various forms, for example, by creating special lending facilities that offer favorable treatment in interest rates, tax and so on. These state interventions, however, make the essential role of corporate law and securities regulation ambiguous, in the sense that if such state aid is strong enough, it would offset the benefit of otherwise attractive reforms in corporate law or securities regulation. Overall, such state aid will be the cost to the economy, although it is not impossible that flourishing of startup businesses will produce more benefits than such cost to the economy. However, such state aid is usually designed to traditional-style small businesses, and new emerging businesses tend to look at capital markets for the source of capital, partly because entrepreneurs in the newer generation have an American mind and partly because new-type businesses have no physical assets to pledge to banks as collateral other than "soft" assets such as human capital and possible future cash flow. More importantly, it is always desirable to improve rules in corporate law and securities regulation, because the benefits brought by such improved rules are the net benefits, assuming that the level of the state aid (and thus the cost of such) does not change. I discuss corporate law and securities regulation in more details later in Sections 4 and 5.

3. Relevance of Corporate Governance

3.1. The Descriptive Aspect of Corporate Governance

Four basic questions regarding corporate governance are: (1) What is corporate governance?; (2) Does it matter?; (3) Do laws or regulations matter?; and (4) What do we know and what do we not know from the empirical studies

in recent years? While the following discussion often relates to large publicly held business corporations, the basic points being discussed are applicable to startup, small businesses as well.

3.1.1. What is corporate governance? Does it matter?

The notion of corporate governance is used in two different contexts: (1) a system or mechanism for stopping fraud and stealing money by managers of the corporation ("misbehavior control mechanism"); and (2) a system or mechanism for enhancing corporate prosperity and performance, and thus economic performance (or economic recovery) in any given economy ("performance enhancing mechanism"). While corporate governance in the former sense is still important, today we tend to put more emphasis on the latter function of corporate governance./1/

3.1.2. Two puzzling linkages or causalities

A. Two linkages

There are two logically possible linkages or casualties that will make laws and regulations on corporate governance important for the economy. One is the linkage between corporate governance and economic performance, and the other is that between laws and regulations and corporate governance.

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laws and regulations ==> corporate governance ==> economic performance

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The existence or strength of each of these two linkages or causalities is not entirely clear. Empirical evidence is split./2/ Under the circumstances, we believe today that corporate governance appears to affect economic performance, and laws and regulations appear to affect corporate governance. If so, corporate governance is important, and laws and regulations are important.

B. Systematic empirical studies

In the past several years, there are two sets of well-known empirical studies: (1) a series of studies by "LLSV": Professors La Porta, Lopez-de-Silanes, Shleifer and Vishny,/3/ and (2) a series of studies by "ECGN": European Corporate Governance Network.

These two sets of empirical studies were comprehensively surveyed and reviewed by Professors Berglof and von Thadden /4/.

LLSV studies show many interesting results, but as far as laws and regulations are concerned, they suggest the importance of proper recognition and legal protection of shareholders' rights, particularly (1) their voting rights

and (2) minority shareholders' rights. Countries whose laws offer good protection of shareholders have good corporate governance.

ECGN studies show somewhat different dimensions. Among others, in Europe, ownership structure is very important for corporate governance. Particularly, the existence of "controlling shareholders" - family, state, or corporate groups - is the key in Europe, and affects corporate governance in an important way. In this respect, the United States is an exception in that ownership of large public corporations are very widely dispersed.

3.2. Legal and Regulatory Reforms for Effective Corporate Governance: Prescriptions

3.2.1. So what should we do (in legal and regulatory reforms)?

The question of what we should do in legal and regulatory reforms for effective corporate governance is very difficult to answer. Laws and regulations change often indeed in response to many things and as a result of many things. We can describe the present state of laws and regulations in any given economy, but presenting proper prescriptions are very difficult for any given economy. Descriptions, even good ones, do not suggest good prescriptions.

After reviewing the past empirical studies, Berglof and von Thadden present 12 specific proposals for effective corporate governance in developing and transition economies (see Appendix 1).

While I very much like their analysis and agree with these proposals, they do not suggest specific legal or regulatory reforms for effective corporate governance. I am not sure we can derive specific implications for legal or regulatory reforms from their proposals. For instance, I agree with the importance of accounting, but accounting plays two different roles: accounting for investors and accounting for creditors. Investors want to know the truth of the firm, while creditors want to be paid back, so that creditor oriented accounting is so-called "conservative accounting." This was traditionally adopted in German and Japanese corporate laws. If firms obtain major capital from creditors, creditor oriented accounting is important, whereas if firms go to well-developed capital markets with dispersed equity investors, investor-oriented accounting is required Also, accounting numbers on the balance sheet, for example, must be correct ones, and this is not easy to assure in many situations.

3.2.2. My suggestion: common and different prescriptions

On the basis of my understanding of the past empirical studies and debates on corporate governance, I wish to be blunt and suggest both

prescriptions that should be common for all Asia-Pacific jurisdictions and those that are not common and should differ among jurisdictions. My common prescriptions are that any corporate system must have transparency and fairness. With respect to my different prescriptions, two determinants of corporate governance are important. One is the form of finance and the other is ownership structure. Note, however, that Berglof and von Thadden argue that a third determinant, that is, the stakeholders' role as non-shareholders is important.

3.2.2.1. Common prescriptions

Today, any corporate governance system must accompany both transparency and fairness. This is being the "global standard." Why? There is no logical reason. For instance, if a firm is owned by a family, there is no need for transparency (unless the family wants capital from outside) - the family knows everything and controls the firm. That's it. I think that the reason why transparency and fairness are required as a common standard for corporate governance today is just the fact of globalization. People act today across countries' borders (as technology made this possible and easy), and it is easier for different people to interact when transparency and fairness exist.

For legal and regulatory settings, to maintain and enhance transparency, disclosure and external auditing by independent auditors are the keys. In contrast, fairness is a vague notion, but I think that strong enforcement is the key to maintaining any legal and regulatory environment supporting fairness.

3.2.2.2. Different prescriptions

I have further prescriptions that are different in any given situation, because two important determinants of corporate governance are different: style of finance and ownership structure. Note again that Berglof and von Thadden argue the importance of non-shareholder stakeholders. They are probably right, but I do not see good prescriptions and so do not discuss it here.

A. Form of finance

Two prototypical forms of finance are bank borrowing and capital markets. In an economy where firms obtain its major capital from banks, banks play an important role in corporate governance. Where capital markets are the major source of capital for firms, capital markets play a role in corporate governance. This latter system, however, has a variety of problems. First, there are conditions for capital markets to function properly. Our experiences show that we need a strong "watchdog", such as a US SEC, for investor protection and maintaining fair and orderly markets - lack of such institution leads to failure in capital market operation. Also, as noted below, ownership structure matters a lot in a capital market based system.

As a prescriptive matter, generally speaking, a capital market based system is better because it offers more efficient ways of allocating resources and capital. To say so does not mean, however, that it is easy to move to a capital market system or that once you move, you can easily maintain efficient capital markets.

Importantly, history shows that if the system is capital market based, we need strong regulation - three strong sets of regulations: (1) strong investor protection, (2) strong SEC (enforcer), as noted above, and (3) a strong legal and regulatory infrastructure about institutional investors - in addition to transparency and fairness.

It is not easy to provide and maintain these three strong regulations, and thus, it is a policy matter whether any given economy should move to a capital market based system.

B. Ownership structure

A wide variety of ownership structure exists on our planet. The role of shareholders in corporate governance depends very much on who the shareholders are, and thus how firm ownership is distributed. In some jurisdictions (typically the US), ownership of publicly held companies is widely dispersed - the general public holds the significant portion of shares of these companies. Yet the general trend is that investor institutionalization is taking place, and mutual funds and pension funds are becoming major shareholders.

There are other patterns as well. In some jurisdictions, families control major companies. In some jurisdictions, even the state holds the substantial portion of shares in major companies. Elsewhere, other "controlling" shareholders exist in major companies. Even more complex, corporate groups are common in many jurisdictions. Of these patterns, investor institutionalization and corporate groups have important implications in corporate governance (see Appendix 2).

I am less confident about what prescriptions can be derived from paying attention to ownership structure. If the economy has dispersed shareholders, we need strong investor protection. If investors are institutionalized, we need strong fiduciary rules.

If controlling shareholders are dominant, whether family, state or something else, I see no good prescriptions. Then perhaps we should go back to the question of whether we should encourage the system to move to a "truly" capital market based system, a system having public investors and institutional investors.

C. Example: Implications of Japan's recent reform in the financial sector

Japan is in the process of the financial "Big Bang" program, by which a drastic overhaul and deregulation is taking place in the financial sector (see Appendix 3). This Japan's Big Bang may well result in important changes. First, various reforms mean that firms will obtain easier access to capital markets, and this will continue to reduce the role of banks. Second, reform of mutual funds and special legislation on asset securitization will increase the presence of institutional investors, who in turn may play some role in corporate governance.

Third, though not directly related to the Big Bang, banks and other financial institutions have been selling their shares in client firms, because holding them is costly. Similarly, cross-holdings among non-financial firms also are being reduced. This means a reduction in "stable shareholders", which suggests a change in the role of shareholders as monitors.

While it has been debated whether banks played a meaningful monitoring role in Japanese corporate governance in the past, their presence will inevitably decrease as a result of the Big Bang. The substitutabilities theory (see Appendix 4) suggests that something must substitute. Thus, the role of shareholders, or of capital markets in general, may increase.

The role of outside directors and auditors might become important. Here, market pressures may force Japanese firms to use internationally accredited auditing firms to prepare their annual reports and conduct their audits, and that would place additional pressure on management, because the information will be reflected (through disclosure) in the capital markets.

Finally, the complementarities theory (see Appendix 4) suggests that to the extent that bank presence is reduced, the lifetime employment system, and thus the system for recruiting senior executives, may change.

4. Reform of Financial Law or Securities Regulation

In this Section, I discuss how to improve financial law or securities regulation in supporting startup, small businesses. The discussion above has indicated that it is a policy decision to what extent any given economy should move to a capital market based system.

It is well-known that venture capitals who supply funds to emerging enterprises develop better when they have easy "exits." They typically want to exit when the business succeeds and reaches to an IPO. In this sense, venture capitals function better when there is a well-functioning capital market./5/ However, as noted above, having and maintaining a well-functioning capital market itself is not costless. There must be three strong regulations: strong investor protection rules, a strong enforcer, and strong fiduciary rules on institutional investors. Viewed this way, in most (though not all) economies in the Asia-Pacific region, the realistic path will be the mix of

bank financing and capital market financing. If so, the way in which venture capitals or other suppliers of capital to startup businesses are organized and operate may be different from that in the United States./6/

Especially when the state provides assistance in this area, it is easier to link such assistance to lending rather than financing in the capital market. Needless to say, the difference between lending and financing in the capital market is that in the former, the lender, not depositors, takes the risk of business failure and in the latter, investors, not intermediaries, take the risk. In startup, small businesses, there is much higher risk of failure. Indeed, experiences in the United States show that one out of a hundred ventures succeeds, and all others fail. When the state wants to help, it is easier to share the risk with the lending institutions, and in fact, this is the common way of state assistance in Japan. The state sets up special institutions that provide lending in favorable terms, and special institutions that provide guarantees to the debts by small businesses owed to banks. For capital market financing, it is difficult for the state to provide such assistance, although it may not be impossible to offer, for example, guarantees to the bonds issued by small businesses.

As noted at the outset, state intervention is not costless to the society. If capital markets function well, that is better without question. The general strategies for developing capital markets were already mentioned: prepare strong investor protection rules (notably disclosure and anti-fraud rules), provide a strong enforcer, and provide strong fiduciary rules on institutional investors. Here, I discuss a few more specific prescriptions for improving securities regulation.

First, preparing proper rules on private placements seems important. A private placement means issuing securities to certain qualified investors who fend themselves, without being subject to general disclosure requirement. Those qualified investors usually have the ability to negotiate with the issuer about contractual terms, so that the issuer can save the cost of complying with complicated mandatory disclosure requirement. The dilemma in securities regulation is that it must be ensured that such privately placed securities will not spill over into the hands of general public investors, so that usually restrictions of transfer of such securities are imposed: privately placed securities must not be transferred to the general public, and they must be traded only among qualified institution themselves. This can be done more easily for debt securities, because equity securities are fungible and it would cause a mess if some of them are traded publicly and some of them are traded privately. Thus in Japan, shares are not eligible to private placement. However, if this rule exists, private placements are difficult to use for small businesses (although an issuance of shares up to fifty investors are exempted from disclosure). The issue is, then, whether we can create effective rules on private placements for equity securities.

Second, general disclosure requirement can be liberalized for small

business financing. The size of the issuance of shares by a small business is relatively small, compared to that by a large company, and the number of investors is also relatively limited. Thus, in the United States, deregulated disclosure is available under Regulation A and Regulation D in the Securities Act of 1933. Auditing requirement for issuers under Regulations A and D is also liberalized. In Japan, after the Big Bang reform in 1998, the similar liberalized disclosure is permitted except that auditing requirement is the same as for larger scale issuers.

Finally, although this point is not limited to small businesses, permitting disclosure in electronic means surely helps small issuers much. Electronic disclosure is less costly, and provides startup businesses with an easier way to tap the capital market. In this respect, again, the United States took the lead. By 1998, all disclosure, including sending prospectus to investors, was made possible in electronic means. In Japan, this will be permitted beginning June in 2001.

Although as noted above there are yet many things to do in Japan, as a result of the Bog Bang reform, there are three stock trading markets available for emerging enterprises today (Mothers at Tokyo Stock Exchange, NASDAQ Japan at the Osaka Securities Exchange, and JASDAQ), and the total amount funded in these three markets in January through September in 2000 by IPOs of emerging companies recorded in 342 billion yen, 3.8 times larger than the amount in 1999. This amount is expected to be the highest in the Japanese history in the entire year of 2000./7/ This trend may be viewed somewhat natural, given that Japan made the decision to move to a capital market based system. However, it is noteworthy that this is not the result of the financial Big Bang only, but the result of other measures, some of which are discussed below.

5. Reform of Corporate Law

Traditional corporate law, especially corporate law with a civil law country origin, assumes relatively large-scale businesses, and thus imposes various measures such as minimum capital, inspection by an examiner of an investment in kind, and mandatory requirement on the composition of the board of directors. For startup, small businesses, such corporate law creates an entry barrier. As noted at the outset, when a person wants to incorporate his or her business consisting solely of his or her website, such property may not be enough to meet the minimum capital for a corporation. Investing the website also would require costly inspection by an examiner. Meeting other mandatory rules in corporate law may also discourage incorporation. In Japan, the minimum capital is 10 million yen, and an in-kind investment must be inspected by a court-appointed examiner. There must be at least three directors, and so on.

There are other restrictive aspects in traditional corporate law: rules concerning classes of shares. While it is common to use preferred stock in

startup businesses in separating control and investment in the US, corporate law in Asia is often inflexible in permitting issuance of preferred stock. For example, in Japan, the term of preferred stock must be stated in the company charter (with small exceptions), non-voting shares must be dividend-preferred shares, and such shares may be issued only up to one-third of the total issued shares.

Also, traditional corporate law is reluctant to incentive schemes, such as stock options. While Japan introduced stock options in 1997, such options may be issued only to the company's directors and employees and the total amount must be up to one-tenth of the total issued shares.

Finally, at a more general level, corporate law and securities regulation often overlap and sometimes even conflict with each other. In Japan, corporate law has a German origin and securities regulation comes from the United States. Although these laws are not the copies of German law and American law, corporate law emphasizes creditor protection to a non-negligible degree (recall minimum capital and inspection of in-kind investment above) and securities regulation emphasizes investor protection. For example, they overlap in auditing requirement ("reporting companies" are subject to CPA auditing requirement both in securities regulation and corporate law), and the problem is arising that securities regulation is now putting more emphasis on financial disclosure on a consolidated basis, while corporate law mandates accounting of individual companies for dividend regulation. How to adjust this dual system will be a major topic in the future in Japan.

All of these problems discourage small businesses in the corporate form. Until today, the Japanese response was to enact special legislation that permits special treatment for certain "authorized" small businesses.

The Ministry of International Trade and Industry ("MITI") (which has a main jurisdiction over small businesses in Japan) has been active in having special statutes passed in the Diet that include special provisions to the Commercial Code (where the major part of corporate law is codified). While this happened more than ten years ago, two recent pieces of legislation show this phenomenon well. And one of these is for small businesses. Specifically, the Act for Creating and Promoting New Businesses in 1998 (the most recent change in 1999 being effective from March, 2000) is a statute that supports startup, new businesses in Japan. Once a business obtains authorization by the MITI under the Act, it receives various favorable treatments in tax, law and other respects. As for corporate law, such business enjoys special favors. First, the limitation of issuing stock options is up to one-tenth of the total issued shares in the general rule in corporate law, but it is expanded to one-third under this Act. Stock options can also be issued to outsiders, while the Commercial Code only permits issuance to the company's directors and employees. Second, the amount of nonvoting preferred shares must be up to one-third of the total issued shares in corporate law in general, but it is expanded to one half.

Such shareholders obtain voting rights after one year from when the preferred dividend is not paid in the general rule, but three years under this Act. Third, while "ex post incorporation" (transfer of property to the company within two years of incorporation), like an in-kind investment, requires inspection by a court-appointed examiner, it can be substituted for by inspection by an examiner selected by the company. As of September 22, 2000, there are 41 companies which obtained authorization under this Act.

It must be noted that special measures recognized in this special statute are generally thought to be incorporated into the Commercial Code in the future. In fact, deregulation of the limitation of the amount of preferred stock, measures concerning stock options and liberalization of inspection on in-kind investments are under consideration in the current program for a wide-range reform of corporate law itself at the Legislative Council Commercial Law Division, an advisory body to the Minister of Justice having jurisdiction over the Commercial Code. Thus, the MITI's actions in special statutes cannot be ignored as an indication for future change in general corporate law in Japan.

6. Conclusion

Emerging enterprises are important sources for economic growth in the Asia-Pacific region and elsewhere. Innovation in information technology is making these enterprises easier to develop and making the market for these startup, small businesses more important for the national economy. The legal and regulatory infrastructure must be prepared and reformed in response to the increasing demand in this sector. How to improve the legal and regulatory environment may be contingent. Specific measures to be taken may vary from jurisdiction to jurisdiction, reflecting a different path that has existed in the particular economy's history. I have indicated that the importance of capital markets is ever increasing in the today's financial sector worldwide, and legal and regulatory reforms to make capital markets function better should be given more serious attention by policy matters. At the same time, organizational law, corporate law in particular, should be reconsidered. By providing strong investor or shareholder protection, ex ante restrictions on activities of corporations should be removed or liberalized. The process of such reform may lead to the merger of corporate law and securities regulation not only for large companies but for small businesses as well.

NOTES

/1/ A very nicely written report that shows this trend is Committee on Corporate Governance (1998) in the UK, popularly known as the Hampel Committee Report. The recommendations in this report were incorporated with slight changes into the "Combined Code of Corporate Governance" of the London Stock Exchange in June 1998. Also, the OECD published "Principles of Corporate Governance" in May 1999, which addresses both aspects of corporate governance mentioned in the text.
/2/ For example, an empirical study about US public companies by Sanjai Bhagat and Bernard S. Black (2000) reports that they find evidence that firms suffering from low profitability respond by increasing the independence of their board of directors, but no evidence that this strategy works -- that firms with more independent boards achieve improved profitability. Thus, their study does not support the conventional wisdom that greater board independence improves firm performance.
/3/ Shleifer and Vishny (1997); La Porta et al. (1997); id. (1998); id. (2000).
/4/ Berglof and von Thadden (1999).
/5/ See Gilson and Black (1998).
/6/ For an interesting discussion on venture capital in Japan, see Milhaupt (1997). See also Milhaupt (1998) for discussion on small businesses and the role of the state.
/7/ See Nihon Keizai Shinbun October 6, 2000.

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Appendix 1: Excerpt from Berglof and von Thadden (1999)

The problem with the OECD guidelines, in particular when applied to developing and transition economies, is that they cover a broad range of rules and principles without specifying clear priorities among them. Given that the guidelines assume many of the institutions that are lacking in these countries they also do not provide priorities across policy areas. Furthermore, even the watered-down language of these prescriptions is often too ambitious for policymakers. Nevertheless, we believe the OECD guidelines provide a useful start. To close the paper, we indicate, therefore, in the following paragraphs how we view the priorities for developing and transition countries.

(1) **Any international guidelines must recognize the international differences in governance systems.** Generalizations are often more harmful than helpful. Ownership and control structures differ tremendously and so do the basic mechanisms for correcting governance failures and the roles of different governance institutions. General principles do exist, however, and should be articulated, in particular when they are unlikely to be so locally. At least, they force domestic actors to make explicit their own preferences.
(2) **The general accounting rules and transparency requirements of the OECD guidelines should be a benchmark.** Transparency concerning ownership and control arrangements is desirable, in particular in improving the liquidity of shares and attracting foreign investors. It is hard to see how there can be any significant social costs to such disclosure, and the benefits seem substantial. The puzzle is to explain why companies in need of external finance have not implemented these guidelines on their own initiative. Doing so would presumably lower their cost of capital. The failure of the Transparency Directive of the European Union also shows that resistance or inertia is considerable. Either companies do not need (or want) outside funds or there are substantial private costs to disclosure. One hypothesis is that insiders to these arrangements are concerned that their legitimacy would be undermined.
(3) **Protection of external investors is more important in transition economies than in developing countries.** The emphasis in LLSV is most appropriate in transition economies where many managers have entrenched themselves in formerly state-owned companies. However, the necessary pressure for change will not come from small shareholders or takeover threats in anonymous equity markets, but rather must come from strategic investors with large stakes, or even from the labor force, political authorities, or others.
(4) **The development effect from any program that focuses solely on the plight of small shareholders is likely to be very small.** It is not clear that access to external funds is a binding constraint for most firms in developing countries. Even where it is, small, anonymous shareholdings will in most cases not be the dominant source of capital. Protection of strategic equity investors can be important, but most finance is likely to come through family ties or, possibly, peer group arrangements. The conclusion is equally valid for transition economies. This is not to say that small shareholder protection should not be part of corporate governance, it just should not be the main focus.
(5) **Protection of creditors is more important than that of shareholders in**

developing and transition economies. Debt is the dominant source of external finance in developed market economies. In relative terms, equity currently is more important in developing countries. But equity is typically raised not in public markets but through family ties or personal relationships. In the short term, substantial increases in external finance are likely to take the form of debt, probably from banks. Recent studies show a strong link between creditor protection and the development of the banking sector. In most transition economies companies have not been successful in raising external finance, but the need is great. Strategic shareholders are important to achieve restructuring, but most external capital in these countries, too, is likely to come as debt.

(6) **The short- and medium-term emphasis on investor protection should not be on creating liquid markets for shares and corporate bonds.** The reason is not that liquid markets and liquidity, as is sometimes argued, are undesirable. Liquid markets generate information and facilitate control transactions in many developed market economies. In developing economies, liquidity is most important when families have to sell out, but this does not seem to be a first-order problem in the short and medium term. In some transition economies liquid equity markets could play a role in helping strategic investors build positions, but it is not clear that insiders will issue shares to let this happen.

(7) **In the long term, liquid securities markets can be important for attracting foreign portfolio investment.** These markets are hard to create, take time to develop and are difficult to sustain. In most countries they do not have an important role as a source of finance. The recent problems in Asia and Russia have also demonstrated how volatile these markets are, but the vulnerability of individual countries seems to be closely related to how well protected external investors are. This may be the type of investment where investor protection matters most. Foreign portfolio investment has important benefits in relieving domestic capital constraints, and the lure of such investment can be important in the implementation of governance reform.

(8) **Reforms focusing on enforcement are more important, and more difficult, than are changes to the letter of the law.** This obvious point needs to be made. Unfortunately, we have not had much to say about how to strengthen enforcement and promote the rule of law. Self-enforcement is necessary, given the weakness of the legal institutions, but as the experience from Russian corporate law reform demonstrates it is not sufficient.

(9) **Reforms must recognize the complementarity of different parts of the law and political institutions.** In countries with strong law enforcement, legal protection and obligations of economic actors must be different from those in ones with weak enforcement. The efficiency of legal procedures, such as the scope of criminal or civil law in business court cases or the use of circumstantial evidence in court, will depend on the overall legal framework and the political structure of the country.

(10) **In many contexts the most immediate concern is to protect stakeholders other than shareholders.** In many transition countries, Russia in particular, the main governance problem is entrenched managers' outright theft from, or at least failure to pay, the government and employees. Ruthless managers also exploit suppliers and customers locked into inherited technological relationships. Weak labor laws in many developing countries discourage firm-specific investment by employees and could also undermine general skill formation. Obviously, a stakeholder approach can allow managers and individual stakeholders to exploit blurred corporate objectives and

paralyze decision-making. But corporate governance reform must strike a balance between financial and non-financial stakeholders and recognize the needs, and in particular the potential value added, of stakeholders other than shareholders.

(11) Implementation and enforcement of fundamental corporate governance reform will in many cases require external conditionality. Governments in developing and transition countries are generally weak. This weakness has many sources, but one important reason, in particular in transition economies, is the political deadlock over central parts of reform. These deadlocks arise out of the distribution effects of reforms. External conditionality can relieve these political constraints. The role of the European Union as an outside anchor to the reform process has been crucial to institutional reform in Central and Eastern Europe. Unfortunately, EU membership has not been in the cards for most of the former Soviet Union (the Baltic countries excluded). Conditionality from the international financial institutions could also go some way and should be systematically used, but it can never have the same leverage effect. For corporate governance reform, explicit or implicit conditions formulated by foreign investors are also important, but this pressure is likely to be less consistent and less coordinated. Here OECD and other guidelines may be useful.

(12) Effective corporate governance reform will often require a combination of threats and co-optation of the main actors. Given the weakness of governments and the absence of credible outside anchors in most developing and transition economies, fundamental reform will not be undertaken against the will of the main actors. Pivotal groups will somehow have to be co-opted. In other cases, threats may be necessary. In the extreme case of Russia, re-nationalization of strategic assets followed by renewed privatization may be the only way to break resistance. Yet, this measure has obvious reputation consequences and the government may not be strong enough to act on such a threat.

Appendix 2: Investor Institutionalization and Corporate Groups

1. Investor Institutionalization

Background

There are a variety of forces which promoted the institutionalization of investors in major countries' capital markets. First, the very strategy of traditional securities regulation, namely disclosure, made the general public rely more on investment advisors and other professionals than themselves. Individual investors do not have the time or the ability to evaluate the vast amount of information disclosed in accordance with the regulation. Although the "efficient market" theory well recognized in financial economics implies that market prices reflect all available information, and therefore investors do not need to search further to "beat the market," the degree of market efficiency depends upon a sufficient level of evaluation of the information available in the market place, and thus upon the activities of market professionals. Moreover, retail investors need advice on how to build the best portfolio of their personal assets (including advice on how much they can spend and save). This type of behavior by public investors is becoming more evident as an aging society progresses.

The second force promoting institutionalization was that a number of countries implemented tax and other policies that encouraged "indirect" investment (through mutual funds and other schemes) in capital markets by the general public. The United Kingdom and other countries seem to have a policy toward encouraging such indirect investment. In Japan, the national policy on this point seems less clear. The Tokyo Stock Exchange, for instance, has a long established policy of encouraging direct investment, and maintains the view that an increase in direct participation by retail investors in the stock market is desirable. The key question is whether a stock market with the vast amount of individual investors is more competitive (and therefore better) than one dominated by a relatively small number of large institutions.

Third, as a result of financial innovations, mostly brought about by technological advancement and deregulation, "new" instruments and techniques have been spawned in the market place. Thus, various sophisticated (and sometimes too complicated?) financial products, as well as complex hedging techniques developed along with the new financial derivatives, abound in the market place. This naturally accelerated the growth, and strengthened the power, of institutional investors who are better equipped with both human and non-human resources to respond to the environment.

The institutionalization of investors called for a change in regulation. In addition to the somewhat straightforward exemption approach to institutions as described above, regulators came to think that institutions, or schemes of collecting money from the general public, should be subject to some form of

regulation. Thus, substantive regulation of pooled investment schemes became another important part of capital market regulation. This regulation has a primary focus on governance, centering upon applying fiduciary principles with a view to preventing conflicts of interest and protecting public beneficiaries. Also, the regulation of retail marketing of the "units" of the pool became an important issue.

Market Participants

In the era of direct investment by public investors, securities companies acted as intermediaries both in primary and secondary markets. Institutionalization, however, changed their strategy, and brought them new business opportunities. In particular, the asset management business has become quite important. Securities companies and others moved to "combine" broker/dealer activities with advisory, pooling and management businesses. As a result, regulatory concerns regarding conflicts of interest became more important than before. Note, in this connection, that pooled investment schemes are often less costly than traditional banking operations (although various regulatory and historical environments make the picture less clear in many countries), and as a result, the banking industry is moving from the traditional banking business to the newer "fee" based, or pooling, business. This, in turn, brings increased competition in the pooling and asset management markets, and makes this area even more important both for investors and regulators.

At the same time, an economy of scope in combining various financial services activities in an integrated fashion accelerated the growth of financial conglomerates, and augmented corresponding regulatory concerns.

Market Structure

The phenomena described above, and particularly the investor institutionalization and the flowering of the asset management business, had an impact on the structure of both capital markets and industrial organization. Although the stock markets established at stock exchanges used to be the only place for stock trading, investor institutionalization, coupled with advanced computer technologies, changed the way of stock trading. Stock exchanges have faced direct competition with various (off-exchange) electronic trading systems, and the structure of stock markets has become more complicated. This has raised the difficult regulatory issue of whether and how to regulate these electronic trading systems.

Also, the ownership structure of public firms was affected. The traditional model of the separation of ownership and control, by which shares of public firms are anonymously held by many dispersed public investors did not reflect the real world. Instead, the shares of public firms became commonly held by a relatively small number of institutional investors (as well as public

investors).

As a result, dual governance problems came to public attention. First, we now observe increased discussion on when and how institutional investors exercise their stockholder rights in the firm whose shares they own, and whether increased activism by institutional stockholders is a good thing for a national economy. Second, governance within these institutions themselves became an important issue. The key question is how the management of these institutions should be accountable to their public beneficiaries, and whether some form of regulation should be installed to secure their accountability.

2. Corporate Groups

Obviously, the sheer existence of a group of companies alone does not necessarily cause problems in corporate governance. There are many legitimate reasons for setting-up such a group: enhancing both economies of scale and scope, improving partitioning of assets, and minimizing taxes. On the other hand, the shareholder controlling a group of companies maximizes his profits by putting the interest of the group as a whole above the various interests of the members of the group. Thus, at the individual company level, the interests of creditors and (minority) shareholders can be jeopardized by the group policy even though it does not specifically aim at an inefficient use of assets in the group as a whole. Indeed, creditors who lend one company of the group would be deceived and expropriated if the assets of the company are taken out and diverted to another company in the group.

Such danger is not deemed large enough for any jurisdiction to per se prohibit the group of companies structure. For example, U.S. courts, which in the nineteenth century showed quite some hostility towards holding companies, are all but ignoring group of companies considered as such. At the other extreme, Germany devotes substantial legislative and judicial attention to groups of companies (Konzernrecht), but does not forbid them.

What many jurisdictions have in common is to limit the controlling person(s) decision-making power and/or to make both control and the group transparent. This presupposes that a group of companies can be identified, which is not an easy task. First, it requires detecting the possible existence of large shareholders, which is often quite difficult due to the non-disclosure of holdings and the widespread use of confidential agreements among shareholders. Second, and more importantly, detecting large shareholdings is not the end, as control may be achieved in many different ways. For example, in small firms, it is normally necessary to own or be able to exercise 50% of the voting rights, whereas in larger firms, owning or being able to exercise merely 10% to 20% of the voting rights is generally all what is needed. In addition, there are more subtle sources of control, as reflected by patterns we observe around the world.

Thus, in the current economic environment, at least four categories of groups can be identified. The first and most transparent category comprises companies where one entity clearly owns all or a controlling block of shares. This is the case when a parent company fully owns one or various subsidiaries (typical in the U.S.), when a wealthy family jointly manages various companies (typical in Germany, Italy or Japan) or when the state has a stake in a holding company (typical in France and Italy). In the second category, companies own shares in one another, so that cross shareholdings exist, but there nevertheless is one company which can be identified as the controlling shareholder of the group because of the relative size of its ownership (typical in Germany). The third category includes companies that are linked together, by cross shareholdings or otherwise, with no single company being a controlling shareholder, but where several companies act in concert and thus can be identified as controlling shareholders (typical in France and Italy). The fourth category is the least transparent and comprises companies with small amount of cross shareholdings, with apparently no controlling shareholder(s), but where there is a coordinated central direction of the activities of the group (sometimes in Japan).

These difficulties in identifying a group of companies other than on a case-by-case basis probably explain that there are only a few jurisdictions next to Germany that have adopted group-specific company statutes. However, all major jurisdictions have either adopted regulatory strategies that are specific to group of companies situations or deal with groups through appropriate reinforcement or combinations of solutions designed for a single corporation.

Appendix 3: Japanese Big Bang Reforms

Japan's Big Bang is a program to undertake an extensive overhaul of the regulatory and institutional structure regarding the financial sector in Japan. The program was launched on the initiative of Prime Minister Ryutaro Hashimoto in November 1996. He pointed out three fundamental principles for the program: free, fair and global. The reform is expected to be accomplished by 2001.

The Japanese economy suffered the bursting of "bubbles" in the stock and real estate markets in 1991. Stock prices dropped more than 60% between 1991 and 1995, and land prices recorded a similar drop, driving the Japanese economy into recession. As a result, financial institutions and financial markets in Japan lost competitiveness. In Japan, the process of deregulation and the proper response to the rapidly changing environment in the world financial markets have been delayed because the Diet and the government had to spend (and are still today spending) an enormous amount of time resolving the banking crisis. The Big Bang program is aimed at remedying this delay, and thus has two notable characteristics: (1) reforms are drastic and extensive in scope, and (2) the timetable is specific and quick.

Selected Items of the Japanese Big Bang

Lifting the ban on pure holding companies (effective, December, 1997, for non financial firms; March, 1998, for financial institutions). The Anti Monopoly Act, which prohibited "pure holding companies" per se, was amended in 1997, and relevant statutes in the financial sector were amended to respond to this change. A pure holding company is a company, more than half of whose assets are shares of other companies. Thus, a financial group may emerge with a holding company structure where banking, insurance and securities businesses are offered through subsidiaries under centralized management of a holding company. In fact, Daiwa Securities Group established a holding company structure on April 26, 1999.

Abolishment of exchange control (effective, April 1, 1998). The Foreign Exchange Act was drastically amended. For instance, anyone may open and maintain a bank account outside Japan without regulatory permission or clearance. Part of the amount of individuals' financial assets in Japan, which total U.S. $10 trillion, may be moved outside of Japan.

Abolishment of regulation on currency exchange industry (effective, April 1, 1998). Also as the result of the Foreign Exchange Act amendments, anyone may engage in the currency exchange industry. Convenience stores and other firms have already announced their entry into this business. For instance, travelers can now buy U.S. dollars at the airport counter of the air carrier.

Establishment of new regulatory bodies (effective, June 22, 1998). A new

agency called the Financial Supervisory Agency ("FSA") was established and given power to regulate banks, securities firms, and insurance companies. This power was transferred from the Ministry of Finance to the FSA. Also, in December, 1998, a new agency called the Financial Reconstruction Commission ("FRC") was established on top of the FSA, and is responsible for licensing and other regulatory activities in the financial sector. The FSA engages in the implementation of financial regulation. The creation of this new regulatory structure suggests that the form of financial regulation in Japan will also change from consensus based regulation to rule based regulation.

Abolishment of fixed commission system of securities brokers (partly effective, April, 1998; fully effective, October 1, 1999). This will inevitably make the securities brokerage industry more competitive.

Entry into securities business: from licensing to registration system (effective, December 1, 1998). The entry level became lower for the securities industry. This change also accompanies the abolishment of the prohibition on securities firms against engaging in non-securities activity. For instance, a manufacturer will be permitted to enter the securities industry while maintaining a manufacturing business. The number of securities firms may increase drastically.

Sale of mutual funds by banks (partly effective, December, 1997; fully effective, December 1, 1998). Only 4% of the U.S. $10 trillion in individuals' financial assets in Japan are invested in Japanese mutual funds. Sixty-five percent are invested in bank deposits and postal savings deposits. When mutual funds become marketed by banks, the picture may drastically change. Also, important reforms for the mutual fund system were made. For instance, a company type fund (which is popular in the U.S. but was not permitted in Japan) became available (effective, December 1, 1998). Also, private funds (funds marketed to a limited number of institutions) became permitted (effective, December 1, 1998).

Asset management by securities firms (effective, December 1, 1998). Securities firms are now permitted to offer asset management services, typically by offering a product known in the U.S. as a "wrap account."

Improvement in accounting (effective, fiscal year 1999). Consolidated accounting with market value accounting of financial assets will be required. The new accounting rules must be consistent with the International Accounting Standards.

Defragmentation among banking, securities and insurance industries. This is an ongoing liberalization program of fragmented industry regulation in Japan. Liberalization measures include permitting mutual entry among banking, insurance and securities industries through the subsidiary or holding company structures, and reducing firewall regulations among banking, securities and

insurance industries. Implementation dates vary, but the greater part will be completed on October 1, 1999.

Securitization of loans, receivables and real property. A special statute was passed in the Diet in June, 1998 (effective, September 1, 1998). This special legislation permits a low cost method of securitizing financial assets, so that financing in the capital markets will become more attractive. Also of importance in this connection is the fact that the secondary market of securities among institutions was liberalized; certain qualified institutions may trade (non equity) securities freely among themselves as under Rule 144A of the Securities Act of 1933 in the U.S. (effective, June, 1998).

Appendix 4: Substitutabilities and Complementarities: Corporate Governance as a System of Components

Two recent theories have enriched our understanding of corporate governance: the ideas of substitutabilities and complementarities that possibly exist among the components of a system.

All social systems can be viewed as consisting of components or sub-systems. Thus, a corporate governance system consists of such elements as firm-size, management-style, financial structure, labor, and other cultural aspects, operating in a legal-framework component.

One theory providing a good analytical tool to understand corporate governance is the idea of substitutabilities. This theory - not uncommon in traditional legal scholarship - suggests that one component of a system can serve as a substitute for another component. For application in corporate governance, see Roe (1977) and Gilson (1996).

For instance, where the market for corporate control is active, as it has been the case in the United States and UK, there is less need for other monitoring mechanisms. Similarly, a country having less-developed capital markets may have stronger bank monitoring or, if bank monitoring does not work, something else, such as a strong board of directors or a controlling shareholder. Thus, France and Italy, two countries where capital markets are not well developed, have a history of heavy monitoring by the government, with the state in fact being a controlling shareholder in many major corporations. It is also possible for various components to combine to substitute for another component. In Germany, both banks and families as controlling shareholders substitute for a less developed capital market. The theory holds even if nothing seems strong in isolation, as appears to be the case in Japanese corporate governance. In this case, one can argue that various components each serve some - though not necessarily a strong - monitoring role, so that in total the system functions.

Another interesting theory is about complementarities. The idea is that various components (sub-systems) of a given system complement one another in certain situations. (Milgrom and Roberts (1994); Gilson (1998); Aoki (1994).) When complementarities exist, the value of the system is not equal to the simple sum of the standard values of the individual components. The integrated value of each component may vary, depending on the degree to which the component, as a whole or in part, is complementary to another component. This suggests that the same mechanism - bank monitoring, for instance - has a different effect in corporate governance when it has complementarities with other components of the system.

Where (as in Germany) firm ownership is not dispersed, bank monitoring is less costly and thus plays a more important role than where (as in

the United States) firm ownership is more dispersed. Where (as in France) state influence pervades both lender and debtor decision-making, bank monitoring is all but meaningless, despite loans being the major source of financing.

Where (as in Japan) employees under a lifetime employment system are dominant in a firm's decision-making, managers (who are committed to maintaining the lifetime employment system) are relatively better at conducting daily business, and thus information provided by banks and other business partners may be more valuable to them - which increases the value of bank monitoring. But where (as in the UK) managers who come from outside are relatively adept at using information supplied by outside sources, the value of monitoring by banks and other business partners is less likely to increase much when long-time employees become managers.

Thus, given the possible existence of substitutabilities or complementarities, the fact that different countries have different corporate governance systems is not a surprise.

A Legal Perspective on Venture Capital and Growth Firm Governance: What We Know and Don't Know

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APEC Symposium on
Emerging Enterprises and Corporate Governance
New Economy and Old Rules

October 16-17, 2000

Overview of Presentation

Recent scholarship has distilled a set of institutional factors that contribute to the success of the venture capital market in the United States. I will briefly review these factors, and contrast the experience of Japan, where the institutional framework for corporate governance has not been as conducive to venture capital and start-up firms.

Next, I will examine several possible alternatives to the U.S. approach to venture capital. One possibility is bypassing the domestic legal regime and piggybacking on the U.S. infrastructure (e.g. Israel). Another possibility is promoting venture capital and start-up firms through regulatory incentives (e.g. South Korea). Finally, I will raise the puzzle of Chinese Taipei, which has a successful venture capital market in the absence of the institutional "preconditions" identified above.

The second part of the presentation will consider two general questions: whether corporate governance matters to start-up firms, and whether law matters to corporate governance. I conclude that corporate governance does appear to matter, for several reasons. First, the experience of Italy and other countries suggests that corporate governance is an important variable in determining whether small firms will grow into large firms. Second, venture capitalists introduce agency problems into the start-up firm dynamic, and agency problems are the classic concern of corporate governance. Third and more generally, the corporate governance environment appears to affect the micro-climate for emerging enterprises. As to the second question, recent scholarship suggests that "old rules" (corporate, securities and bankruptcy law) matter a great deal to the new economy, although precisely how they matter remains a topic of debate.

I close with some tentative conclusions emerging from our comparative inquiry.

I. Legal and Institutional Preconditions to Venture Capital Markets? A U.S. Perspective

A. Exit Options

1. Stock Markets
2. Mergers and Acquisitions

The *type* of exit options available may matter crucially to the overall success of the venture capital market (Gilson & Black, 1998). However, supply side factors also appear to be very significant (Milhaupt, 1997).

B. Incentive Structures

1. Stock Options
2. Contracting practices
3. Regulatory incentives (ERISA)

C. Employment Practices

1. Covenants not to compete (Gilson, 1999)
2. Labor market dynamics

D. A Comparative Example: U.S.-Japan

Milhaupt (1997) argues that the institutional structure supporting Japan's bank-oriented system of corporate finance and governance is not conducive to a vibrant venture capital market.

II. Alternatives to the U.S. System?

A. Piggybacking on the U.S. Market

Example: Israel

Israel's tax and corporate laws deemed antiquated; more than 90% of Israel's high tech start-ups are incorporated in Delaware.

- ranks third in world in number of NASDAQ-listed technology cos.
- went from 0 to 130 VC funds since 1992
- 3000 high tech companies

B. Governmental Intervention

Example: South Korea

In 1997, South Korea enacted a Special Law to Promote Venture Capital Companies. The law was designed to emulate the success of the U.S. venture capital market (Ko & Shin, 1999). However, it adopts a regulatory approach to venture capital:

- favorable tax and employment treatment available only to firms meeting specified criteria as a "venture capital backed company" under the law.

C. Confounding Success Story

Example: Chinese Taipei

Chinese Taipei has one of the most active venture capital markets in the world; yet it does not appear to share many of the institutional characteristics identified as crucial to success in the U.S. market. Liu (1997) discusses features of the legal and regulatory system:

- bank-oriented finance
- tightly regulated IPO market
- corporate law rigidities
- civil law regime

III. Corporate Governance and Law: Their Relevance to Emerging Enterprises

A. Does Corporate Governance Matter to Emerging Enterprises?

1. Experience suggests that in the absence of good governance institutions, small firms will stay small.

Example: Italy (Macey, 1998)

2. Venture capitalists and agency problems (Sahlman, 1990)

3. Entrepreneurship and the corporate governance environment

- experienced managers
- mentors
- attitudes toward failure
- legal innovation

B. Does Law Matter to Corporate Governance?

1. Provocative new body of research suggests that it does:

"The legal approach to corporate governance holds that the key mechanism is the protection of outside investors—whether shareholders or creditors—through the legal system, meaning both laws and their enforcement….[V]ariations in law and its enforcement are central to understanding why firms raise more funds in some countries than in others."
(La Porta, Lopez-de-Salinas, Shleifer & Vishny, 2000)

2. But we still do not understand precisely how it matters.

IV. Some Tentative Conclusions

A. Success of the U.S. venture capital market rests on a complementary system of institutional supports.

B. Alternatives appear possible, but are not well understood.

C. Corporate governance matters to emerging enterprises.

D. Law matters to venture capital markets and corporate governance:

- flexible enabling statutes
- appropriate organizational forms
- sophisticated contracting practices and ex post judicial review
- adequate capital market supervisory structures
- efficient bankruptcy regimes
- employment laws that do not hinder mobility

E. But good law is almost certainly not the only component of a healthy climate for emerging enterprises. Other possibly relevant factors:

- risk tolerance
- social acceptance of failure
- availability of mentors
- transmission of tacit knowledge

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How Venture Capital Is Reshaping The New Asia Economy

Taipei

October 16, 2000

Ta-lin Hsu
H&Q Asia Pacific

H&Q
Asia Pacific

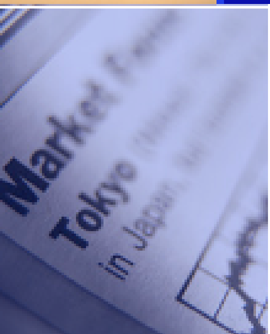
H&Q Asia Pacific: Profile

- **Offices in 11 key locations:**

  Bangkok
  Beijing
  Hong Kong
  Jakarta
  Manila
  Kuala Lumpur
  Palo Alto
  Seoul
  Singapore
  Taipei
  Tokyo

- **90 employees worldwide, of which 55 are investment professionals and managers**

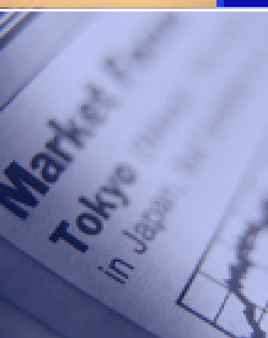
H&Q
Asia Pacific



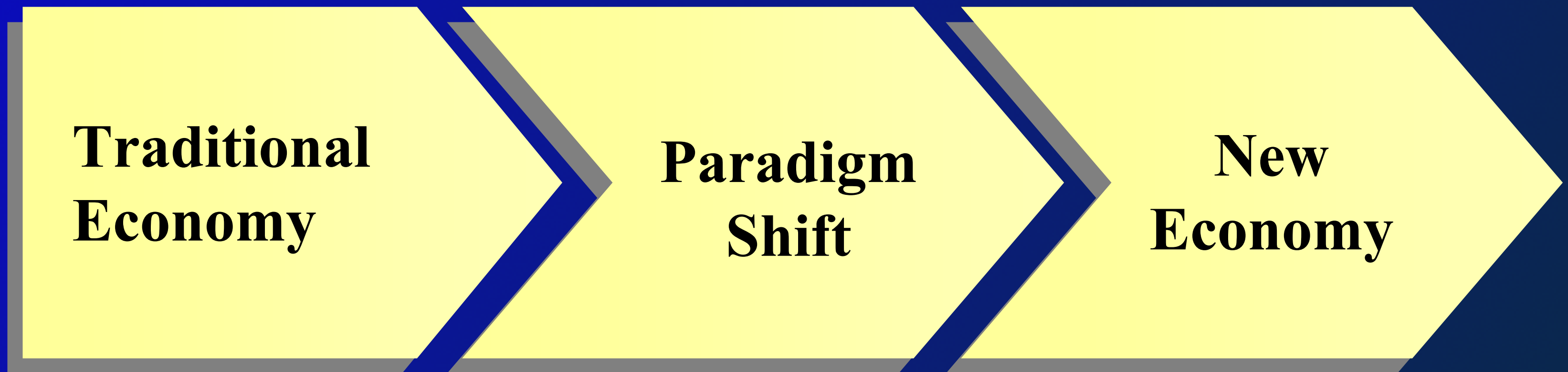
H&Q Asia Pacific: Asset under Management

- 16 funds, $1.6 billion under management
  - 13 country funds totaling $500 million
  - 3 regional funds totaling over $1.1 billion
  - APGF III closed in Jan. 2000 at US$750 mn
- 230+ portfolio companies

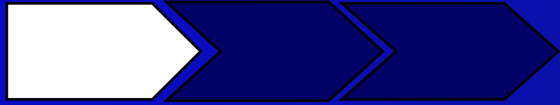
H&Q
Asia Pacific



Evolution of New Economy



Traditional Economy

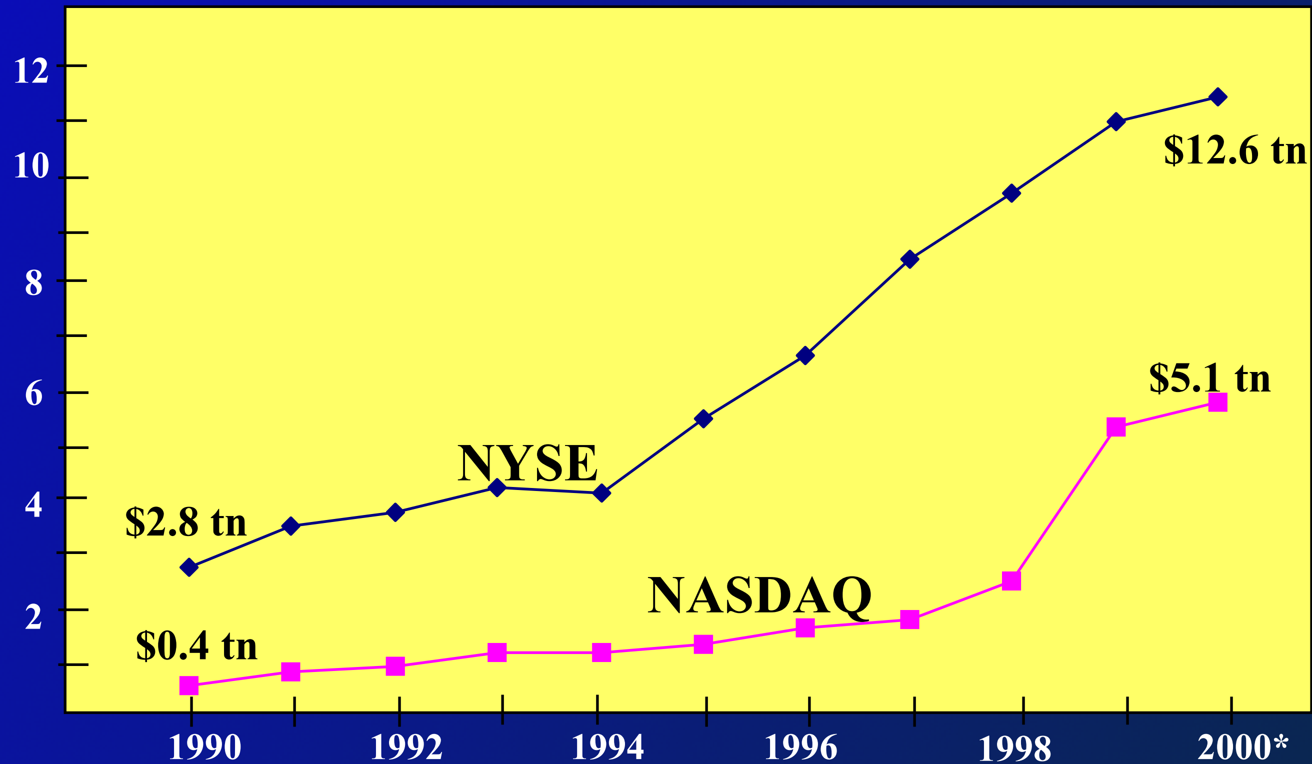


Underdeveloped Financial Markets

- **Low market capitalization**
- **Relatively low share trading volume**
- **Mostly non-technology related with low P/E ratio**
- **Limited growth expectation**

Paradigm Shift

Rapid Growth of Financial Markets



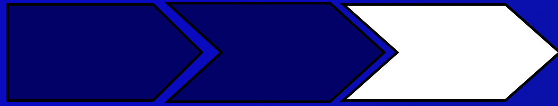
H&Q Asia Pacific

Paradigm Shift

Influx of Technology and Capital

- Technological revolution
  - Semiconductor
  - Personal computer
  - Internet
  - Broadband
  - Optical component
  - Biotechnology
- Wave of funds into venture capital and financial markets
  - Pension and mutual funds
  - Investors seeking higher return

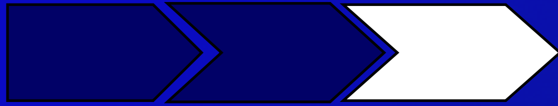
New Economy



Liquidity Driven Market Condition

- **Huge total market capitalization**
- **Influential analysts directing flow of funds**
- **Internet enabled financial market**
    - **Cyber trading**
    - **Real-time availability of information**

New Economy



Focus on Innovative Companies

- **High growth potential**
  - **Innovative technology/products/services**
  - **Not necessarily profitable in short run**
  - **High Price-Earnings Ratio**

- **Industry leaders**
  - **Winner-takes-all**
  - **Direct play on market hype**

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Asia Pacific

Driving Forces of New Economy

- Financial Tsunami
- Super Currency
- Creation of 800 lb Gorillas
- Innovation & Venture Capital

Financial Tsunami

- **US$18 trillion market capitalization in NASDAQ and NYSE (10/2000)**
- **Near perfect capital market**
  - **Instantaneous availability of public information**
  - **Greater liquidity through cyber trading**
- **Analysts directing huge swirl of capital**

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Financial Tsunami

Annual Trading Volume

In 1980
- NASDAQ: 6.7 bn
- NYSE: 13.1 bn

In 1999
- NASDAQ: 265.6 bn
- NYSE: 203.9 bn

Billions of Shares Traded (0–300); Year (1975–1999)

Legend: Nasdaq, NYSE, Amex

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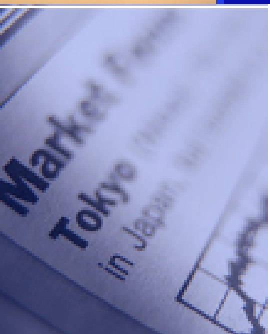
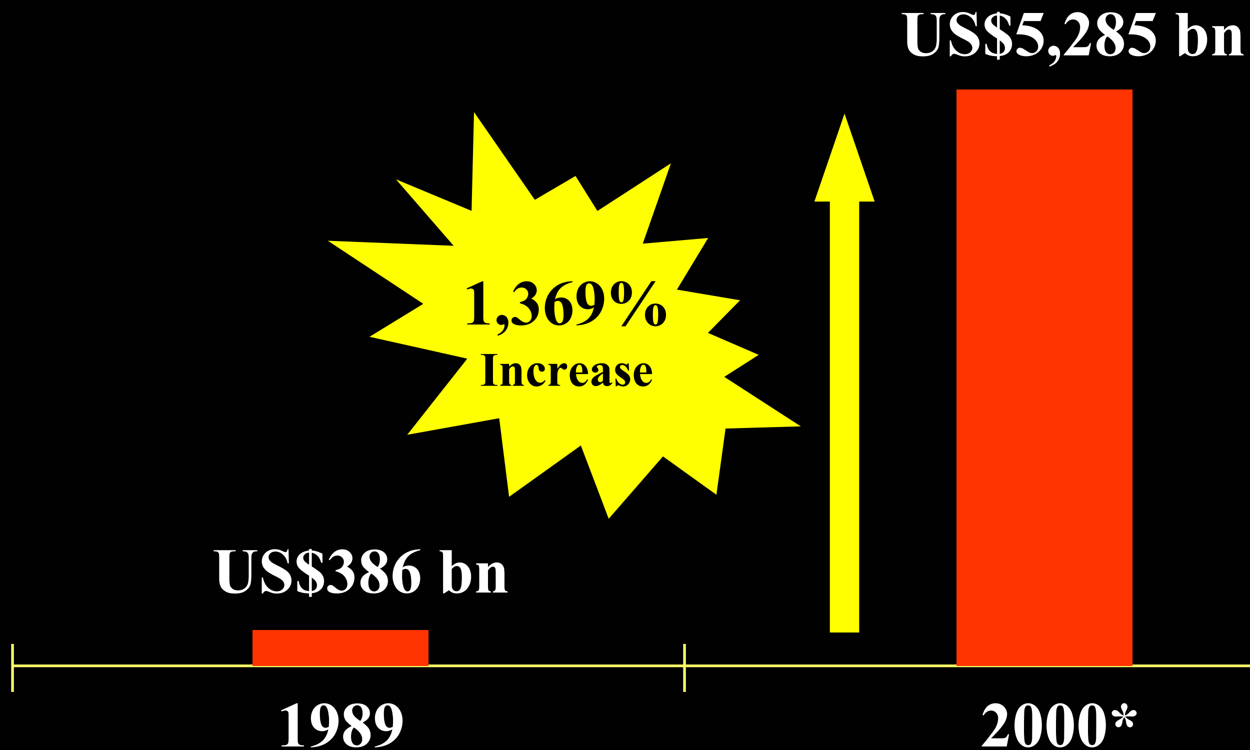
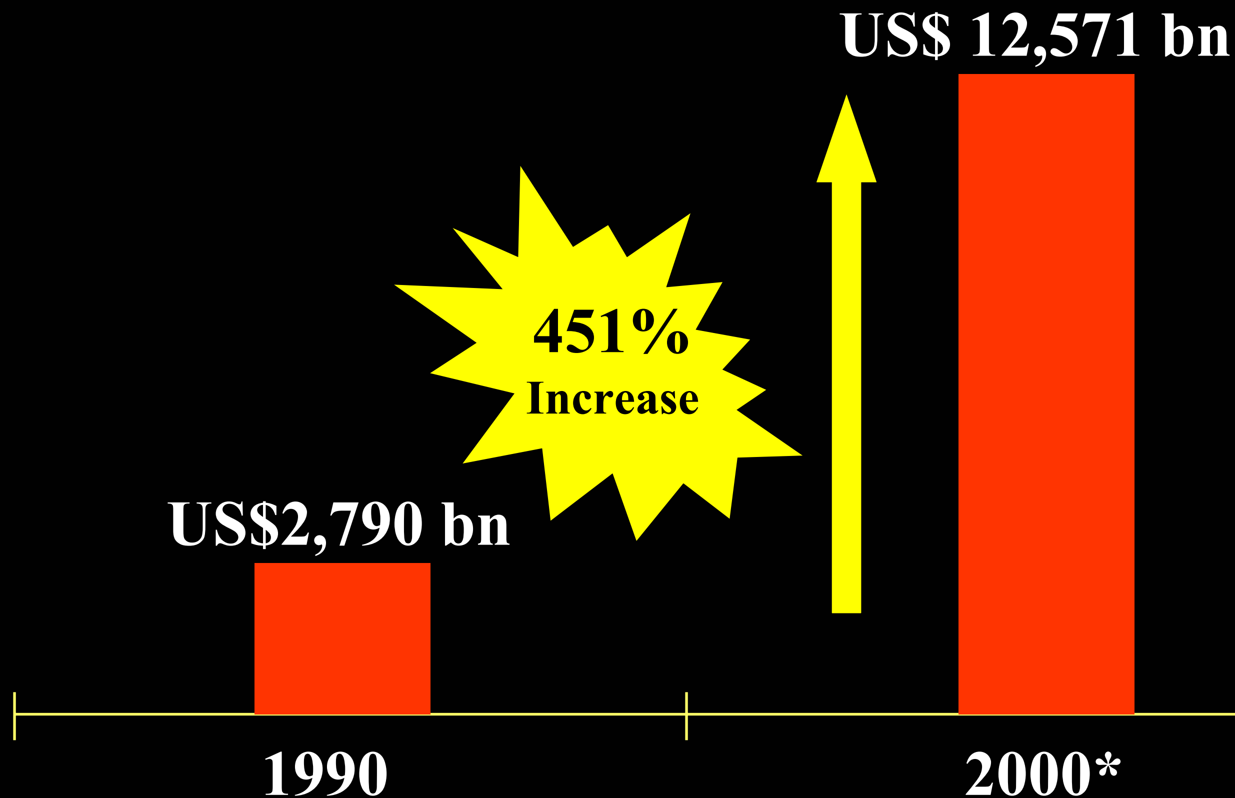


Financial Tsunami

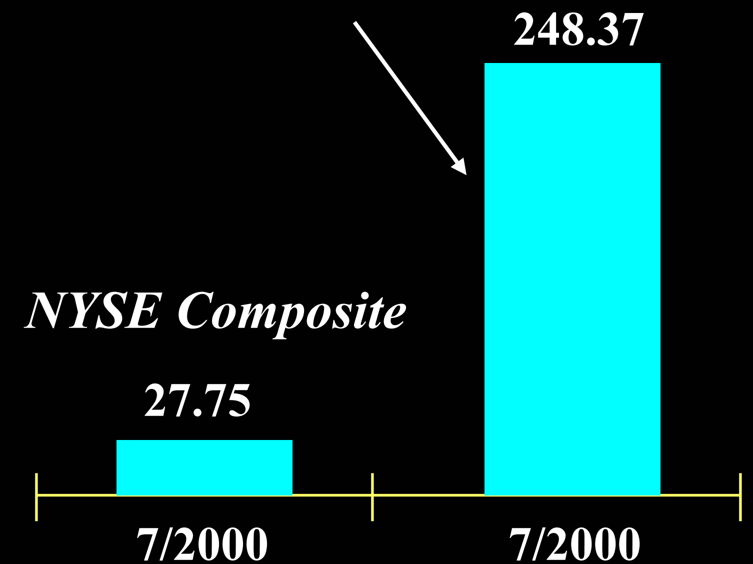


Financial Tsunami



Super Currency

- Extreme PER
- Leveraging high valuation to acquire smaller companies
  - ➢ Support high growth expectation
  - ➢ Further expansion of market capitalization

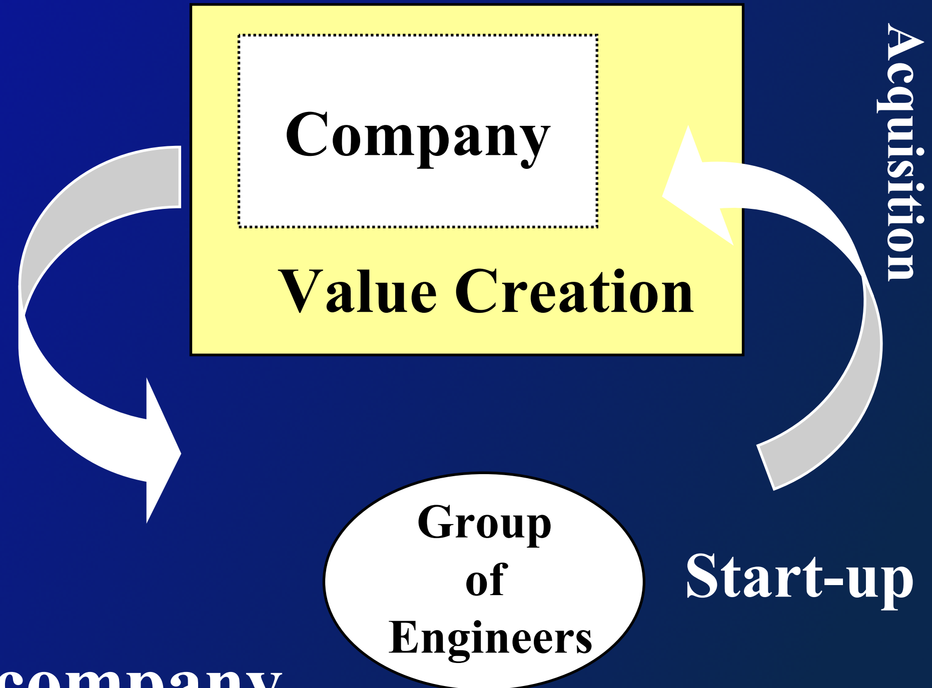


* This figure does not reflect companies with negative earnings.

H&Q Asia Pacific

Super Currency: Case Study

- Leveraging super currency to further increase value
- Engineers establishing start-ups
  - Flexible business structure
  - Shorter dev't period
- Acquisition by a larger company
  - Value creation: much greater incremental value than acquisition cost



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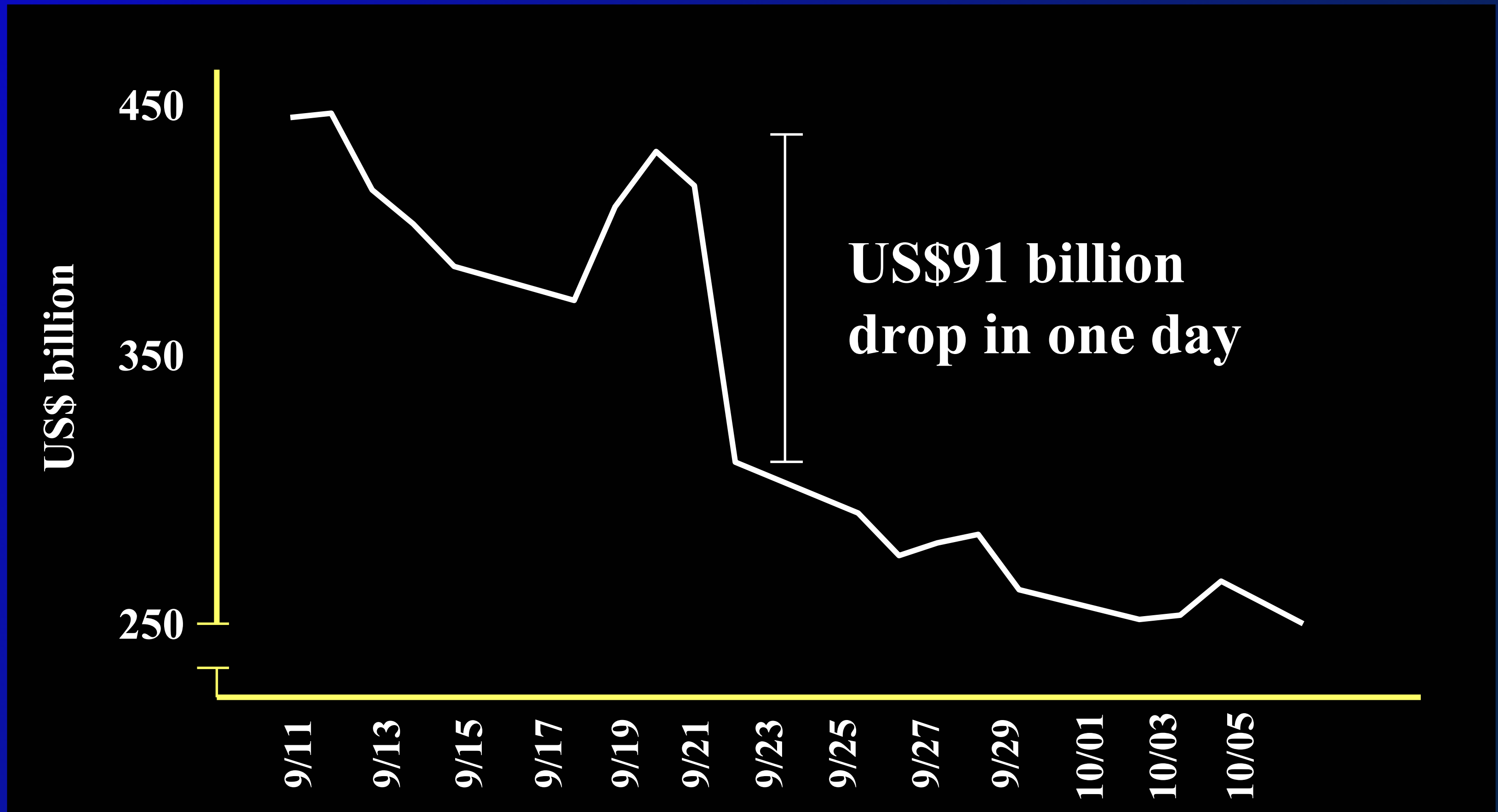
Super Currency: Case Study

- **On Friday (9/22/2000), Intel announced a lower than expected earnings report**



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Creation of 800 lb Gorillas

As of October 12, 2000

CISCO SYSTEMS	(US$378 bn)	BEA SYSTEMS	(US$29 bn)
MICROSOFT	(US$290 bn)	ARIBA	(US$30 bn)
INTEL	(US$262 bn)	VOICESTREAM	(US$24 bn)
IBM	(US$208 bn)	EXODUS COMM	(US$19 bn)
EMC	(US$196 bn)	EBAY	(US$17 bn)
ORACLE	(US$188 bn)	AMAZON.COM	(US$11 bn)
SUN MICRO	(US$172 bn)	EXTREME NET	(US$11 bn)
INFOSYS	(US$159 bn)	PHONE.COM	(US$9 bn)
AOL	(US$133 bn)	RAMBUS	(US$7 bn)
LUCENT	(US$108 bn)	3COM	(US$7 bn)
HP	(US$90 bn)	CADENCE	(US$6 bn)
JUNIPER	(US$63 bn)	LYCOS	(US$6 bn)
QUALCOMM	(US$59 bn)	BROADVISION	(US$6 bn)
BROADCOM	(US$51 bn)	RFMD	(US$5 bn)
YAHOO!	(US$47 bn)	CRITICAL PATH	(US$3 bn)
VERISIGN	(US$37 bn)	DIGEX	(US$2 bn)

Creation of 800 lb Gorillas

- **Innovative companies have potential to become 800 lb gorillas**
  - ➢ **Industry leaders**
  - ➢ **Exponential growth expectation**

- **Self-fulfilling inv't model**
- **Investors love 800 lb gorillas**
  - ➢ **Liquidity**
  - ➢ **Lesser risk**
  - ➢ **Great market perception**

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Innovation & Venture Capital

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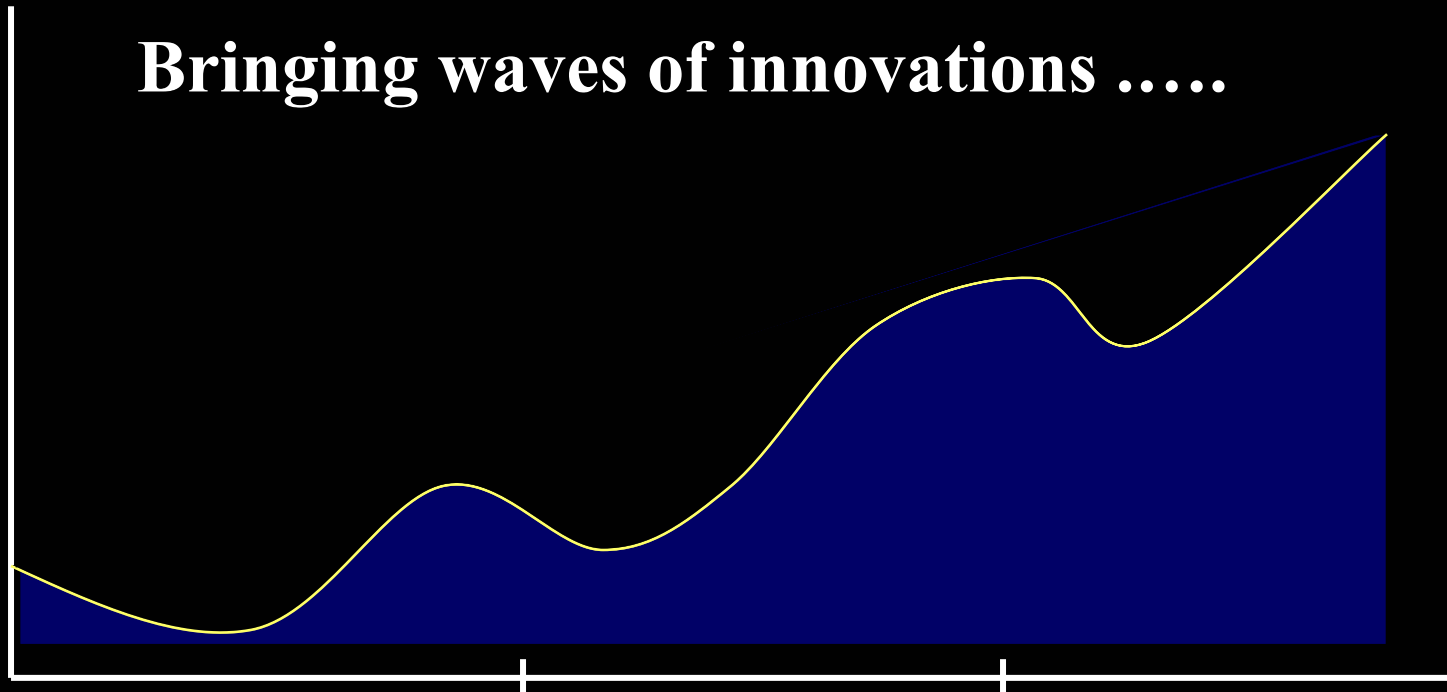
- **Venture capital is key to innovation**
  - ➢ **Focusing on start-ups/high growth companies**
  - ➢ **Encouraging development of innovative technologies and products**
- **Venture capital may be the only source of funding**
  - ➢ **High risk/high return investment**
  - ➢ **Commercial banks unlikely to provide seed financing**

Innovation & Venture Capital



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Innovation & Venture Capital

- **Venture capital enables innovative companies to grow….**

Conclusion

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Public Policies Fostering Entrepreneurship [1]

Mitsuru Taniuchi
Chair, APEC Economic Committee

1. The Case for Fostering Entrepreneurship: Japan's Experience

The rapid advance of information technology and the growing importance of knowledge call for innovative ideas, initiatives of individuals rather than organizational discipline, flexibility to adjust, and greater speed to take decisions. As the new era of the new economy unfolds, entrepreneurship has taken on renewed importance. Entrepreneurship is the ability to marshal resources in order to seize new business opportunities with uncertainties. As such, entrepreneurship is central to economic growth, particularly in times of strong technological change.

Against this backdrop, there has recently been a growing interest in entrepreneurship in many APEC economies. Taking the case of Japan, the interest in starting new businesses among mid-career business people and fresh graduates has been notably growing in recent years. In fact, new IT-related companies and other venture businesses have been on the rise. Over the past year, two new stock markets catering to new growth companies (Mothers and Nasdaq-Japan) have started operation.

Yet, overall, the state of entrepreneurship remains dire in Japan. "The World Competitiveness Yearbook" published annually by the International Institute for Management Development (IMD) of Switzerland has put Japan at the bottom of its ranking on entrepreneurship. Creation of new firms in Japan has indeed remained very low, accounting for only 4-7% of the total number of firms over the past 15 years. By contrast, the US economy has actively created new firms, churning out about 15-17% of total a year over the same period (Economic Planning Agency of Japan, 1999).

In an effort to reverse the disappointing trend, the Japanese government has recently introduced a variety of policy measures to foster entrepreneurship. Such measures include revising corporate laws concerning stock options and bankruptcy, deregulation aimed at enhancing labor market flexibility, expanding the availability of finance and advisory services for new companies through public financial and non-financial institutions, and changes in tax codes regarding investment in start-up companies and loss carryover for small companies.

This paper considers options for public policies to foster entrepreneurship, referring to the experiences of Japan and some other economies. The grounds for taking such public

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[1] This paper is a part of the APEC Economic Committee's report of "APEC Economies Beyond the Asian Crisis", which will be published and submitted to the APEC Ministerial Meeting in Brunei in November 2000. I have directed the research work of this project.

policies will be also examined.

2. The Role of Government in Encouraging Entrepreneurship

Needless to say, the key drivers of entrepreneurial activities are private businesses, and private initiatives are central to entrepreneurship. Yet, governments have an important role to play in fostering entrepreneurship. The key role of government is to provide the right institutional and policy environment enabling entrepreneurship to flourish.

To the extent that entrepreneurship is instrumental to harnessing new technologies, it promotes productivity and economic growth. Furthermore, evidence indicates that entrepreneurship boosts employment. Over the past decade or so, smaller firms including newly-created firms have been creating jobs, whereas larger firms have been reducing jobs in major economies in the world (OECD, 1998). Fostering entrepreneurship has become an effective way to promote economic growth and employment. Priority consideration should be given to public policies which encourage entrepreneurship.

First and foremost, governments need to provide an environment in which the market mechanism functions most efficiently. Entrepreneurship cannot flourish when markets are not competitive. Well-functioning markets can send right signals for entrepreneurs as well as existing firms in mobilizing and allocating resources (human, financial, and physical) to their best uses. To that end, stable macroeconomic conditions are a precondition. Deregulation and trade/investment liberalization are also important in removing obstacles hindering the working of markets. It should be noted that government regulations often pose greater disadvantages on entrepreneurs than existing companies.

Second, governments need to review whether corporate laws, taxation, and other institutional arrangements do not unduly penalize risk-taking, because entrepreneurs take risks to seek new or unexploited profit opportunities. For example, unwieldy regulations on the use of stock options need to be removed, and bankruptcy laws need to strike the right balance between the protection of interests of lenders and investors and the ability of bankrupt owners to try another chance.

Third, governments have a role in education and technology development, which have "externality," yielding greater benefits to society than the benefits accrued to individuals. Governments need to revise as necessary rules and regulations on schools and universities with the aim of encouraging entrepreneurship education and life-long learning. There is scope for governments to facilitate university-company cooperation.

Furthermore, many governments assist potential entrepreneurs and new companies by providing advisory services and other business incubation services at no or subsidized costs, and by enhancing the availability of finance through public financial institutions. The idea is that governments need to complement markets in encouraging entrepreneurship with the aim of promoting growth and employment. There may be some grounds for such public intervention, although the costs and benefits of measures

need to be gingerly weighed.

Against the background of the above discussions on the role of government, policy options for fostering entrepreneurship will be examined in what follows. Japan's recent survey asking small firms to identify major difficulties in starting up businesses provides a useful guide in identifying major areas that governments need to address. (See Figure 1.) Policy measures in the following areas will be considered.

1) access to finance,
2) human resources,
3) access to technologies and information,
4) legal infrastructure.

3. Expanding Access to Finance

Entrepreneurs are likely to face some extra difficulties in obtaining finance. There are limitations on bank loans to finance new companies that often involve higher risks than matured companies. In addition, new companies likely have limited cash flow to service debts, and lack collateral to cover loans.

Equity is a better source of finance than bank loans for much of new businesses. Equity holders can share in profits when the new venture turns out successful, while banks (more generally debt holders) cannot benefit beyond the fixed interest payments. A statistical examination indicates that entrepreneurial activities are livelier in economies where stock markets are developed. (See Figure 2.)

1) Equity Investment by Angels and Venture Capitals

Generally, a new venture requires different types of equity finance as it grows. In the start-up stage, the periods leading up to start-up and immediately after, an entrepreneur often needs relatively small amounts of fund enduring high risks. As the company grows and enters the "mezzanine stage" leading up to initial public offering (IPO), the risk endurance of funds becomes less important and the volume of funds in turn grows in importance.

In the US, most entrepreneurs start new businesses, securing needed funds from their own savings, families, and friends. In the start-up stage and the early mezzanine stage, another important source of funds is "angels," who are wealthy individuals providing private equity funds in new ventures and often successful entrepreneurs themselves. In the mezzanine stage, venture capital firms play an important role. Venture capitals are financial intermediaries that pool risk-enduring funds from investors and make equity investments in young companies. Angels and venture capitals not only take significant financial stakes in young growing companies, but also provide them with business expertise which entrepreneurs often lack. As the company further grows through the late mezzanine stage to IPOs, investment banks come to play a significant role in financing company growth.

To see the importance of equity finance in fostering new businesses, one can examine the statistical relationship between the availability of venture capitals in major

economies and the state of entrepreneurship as measured by IMD's "the World Competitiveness Yearbook." (See Figure 3.) There is indeed a positive relationship between the availability of venture capitals and entrepreneurship.

One policy measure to foster equity funding to new business concerns income taxation on individuals investing in new businesses, who are called "angels". Since angels earn most profits in the form of capital gains through IPO and M&A, their income from investment carries high risks. Reducing tax on the capital gains of angels may have positive effect on their behavior towards risk taking. Income taxation allowing carrying losses forward would also encourage investments into such companies that carry higher investment risks. In Japan, a preferential income tax treatment for individuals investing in young companies (the "angels taxation") was introduced in 1997 and subsequently expanded in 2000. The U.S. introduced the angel taxation earlier.

Another taxation measure helpful in fostering new businesses pertains to loss carryover in corporate income taxation. A newly-created company usually does not make profits for initial few years or so. Generally, the more innovative the company's product, the longer lead-time for profits. That is because a new innovative company needs to invest heavily in R&D in the initial stage, and it also have to make greater efforts in developing a new market for its innovative product than entering an existing market. Some of such innovative start-ups, though profitable as it is in the long run, could be discouraged if corporate income taxation on an annual basis lowers its profitability. Thus, loss carryover provision during the early years of operation for new ventures may encourage the creation of new innovative firms. A study in the United States shows that it takes a lot longer, on average, for an innovative start-up to post a profit and to clear accumulated debts, than less innovative start-ups (Bygrove and Timmons, 1993).

2) Tapping Stock Markets

In many economies, stock markets targeting new growth companies have been opened and developed. Such stock markets help young companies to raise equity funds from a wide variety of investors. They are also important as a channel of exit for investors like angels and venture capitals to harvest their investments and move on to other new opportunities.

The most well-known such market is NASDAQ (National Association of Securities Dealers Automated Quotation System) in the US established in 1971. Over the last few years, new stock markets for new companies have started operation in APEC economies as well. Major examples include KOSDAQ (Korean Association of Securities Dealers Automated Quotation System) in 1996, Mothers (Market of the High-Growth and Emerging Stocks) in 1999 and NASDAQ-JAPAN in 2000 both in Japan, GEM (Growth Enterprise Markets) in 1999 in Hong Kong, and TIGER (Taiwan Innovative Growing Entrepreneurs) in 2000 in Chinese Taipei.

IPOs at stock markets are an important means for angels and venture capitals to exit from their investments, reaping the capital gains and reinvesting in other budding companies. To this end, it is important for new promising companies to be able to achieve IPOs at reasonably short periods of time. In the US, it takes only about six years,

on average, for a new company to make an IPO after its establishment. Given this relative ease of making IPOs, investors in the US can exit earlier, even before IPOs, by selling their investments to other parties by way of M&A.

Thus, the recent opening of new stock markets for new small companies in the APEC region is a welcome development for fostering entrepreneurship. For such new stock markets to succeed, lowering listing requirements for ease of new listing must be accompanied by stringent rules for de-listing and tighter timely requirements for disclosure. That would enable investors to make informed decisions at their own risk. For example, in NASDAQ in the US and other stock markets for new companies, it is possible for new companies posting no profits as yet to be listed unlike in traditional stock exchanges.

Since new companies have only limited numbers of shares for trade unlike large established companies, securing liquidity is of critical importance. To that end, market makers, who are securities companies (dealers) standing ready to buy and sell shares of particular companies at quoted prices, play an important role. In economies where market making is not as yet fully developed, it is important to develop conditions conducive to market making, including investor protection measures.

In many economies, financial institutions like pension funds and insurance companies are subject to various restrictions on their portfolios including caps on equity investments, with the aim of helping maintain prudence in investment. Such restrictions may need to be reviewed with the view to the need for enhancing equity finance for new businesses. In this regard, it is worth noting that, in the early 1970s, the US government relaxed the regulations on pension funds regarding equity investment in non-listed companies, leading the way to the subsequent rapid development of the venture capital industry in the US.

3) Financing by Public Financial Institutions

Equity finance, important as it is, cannot satisfy all the financing needs for new companies. Bank loans (and loans from other financial intermediaries) are an important source of finance for new companies as well. However, as mentioned earlier, there are some difficulties for banks to extend loans to new companies, due to higher credit risks, lack of collateral, and limited cash flows.

In an effort to complement financing by the private sector, governments often make loans or equity funds available for new firms through public financial institutions. In many economies, there are a variety of programs including lending on preferential terms, co-financing with private banks by which public institutions aim at priming the pump, loan guaranty, and indirect equity investment through privately-managed investment funds. A successful case of public assistance for financing new businesses is the SBIC (Small Business Investment Company) program in the US. SBICs are the privately-managed venture capitals whose funds are partly provided by the federal government's Small Business Administration (SBA).

4. Mobilizing Human Resources for New Businesses

1) Flexible Labor Markets

Flexible labor markets are important to foster entrepreneurship, insofar as they enable new firms to secure competent workers and professionals and to respond quickly to changes in circumstances. They also work as a safety net, since they assure that, in times of business failure, entrepreneurs and their employees be able to find jobs.

Therefore, deregulation in labor markets is important for enhancing the efficiency of the economy at large, but also vital for underpinning entrepreneurial activities. In Japan, the government has recently deregulated tight restrictions on the operation of job-placement companies and temporary-staff-dispatching companies.

The pension system, taxation, and other arrangements may have some effects inhibiting labor mobility. For example, when company pensions are not portable, workers may be discouraged from leaving secure jobs. Defined-contribution pension plans with individualized accounts have less distortion on workers' decision. Likewise, if companies generously provide fringe benefits like low-cost housing as part of compensation and such fringe benefits are not taxed, workers may be discouraged from starting new businesses. In Japan, fringe benefits account for about 17% of labor costs. Thus, it is important to review various economic and social arrangements pertaining to labor mobility, with the view to restoring neutrality for workers' decision on continuing or leaving the present jobs.

2) Education

There is little doubt that entrepreneurship in the society hinges on cultural factors regarding emphasis on individuals' independence and respect for entrepreneurs starting their own businesses. Entrepreneurial activities tend to be sluggish when educational systems do not embrace the needs of a competitive economy. (See Figure 4.)

Here, education plays a critical role in creating entrepreneurs for future business start-ups. Education fostering entrepreneurial spirit and ability can be implemented by strengthening the interaction between industry and schools/academia, promoting internships to expose students to real businesses, and expanding life-long educational programs. In the US, more than 500 entrepreneurial training courses have been established in universities and graduate schools, contributing to active creation of new businesses.

5. Expanding Access to Technologies and Information

Technological innovations are the seed for business start-ups. Innovative ideas can turn into successful ventures only when they are married with managerial skills and business know-how. Information regarding technological innovations, business opportunities, and business skills is key to linking up ingredients of new businesses. Thus, of great importance is access to technologies and information.

1) University-Company Cooperation

In enhancing access to technologies and information, cooperation between universities

and companies is of particular importance. (See Figure 5.) The significance of university-company cooperation in fostering new businesses in high-tech areas is well underscored by Silicon Valley where Stanford University has been playing an eminent role. Such "hot spots" of entrepreneurial activities include Gladstone in Australia, Valencia region in Spain, and Hsinchu Science-based Industrial Park in Chinese Taipei. These cases point to the significance of spatial concentration of business activities. Universities and research institutions can serve as a core of the clustering of venture businesses.

Some policy measures are useful in facilitating the matching of new technologies developed in universities and business expertise. In the US, "technology licensing organization (TLOs)" was introduced in 1980 to facilitate the transfer of technologies from universities to businesses. TLOs excavate new technologies that are developed in universities and have potential for commercialization, and confer licenses for the use of such technologies on private companies. Part of licensing fees is reinvested in further researches.

Japan has recently been keen to promote university-company cooperation. Japan has emulated the US model of TLOs, introducing new legislation in 1998. Ten TLOs have already been established and are expected to boost the transfer of technologies from universities to businesses. The government has also relaxed restrictions on professors and research staff of national universities to pursue business interests in commercializing their own scientific findings.

2) Foreign Direct Investment

For APEC developing economies, new technologies and innovations will become increasingly important as a source of economic growth. As economic development progresses, capital stock and labor contribute less and less to boosting economic growth as the law of diminishing returns sets in. In order to sustain growth and promote higher living standards, production efficiency needs to be improved by introducing new technologies.

Foreign direct investment is an effective way to introduce new technologies that are not available domestically. Foreign direct investment stimulates competition, and generates new business opportunities as foreign subsidiaries procure some of needed supplies domestically. This opens the way for new businesses to expand. There is a positive if not strong relationship between FDI inflow and the degree of entrepreneurship across different economies. (See Figure 6).

Thus, further investment liberalization is called for to introduce new technologies and stimulate entrepreneurship. Protection of intellectual property rights is of particular importance in enticing high-tech industries in developing economies where violation of intellectual property rights is rampant.

3) Business Incubation

The public sector and private companies provides business incubation services assisting entrepreneurs in starting and managing new businesses. They typically provide

workspace equipped with utilities and some facilities for new companies on preferential and flexible terms. In addition, they often provide various advisory services including business management, finance and accounting services, access to business network, and legal services. Private companies providing business incubation services can recoup expenses and make profits by sharing in future profits of successful new businesses.

Business incubation itself has become a new business opportunity, as new businesses are on the rise particularly in IT-related industries. However, many governments have come to get involved in business incubation in one way or another. The underlying idea is that markets under-supply business incubation services in view of the need for promoting new businesses and employment, so that governments need to either undertake business incubation activities or assist them through subsidies and other means.

It is important to note that, however important promoting entrepreneurship is, the need for public intervention to incubation activities should be weighed carefully. Generally, the existence of "externality" merits public intervention. Namely, public intervention can be justified, when business incubation generates greater returns to the society than all the returns accrued to incubation operators and as a result the private sector supplies less incubation services than is socially desirable. In this regard, policy objectives such as balanced regional development may provide the case for government measures. While applying this general rule in the real world is a difficult task, governments need to gingerly weigh costs and benefits of public assistance to business incubation.

6. Developing Legal Infrastructure

Corporate laws need to be reviewed and revised as necessary, with the view to promoting entrepreneurship.

When bankruptcy laws exert too harsh penalties on failed business owners, they would discourage people to start their own businesses and make it difficult for bankrupt individuals to try a second chance. Likewise, when bankruptcy laws do not allow failed companies under receivership to restructure and restart all over again with relative ease, they would have dampening effects on entrepreneurship. An appropriate balance needs to be found between the rights of creditors and the future prospects of failed companies/owners.

Since stock options are a useful means for new businesses to pay remuneration to investors and mangers, as cash flows and profits are very limited when new businesses start operations. When new companies turn out successful and thus boost their market values, stock options confer huge profits to their holders, giving strong incentives for investors, executives, and workers to help grow their companies. In light of the importance of stock options in fostering new businesses, corporate laws and taxation regarding stock options need to be revised as appropriate. Some provisions in corporate laws may make the use of stock options unwieldy for new companies. When capital gains taxation is levied on stock options before the options are exercised, the attractiveness of stock options may be reduced.

As the new economy dictates speed and flexibility, many firms, new and old alike, have reorganized cooperate structures into more decentralized ones, and have adopted performance-based compensation for managers and workers. Corporate laws and taxation should not inhibit flexible corporate restructuring. For example, the prohibition of establishing holding companies was a stumbling block for corporate restructuring in Japan until recently.

In efforts to promote entrepreneurship and facilitate flexible corporate restructuring, Japan has recently introduced a number of measures. In 1999, Parliament introduced new legislative measures to allow start-up companies to offer stock options to a wider group of stakeholders. Bankruptcy laws were also revised to streamline procedures to enable firms in distress to get back on their feet quickly, and a more comprehensive review of bankruptcy laws is now underway.

7. Summary

In wrapping up all the above discussions, it should be useful to lay out a menu of public policies fostering entrepreneurship in a summary form. There is much scope for future research work to develop public policies for entrepreneurship, taking a closer look at differing conditions APEC economies confront. Yet, this research drawing on experiences in Japan and a few other APEC economies provides a useful analytical basis to consider a menu of policies for entrepreneurship. The following areas are worth further study by APEC economies.

- Establish enabling economic conditions
  - ✧ Stable macroeconomic environment, deregulation, and trade/investment liberalization are of particular importance.

- Expand access to finance
  - ✧ Introduce "angel taxation" that does not levy high taxes on fluctuating investment incomes of individual investors in new businesses.
  - ✧ Allow loss carryover for a longer period for new businesses in corporate income taxes.
  - ✧ Develop stock markets for new business that have lower listing requirements but require stringent rules on disclosure and de-listing. Develop market makers to increase liquidity in secondary markets.
  - ✧ Review restrictions on equity investment by financial institutions without compromising prudence in their portfolios.
  - ✧ Utilize public financial institutions to supplement finance from private sources.

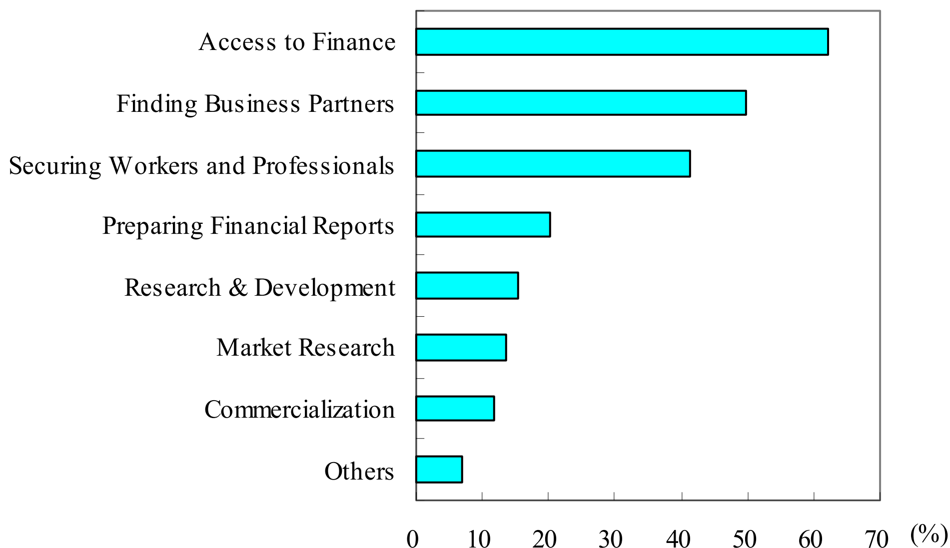
- Mobilize human resources for new businesses
  - ✧ Increase labor market flexibility by deregulation.
  - ✧ Revise as necessary the pension system and taxation with the view to restoring neutrality between continuing and changing jobs. Lack of portability of company pensions may discourage people to start their own businesses. Taxation on different forms of workers' compensation may provide incentives to stay with

secure jobs.
  - ✧ Promote internship for students, and life-long education for workers of all age groups. Amend as necessary government regulations on educational/academic institutions in introducing internship and offering new programs for life-long education.

- Expand access to technologies and information.
  - ✧ Facilitate cooperation between universities and companies. "Technology transfer organizations" in the US may serve as a model. Deregulate as necessary regulations on activities of universities and researchers.
  - ✧ Support basic research that has spillover effects to applied research and innovations.
  - ✧ Strengthen intellectual property rights in developing economies.
  - ✧ Push further for investment liberalization in developing economies. FDI brings in new technologies as well as financial resources.
  - ✧ Examine the role of government in promoting business incubation.

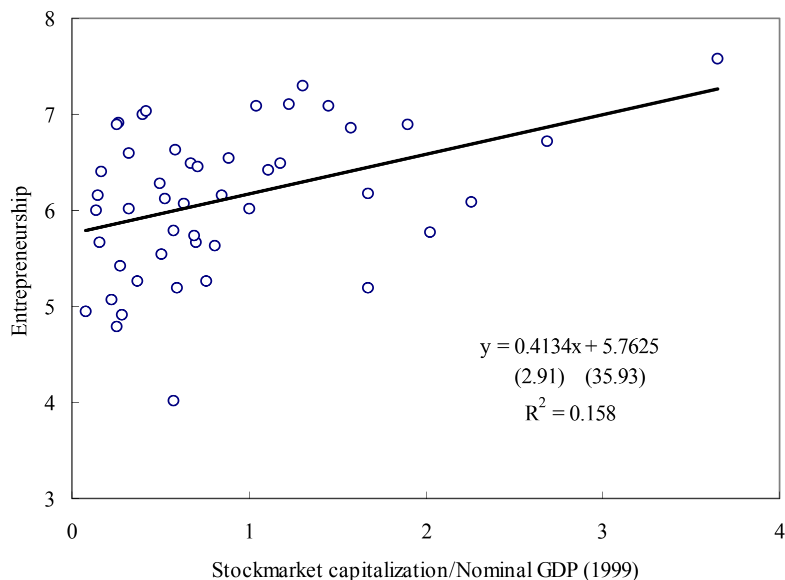
- Develop legal infrastructure.
  - ✧ Revise as necessary bankruptcy laws with the view to promoting new businesses and swift reconstruction of failed companies. Too harsh penalties on failed company owners and protracted processes to reconstruct companies under receivership may discourage entrepreneurship.
  - ✧ Revise as necessary corporate laws and taxation regarding stock options. Stock options are a useful means for new businesses to pay remuneration to investors, executives, and workers, and give strong incentives for them to help grow their companies.
  - ✧ Revise as necessary corporate laws and taxation pertaining to corporate restructuring.

Figure 1. What Difficulties Japan's Start-ups Face



Note: The result of a survey in which entrepreneurs are asked what factors are most critical in making their business start-ups difficult. Multiple answers.
Source: Small and Medium Enterprise Agency, Government of Japan, *White Paper on Small and Medium Enterprises in Japan*, 1999

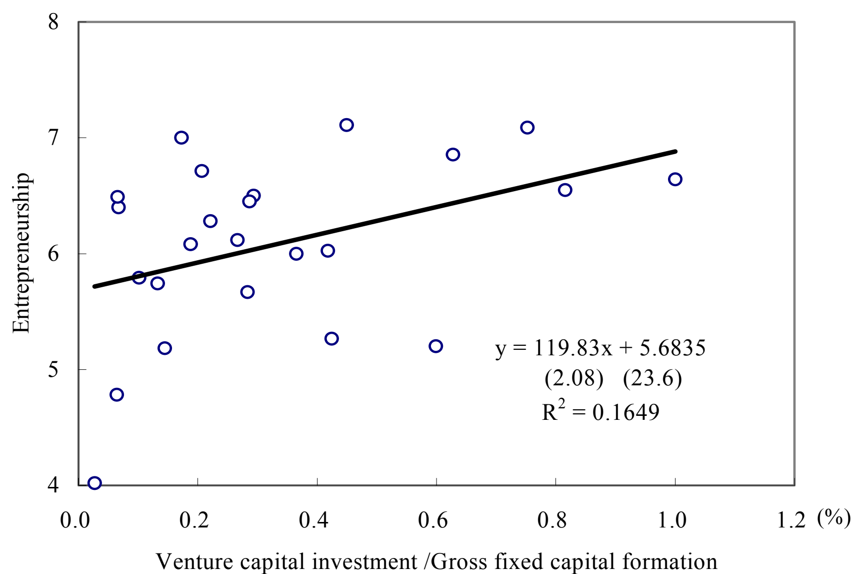
Figure 2. Equity Finance and Entrepreneurship



Note: 1. "Entrepreneurship" is measured (0-10) by the IMD survey (2000), which asks top and middle executives in each of the 47 countries about various competitiveness conditions of the country.
2. "Entrepreneurship" shows how much sense of entrepreneurship managers generally have.

Source: IMD, *The World Competitiveness Yearbook*, 2000; OECD, *National Accounts*; IMF, *International Financial Statistics*, May 2000; Economic Planning Agency, Government of Japan, *Annual Report on National Accounts FY2000*

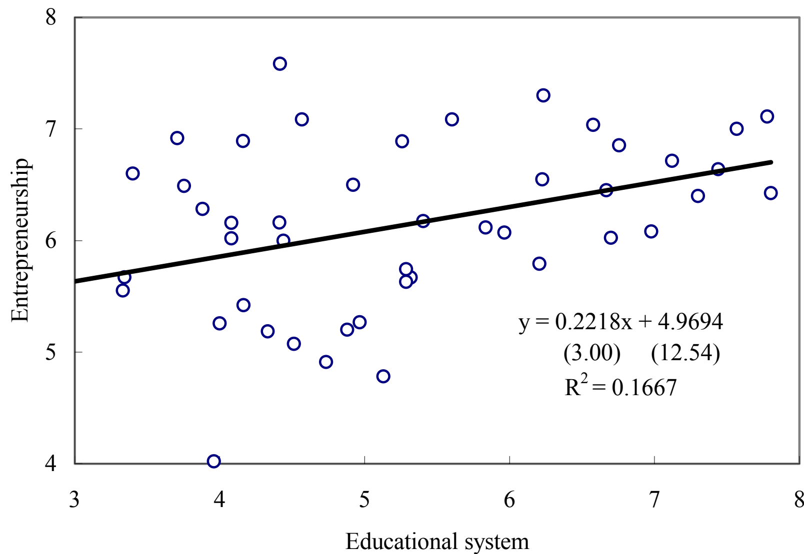
Figure 3. Venture Capital Investment and Entrepreneurship



Note: 1. "Entrepreneurship" is measured (0-10) by the IMD survey (2000).
2. Samples are 24 OECD countries.

Source: IMD, *The World Competitiveness Yearbook*, 2000; OECD, *National Accounts*; IMF, *International Financial Statistics*, May 2000

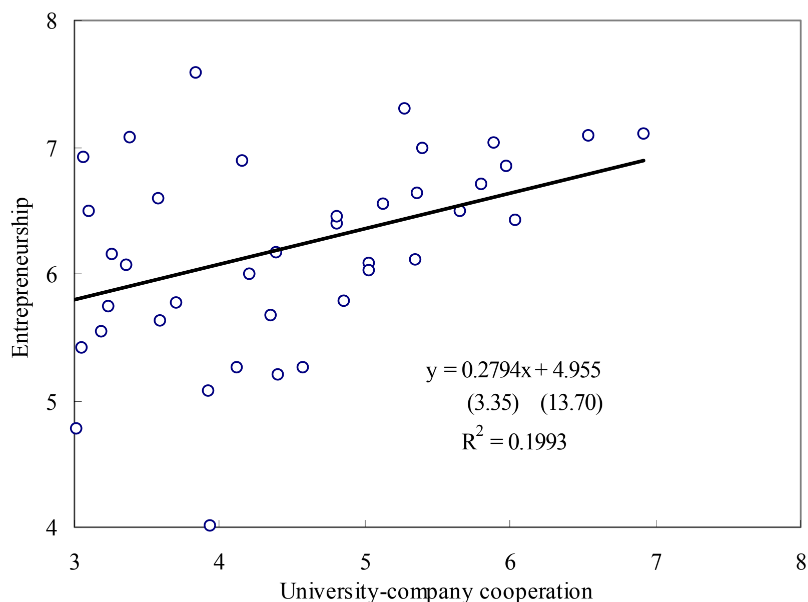
Figure 4.   Educational System and Entrepreneurship



Note: 1. "Entrepreneurship" and "Educational system" is measured (0-10) by the IMD survey (2000).
2. "Educational system" shows the degree to which the educational system meets the needs of a competitive economy.

Source: IMD, *The World Competitiveness Yearbook*, 2000

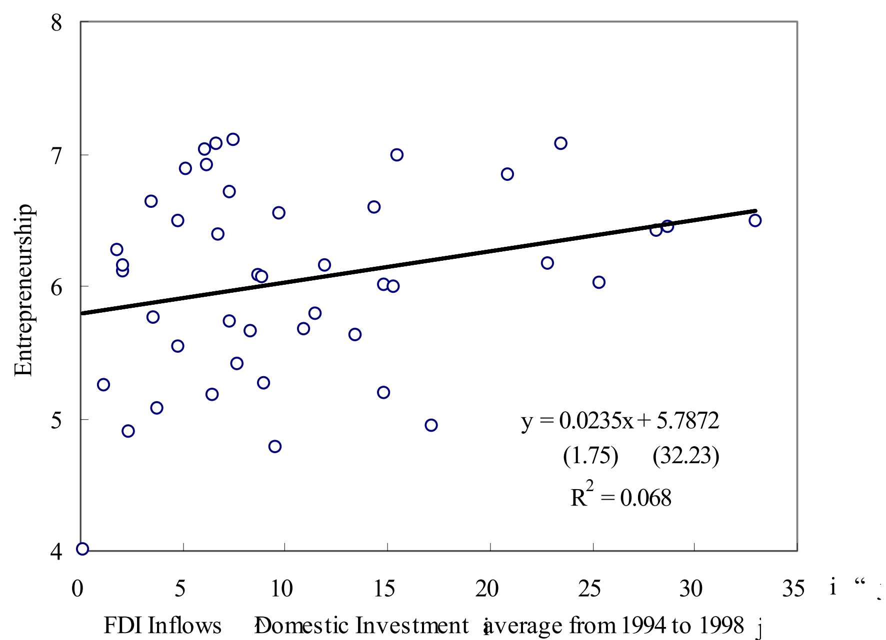
Figure 5. University-company Cooperation and Entrepreneurship



Note: 1. "Entrepreneurship" and "University-company cooperation" is measured (0-10) by the IMD survey (2000).
2. "University-company cooperation" shows the degree to which technology transfer between universities and companies is sufficient.

Source: IMD, *The World Competitiveness Yearbook*, 2000

Figure 6. Foreign Direct Investment and Entrepreneurship



Note: 1. "Entrepreneurship" is measured (0-10) by the IMD survey (2000).
2. "Domestic Investment" is gross fixed capital formation in respective economies.

Source: IMD, *The World Competitiveness Yearbook*, 2000; IMF, *International Financial Statistics*, 2000

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Exclusive Presentation

To APEC Symposium on Emerging Companies and Corporate Governance on New Economy and Old Rules

for the topic of

Accounting Transparency and Related Issues

The Westin Hotel
October 16-17, 2000

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COSO = Committee of Sponsoring Organization of Treadway Commission, SEC-USA, reporting in 1992

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Comprehensive Perspective of Transparency Framework

It Should be viewed as :

- Transparency in Public Sector
- Transparency in Private and Social Sectors

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Transparency Framework

- Transparency in Public Sector includes:
  - Fiscal policy framework
  - Monetary policy framework
  - Foreign direct investment policy
  - Legal framework
  - Good public governance
  - Infrastructure for corporate and social governance

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Transparency Framework (continue)

Transparency in Private and Social Sectors includes:

- Corporate Governance
- Financial Reporting requirements and accounting standards
- Corporate insolvency
- Financial sector supervision
- Social Governance

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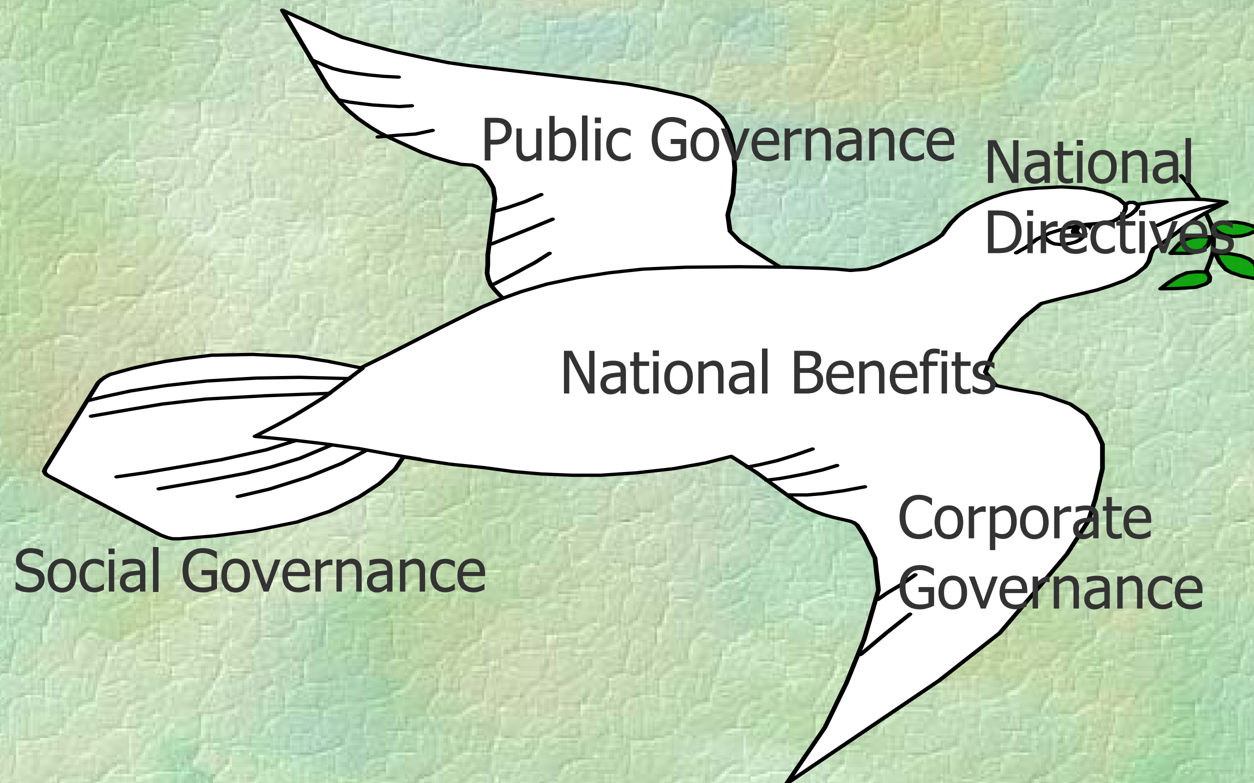
Thailand Association of Good Governance's Framework



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Translating Transparent Disclosure into SME Bottom Line

- Enhance SMEs Reputation
- Improve market share/sale volume
- Induce potential alliance/stakeholders
- Low cost of capital
- Improve employee understanding
- Mitigate fraud cases
- Administration Expenses are under better control

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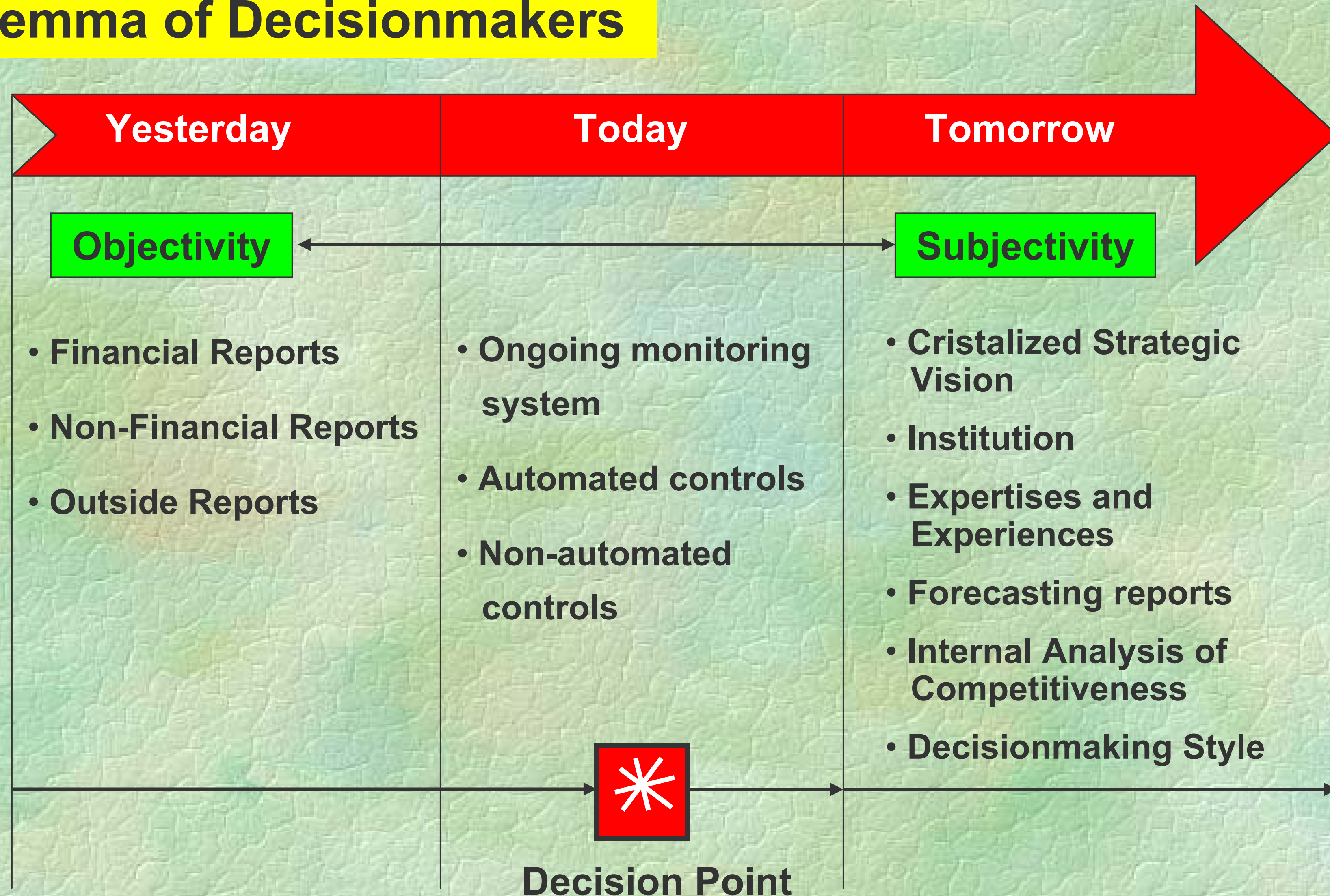
Dilemma of Decisionmakers



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Who will value SMEs disclosure ?

- Lenders/creditors
- Regulators
- Maketplace
- Employees
- Public at large
- International Good Corporate Citizenship Society

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Reality of Decision

Decision = Emotional + Rational

(Subjectivity) + (Objectivity)

Human is the most sophisticated animal

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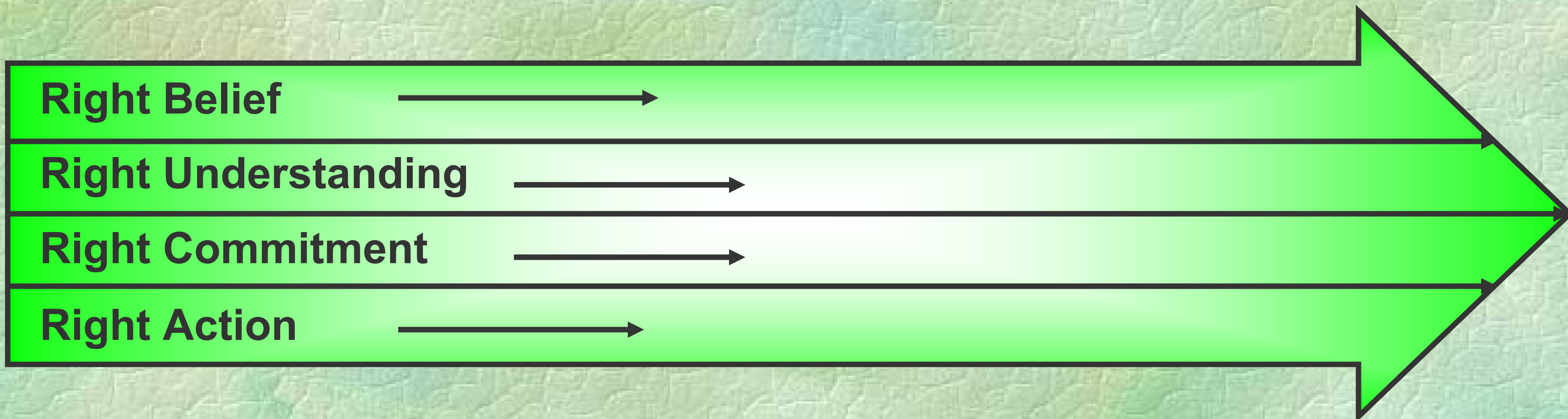
Reliability is derived from *Integrity*



…. Financial information is the "Yesterday Oriented" matter

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Non-financial Information

- Crucial factors in decision making process
- “Today Oriented” and “Tomorrow Oriented”

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Attributes of Transparency

- Compliance with convergent principles
- Timely basis
- Completeness
- Understandability
- Usability

…. Transparency is not equal to business intelligence, nor trade secret disclosure.

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Key Infrastructure for Improving Accounting Transparency

There are :

- Institutional framework
- Internal Control System
  (The Nervous System of the company)
- Accounting standards and treatments
- Auditing standards and practices
- Regulatory surveillance and fair enforcement

Above all, the right belief and mindset, along with pressures from stakeholders are the driving forces for transformation

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How Transparency Works

Since financial statements are one of the principal sources of information, due to its objectivity in nature, used by decision makers. We should expect to see :

- Removal of the true and fair override
- Education of the true values of transparent disclosure
- Removal of excessive-detailed disclosure requirements from the laws and regulations to professional standards and the market force pressures

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Further Challenges

- How business leaders translating their reputation into bottom lines.
- How to change the mindset and understanding that accounting disclosure is the “Necessary Evil” to “Invisible Hands” to enhance your ability to achieve your bottom lines and growths.
- Excessive details of laws and regulations leading to rent-seeking, how to handle these issues.
- “Locally-based Globalism” works well in your company VS “Globalization Game”

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Last Comment

- Transparency is essential, but not sufficient to grow your business.
- More Rules, More Auditors are not Good Control nor More Transparency.
- Transparency is only one principle among others, accountability, responsibility, equitable treatment, long-term value focused, striving for excellence and competitiveness

..Good Luck !

Thank You...

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BOARD STURCTURE AND CORPORATE DEVELOPMENT AFTER IPO

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COLLEGE OF MANAGEMENT NATIONAL TAIWAN UNIVERSITY

BOARD STRUCTURE AND CORPORATE DEVELOPMENT AFTER IPO

I. INTRODUCTION

II. ROLE OF CORPORATE BOARD .

III. CHARACTERISTICS OF OWNERSHIP AND BOARD STRUCTURE OF EMERGING CORPORATIONS IN TAIWAN

IV. CONSTRAINTS OF CORPORATE DEVELOPMENT IN TRADITIONAL BOARD STRUCTURE

V. BOARD RESTRUCTURE AND CORPORATE DEVELOPMENT

VI. CONCLUSIONS

II.ROLE OF CORPORATE BOARD

A. MONITORING ROLE OF CORPORATE BOARD

- Agency problem arising from ownership and management
- Information asymmetry
- Moral hazard
- Independence requirement

B. ADVISORY ROLE OF CORPORATE BOARD

- Corporate strategy development requires broader expertise at the board
- Effective board provides information and knowledge
- Board directors serve as corporate advisors
- Competence requirement

III. CHARACTERISTICS OF OWNERSHIP AND BOARD STRUCTURE OF EMERGING CORPORATIONS IN TAIWAN

A.CONCENTRATED OWNERSHIP IN FAMILY

Figure 1

Control of Publicly Traded Companies in East Asia						
Country	Number of Corporations	Widely Held	Family	State	Widely Held Financial	Widely Held Corporation
Hong Kong	330	7.0	71.5	4.8	5.9	10.8
Indonesia	178	6.6	67.3	15.2	2.5	8.4
Japan	1240	85.5	4.1	7.3	1.5	1.6
Korea	345	51.1	24.6	19.9	0.2	4.3
Malaysia	238	16.2	42.6	34.8	1.1	5.3
The Philippines	120	28.5	46.4	3.2	8.4	13.7
Singapore	221	7.6	44.8	40.1	2.7	4.8
Taiwan	141	28.0	45.5	3.3	5.4	17.8
Thailand	167	8.2	51.9	24.1	6.3	9.5

Source:Claessens,Djankov and Lang. "Who Controls East Asian Corporations?" The World Bank,1999

Figure 2-1

	Control of Publicly Traded Companies in East Asia,By Size					
Country	Category	Widely Held	Family	State	Widely Held Financial	Widely Held Corporation
Hong Kong	All Firms	7.0	66.7	1.4	5.2	19.8
	Largest 20	5.0	72.5	7.5	10.0	5.0
	Middle 50	6.0	66.0	2.0	4.0	22.0
	Smallest 50	14.0	57.0	3.0	1.0	25.0
Indonesia	All Firms	5.1	71.5	8.2	2.0	13.2
	Largest 20	15.0	60.0	20.0	0.0	5.0
	Middle 50	6.0	62.7	3.3	3.0	25.0
	Smallest 50	0.0	93.0	0.0	1.0	6.0
Japan	All Firms	79.8	9.7	0.8	6.5	3.2
	Largest 20	90.0	5.0	5.0	0.0	0.0
	Middle 50	96.0	2.0	0.0	0.0	2.0
	Smallest 50	0.0	57.0	0.0	30.0	13.0
Korea	All Firms	43.2	48.4	1.6	0.7	6.1
	Largest 20	65.0	20.0	10.0	0.0	5.0
	Middle 50	66.0	11.0	5.0	0.0	18.0
	Smallest 50	0.0	97.0	0.0	1.0	2.0

Source:Claessens,Djankov and Lang. "Who Controls East Asian Corporations?" The World Bank,1999

Figure 2-2

	Control of Publicly Traded Companies in East Asia,By Size					
Country	Category	Widely Held	Family	State	Widely Held Financial	Widely Held Corporation
Malaysia	All Firms	10.3	67.2	13.4	2.3	6.7
	Largest 20	30.0	35.0	30.0	0.0	5.0
	Middle 50	12.0	69.0	10.0	4.0	5.0
	Smallest 50	0.0	84.0	5.0	2.0	9.0
The Philippines	All Firms	19.2	44.6	2.1	7.5	26.7
	Largest 20	40.0	40.0	7.5	7.5	5.0
	Middle 50	16.0	42.0	0.0	9.0	33.0
	Smallest 50	16.0	45.0	2.0	6.0	31.0
Singapore	All Firms	5.4	55.4	23.5	4.1	11.5
	Largest 20	20.0	32.5	42.5	0.0	5.0
	Middle 50	10.0	46.0	35.0	4.0	5.0
	Smallest 50	2.0	67.0	4.0	5.0	22.0
Taiwan	All Firms	26.2	48.2	2.8	5.3	17.4
	Largest 20	45.0	15.0	15.0	5.0	20.0
	Middle 50	36.0	38.0	0.0	6.0	20.0
	Smallest 50	6.0	80.0	0.0	4.0	10.0
Thailand	All Firms	6.6	61.6	8.0	8.6	15.3
	Largest 20	10.0	57.5	20.0	7.5	5.0
	Middle 50	6.0	47.0	10.0	15.7	21.3
	Smallest 50	0.0	76.7	2.7	5.0	15.7

Source:Claessens,Djankov and Lang. "Who Controls East Asian Corporations?" The World Bank,1999

Figure 3

Concentration of Corporate Ownership in East Asian					
Country	Average Number of Firms per Family	% of total market capitalization that families control			
		Top 1 Family	Top 5 Families	Top 10 Families	Top 15 Families
Hong Kong	2.36	6.5	26.2	32.1	34.4
Indonesia	4.09	16.6	40.7	57.7	61.7
Japan	1.04	0.5	1.8	2.4	2.8
Korea	2.07	11.4	29.7	26.8	38.4
Malaysia	1.97	7.4	17.3	24.8	28.3
The Philippines	2.68	17.1	42.8	52.5	55.1
Singapore	1.26	6.4	19.5	26.6	29.9
Taiwan	1.17	4.0	14.5	18.4	20.1
Thailand	1.68	9.4	32.2	46.2	53.3
Source:Claessens,Djankov and Lang. "Who Controls East Asian Corporations?" The World Bank,1999					

A.CONCENTRATED OWNERSHIP IN FAMILY

- Family-controlled business constitutes basic operating unit
- Family provides needed manpower
- Family-controlled business reduces transaction cost
- Family structure provides strong leadership and management team

B.OVERLAPPING OF MANAGEMENT AND OWNERSHIP

Figure 4

	Means of Enhancing Control in East Asian Corporations				
Country	Cap=20%V	Pyramids With Ultimate Owners	Cross Holdings	Controlling Owner Alone	Management
Hong Kong	18.84	25.1	9.3	68.1	53.4
Indonesia	19.17	66.9	1.3	50.9	84.6
Japan	19.89	36.4	11.6	87.2	37.2
Korea	19.64	42.6	9.4	76.7	80.7
Malaysia	18.11	39.3	14.9	37.4	85
The Philippines	18.71	40.2	7.1	35.1	42.3
Singapore	19.91	55	15.7	37	69.9
Taiwan	19.61	49	8.6	43.3	79.8
Thailand	19.22	12.7	0.8	18.9	67.5
East Asia Nine	19.23	40.8	8.7	50.6	66.8

Source:Claessens,Djankov and Lang. "Who Controls East Asian Corporations?" The World Bank,1999

B.OVERLAPPING OF MANAGEMENT AND OWNERSHIP

- Family members serve important management positions
- Family-designated management teams are subject to family influence

C.FAMILY CONTROLLED BOARD STRUCTURE

Figure 5

No. of OTC-Traded Firms Required to Add Independent Directors at IPO				
	1997	1998	1999	2000*
No. of Firms Required to Add Independent Directors	8	13	37	47
No. Firms Applying for IPO	85	93	80	99
Percentage of A/B	9.41%	13.98%	46.25%	47.47%
*As of September 2000				

C.FAMILY CONTROLLED BOARD STRUCTURE

- Family members are elected to the board
- Family-designated members are selected as directors
- “Independent” or “outside” directors are not effective

IV. CONSTRAINTS OF CORPORATE DEVELOPMENT IN TRADITIONAL BOARD STRUCTURE

Figure 6

Time of Corporate Failures after IPO				
Years	3-5	6-8	9 and more	Total
No. of Firms	13	8	8	29
Percentage	44.8%	27.6%	27.6%	100%

Figure 7

Industry Sector of Failing Companies	
Industry	No. of Companies
Food	4
Plastics	3
Textile	3
Machinery	2
Chemistry,Paper	3
Steed and Metal	5
Auto	2
Construction	5
IT	1
Other	2

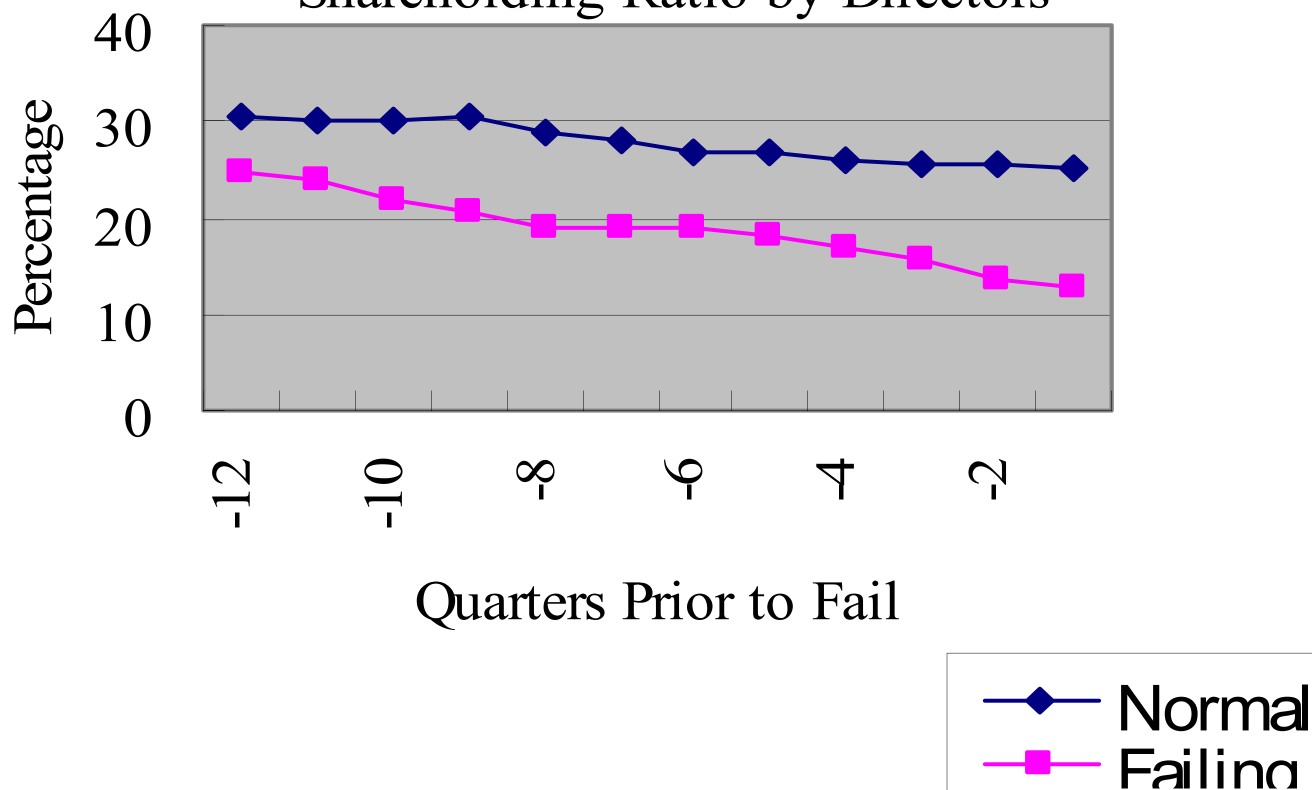


Figure 8
Shareholding Ratio by Directors
Percentage
40
30
20
10
0
-12
-10
-8
-6
-4
-2
Quarters Prior to Fail
Normal
Failing

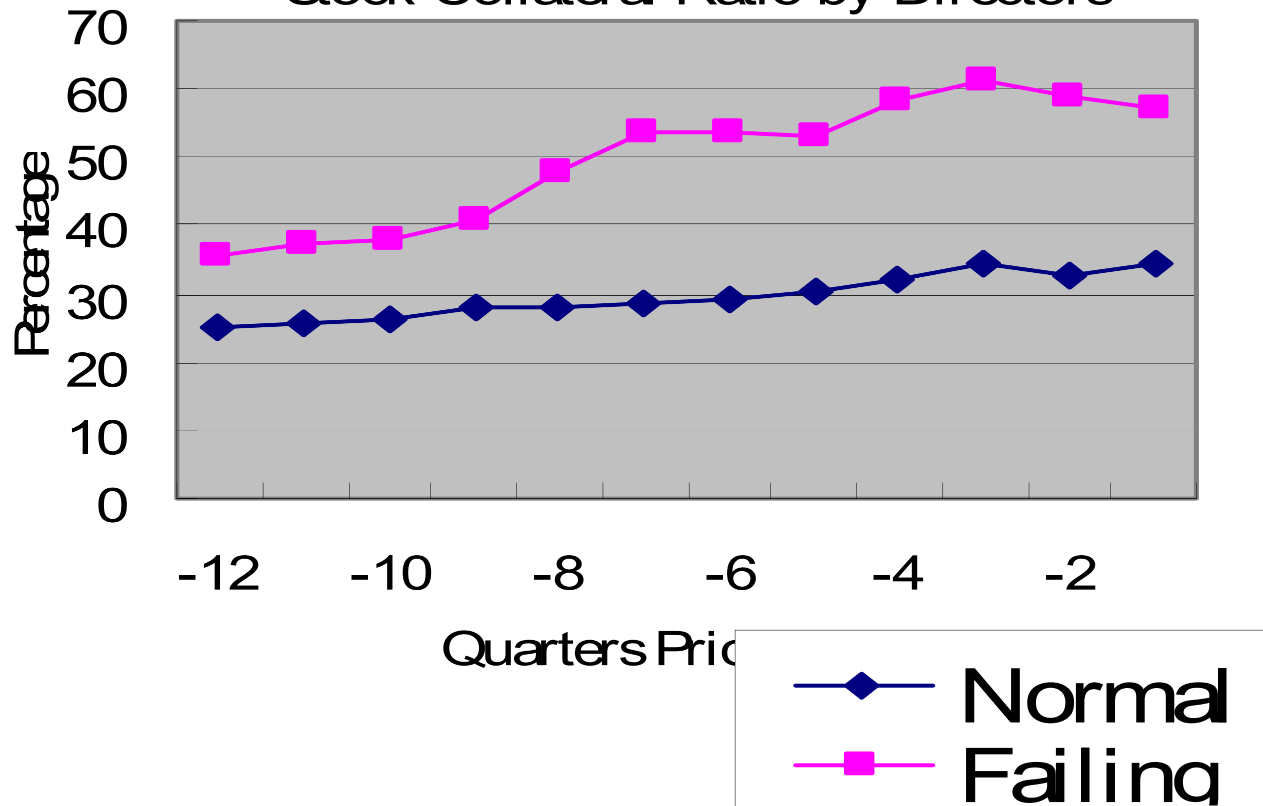


Figure 9
Stock Collateral Ratio by Directors
Percentage
70
60
50
40
30
20
10
0
-12
-10
-8
-6
-4
-2
Quarters Pric
Normal
Failing

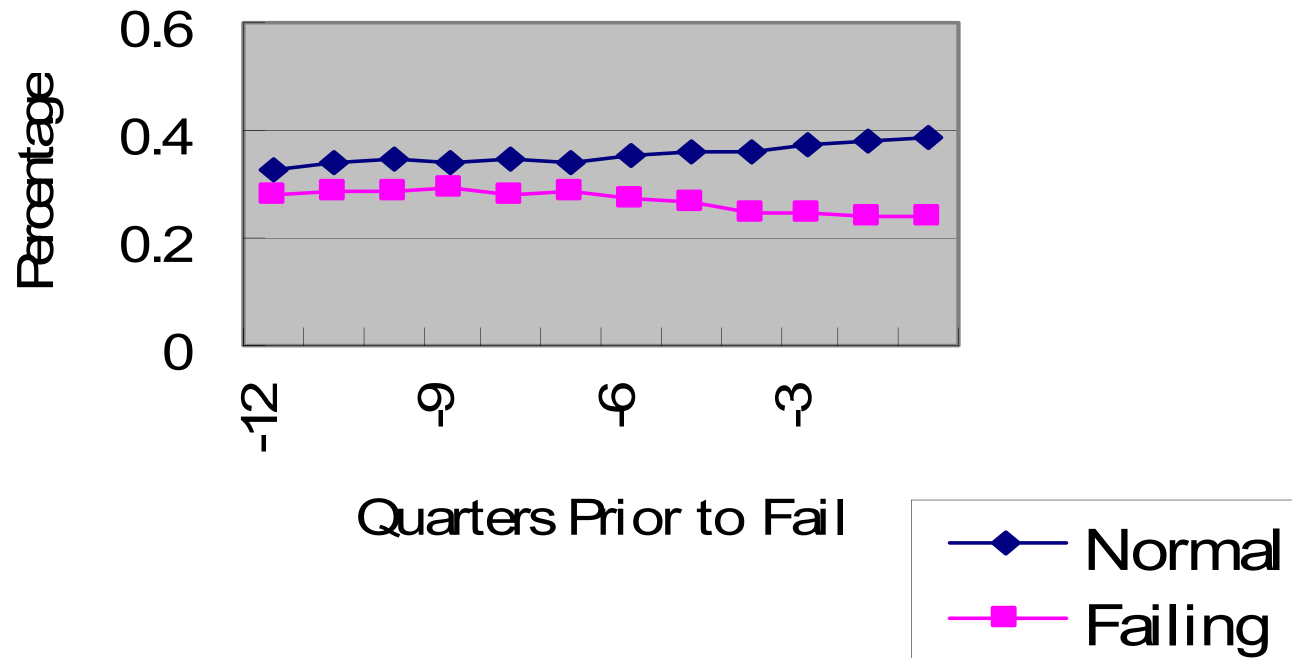
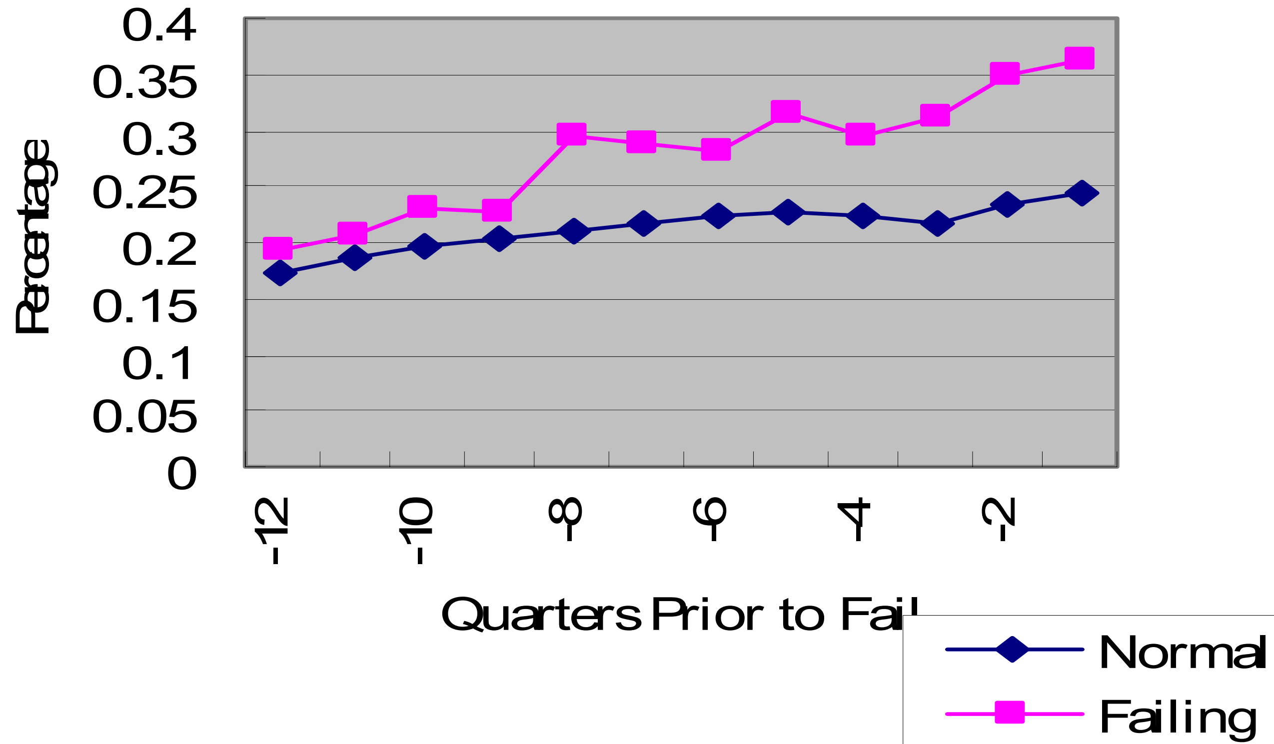


Figure 10
Percentage of Directors by Held by Largest Controlling Family
0.6
0.4
0.2
0
Percentage
-12
-9
-6
-3
Quarters Prior to Fail
Normal
Failing



Figurre 11
Percentage of Directors Held by Largest Institutional Investors
0.4
0.35
0.3
0.25
0.2
0.15
0.1
0.05
0
Percentage
-12
-10
-8
-6
-4
-2
Quarters Prior to Fail
Normal
Failing

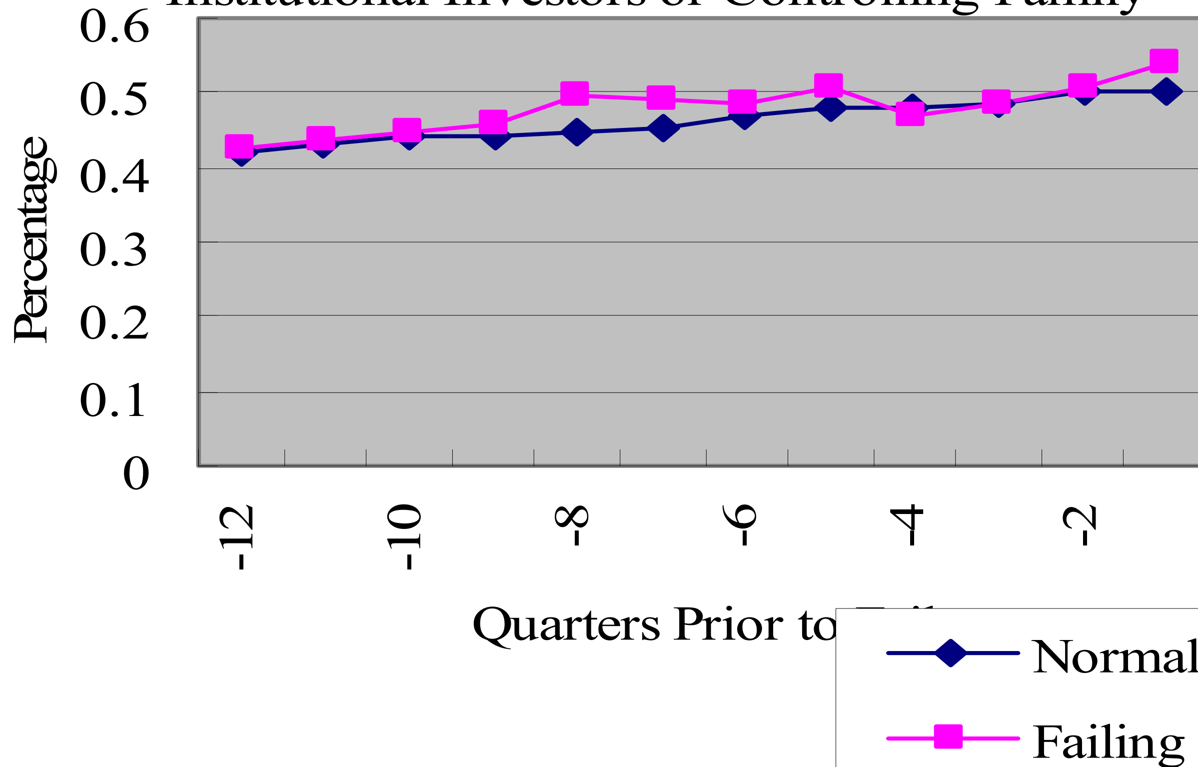


Figure 12
Percentage of Directors Held by Largest Institutional Investors or Controlling Family
Percentage
0.6
0.5
0.4
0.3
0.2
0.1
0
-12
-10
-8
-6
-4
-2
Quarters Prior to
Normal
Failing

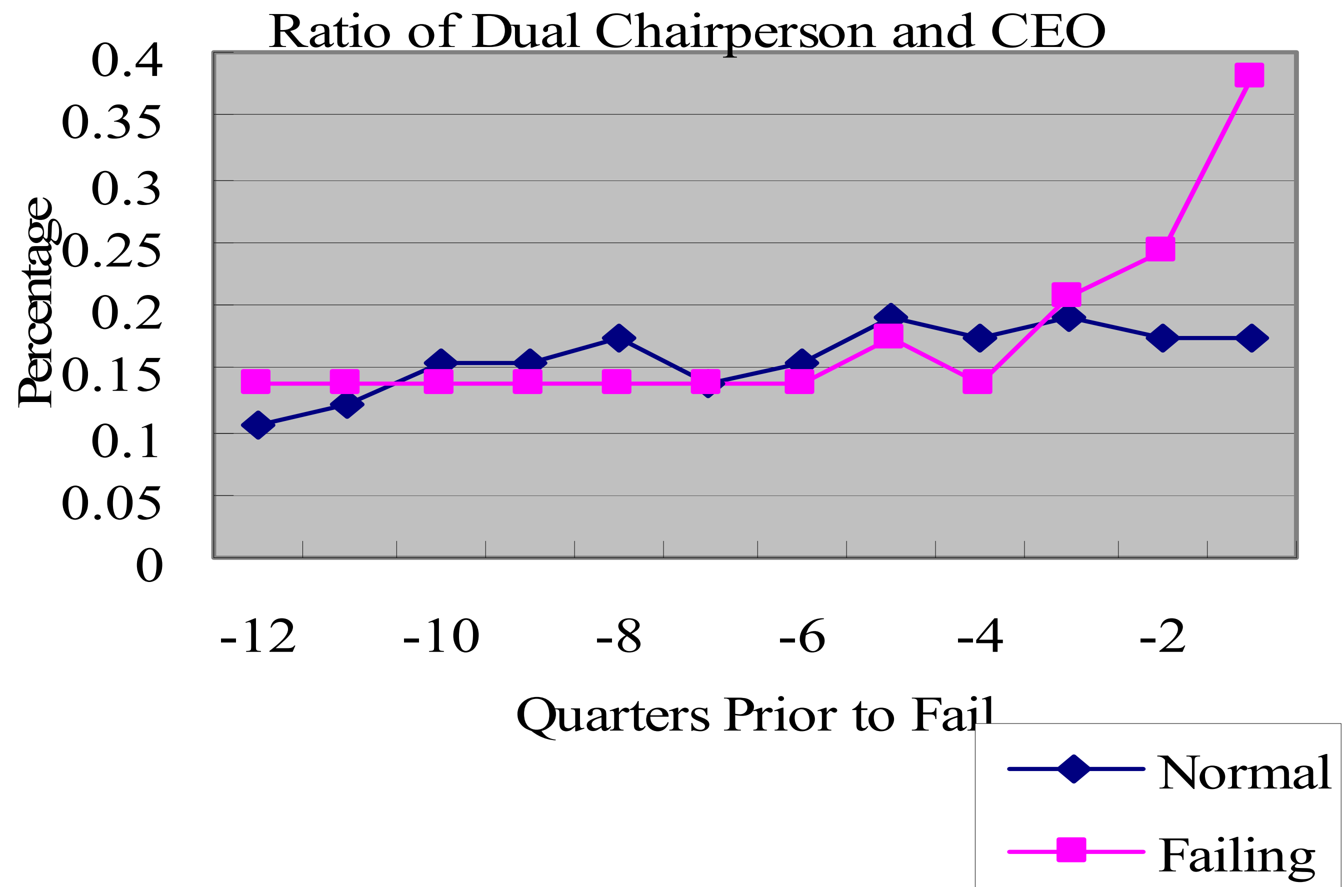


Figure 13
Ratio of Dual Chairperson and CEO
Percentage
0.4
0.35
0.3
0.25
0.2
0.15
0.1
0.05
0
-12
-10
-8
-6
-4
-2
Quarters Prior to Fail
Normal
Failing

IV. CONSTRAINTS OF CORPORATE DEVELOPMENT IN TRADITIONAL BOARD STRUCTURE

A. CORPORATE DEVELOPMENT REQUIRES KNOWLEDGEABLE AND INDEPENDENT INPUTS AT THE TOP

B. FAMILY-CONTROLLED BOARD TENDS TO LIMIT TALENT POOL

C. TIGHTLY-CONTROLLED BOARDS ARE MORE LIKELY TO CREATE AN ENVIRONMENT LEADING TO MORAL HAZARD

D. POWERFUL CHAIRPERSON/CEO WITH CONTROLLING OWNERSHIP ARE LESS LIKELY TO RECEIVE DIVERCE VOICE IMPORTANT FOR CORPORATE DEVELOPMENT

E. CORPORATE FAILURES DURING ASIAN FINANCIAL CRISIS INDICATES POTENTIAL RISK OF CLOSELY-HELD BOARD

V. BOARD RESTRUCTURE AND CORPORATE DEVELOPMENT

A. FAST CHANGING TECHNOLOGY AND EVER INCREASING COMPETITION REQUIRES COMPANIES TO RESTRUCTURE THEIR BOARDS FOR CORPORATE DEVELOPMENT

B. EMERGING COMPANIES NEED TO RECOGNIZE THE LIMIT OF THEIR EXISTING BOARD AND UNDERSTAND THEIR RISKS AS WELL AS PRESSURES AFTER IPO

C. EMERGING COMPANIES WITH TIGHTLY CONTROLLED BOARDS NEED TO OPEN THEIR DIRECTORSHIP FOR INDEPENDENT AND COMPETENT MEMBERS

D. BEST PRACTICES ARE IMPORTANT FOR CORPORATE BOARDS TO BE INSPIRED FOR THEIR IMPROVEMENT

E. EDUCATION FOR BOARD OF DIRECTORS ARE NECESSARY FOR THE DIRECTORS TO CARRY OUT THEIR RESPONSIBILITIES

VI.CONCLUSIONS

A.THERE IS A NEED TO PROVIDE MORE CONVINCING EVIDENCE ON THE VALUE OF GOOD CORPORATE GOVERNANCE TO THE MARKET

B.EQUITY FUNDING LIKE VC WILL INDUCE MORE ACCOUNTABILITY FOR CONTROLLING SHAREHOLDERS

C.PROMOTION OF GOOD CORPORATE GOVERNANCE AT IPO WILL ENHANCE THE AWARENESS

D.EDUCATIONAL SERVICE FOR BOARD DIRECTORS ON CORPORATE GOVERNANCE ARE IMPORTANT TO CHANGE THEIR PERSPECTIVES AND GOVERNANCE BEHAVIORS

E.BEST PRACTICES NEED TO BE PROMOTED AND RECOGNIZED BY REGULATORS

BOARD STRUCTURE AND CORPORATE DEVELOPMENT AFTER IPO

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***Presented on the APEC Symposium on Emerging Enterprises and Corporate Governance: New Economy and Old Rules, October 16-17, The Westin Taipei, Chinese Taipei.**

INTRODUCTION

The East Asian financial crisis starting mid-1997 has awakened many countries in this region that, to recover from this crisis and continue their economic growth, East Asian countries would have to restructure their corporate governance system (Nam, Kang and Kim, 1999). While there are three main requirements for effective corporate governance, including transparency, equity and accountability, it is the corporate board that provides pivotal mechanisms to implement the required governance elements. Many governance systems have assumed the existence of separation of ownership and management and developed corresponding structure to protect financial creditors or equity holders. However, it is prevalent among East Asian countries except Japan to have concentrated ownership within family members (Ko, et al., 1999; Nam, Kang and Kim, 1999). It is very likely that the board is under the control by the largest shareholders or their family members. With this type of structure, the board may not be able to perform its legal obligation properly. The paper is to present a discussion on the board's role in Asian context and make suggestions for the restructuring of the board after IPO. The remainder of this paper is organized as follows. The second section reviews the role of corporate board in more details in terms of its monitoring and strategic development perspectives. The third section discusses the characteristics of ownership and board structure of emerging companies in Chinese Taipei. The fourth section analyzes the consequence of corporate development resulting from traditional board structure. The fifth section discusses the necessary board restructure for continuing corporate development. The last section concludes this paper with further observations and suggestions.

THE ROLE OF CORPORATE BOARD

The corporate board is charged with the final responsibility of managing a corporation with the best interests of its shareholders. This responsibility includes the function of monitoring the performance of management and the approval of corporate strategies. There are competing views on the board's primary responsibility and whether the board is able to accomplish this responsibility effectively.

In the agency framework, with separation of ownership and management, the board's responsibility is directed toward the protection of shareholders from corporate management, and the board serves in a monitoring role (Berle and Means, 1937; Millestein and MacAvoy, 1998; Rediker and Seth, 1995; Westphal, 1998). In this view, although the management of modern corporation is delegated by the shareholders to conduct corporate affairs in the best interest of the shareholders, the management may instead take actions to maximize their own interest. This agency problem arises from the conflicting goals of, as well as the information asymmetry between, shareholders and managers (Jensen and Meckling, 1976). Several mechanisms have been devised to mitigate the agency problem, including incentive compensation scheme, threat of corporate takeover, competition of product market, etc. Among these mechanisms, monitoring by the board of directors is a critical one. If the board is structured with

more independence from the management, it will be able to monitor or control the decision making by the management on behalf of the shareholders (Fama and Jensen, 1983; Millestein and MacAvoy, 1998). Thus, corporate board with strong element of independence can provide monitoring and controlling function to mitigate the deviation behavior of management although the effectiveness of such function have been questioned in some empirical research (Westphal, 1998, Westphal and Zajac, 1995).

Another perspective on the role of corporate board emphasizes on the board's function to provide advisory service in shaping the development of corporate strategies (i.e., advisory role). When corporate managers present their strategic plan to the board, the board of directors with various expertise and knowledge are in a position to refine the plan. As a result, board of directors should be able to provide positive inputs into strategic development that eventually correlate with improved corporate performance (Charles and Snell, 1988; Hermalin and Weisbach, 1991; Vance, 1983; Zahra and Pearce, 1989). This view assumes that board directors have information or knowledge useful for the development of corporate strategies. Such information or knowledge could be firm-specific or simply obtained by the directors from their diverse experiences or contacts. In fact, an effective board of directors would need to serve in both monitoring and advisory roles. It is within the design of board composition and selection to achieve this goal.

CHARACTERISTICS OF OWNERSHIP AND BOARD STRUCTURE OF EMERGING CORPORATIONS IN CHINESE TAIPEI

Previous researches have indicated concentrated ownership in families of public-traded companies is prevalent in East Asian countries (Claessens, et al., 1999). It is even more so for emerging corporations. This prevalent form of business ownership has its cultural root and economic reasons. For example, in Chinese Taipei, family usually constitutes a basis to develop business at the inception of a company. One study indicates that 78% listed companies of Taiwan Stock Exchange in 1995 is controlled by various family groups (Su, Yeh and Ko, 1998). Family members provide needed manpower to start a business. The closer ties of family members also reduce transaction costs that would otherwise be prohibitive for low-cost operation. The familial structure provides a parallel organizational structure to carry out necessary business activities with efficiency. Therefore, family-controlled business takes the advantage of having a strong leadership and cohesive management team for business development (Ko, et. al, 1999).

This concentrated ownership within family groups has also led to a widespread board structure, dominated by family-related or family-designated board directors. For the companies applying for IPO in Taiwan Stock Exchange or Over-The-Counter Stock Exchange, a great majority of their boards are controlled by family members or family-designated representatives. This type of board structure may not be inappropriate for private companies, but it becomes a concern for the exchanges and securities regulators as public investors are becoming shareholders. This type of closed board structure is being slowly opened by the stock exchange by requiring the addition of

non-family member in the board.

Another characteristic of the emerging companies applying for IPO is the overlapping of management and ownership. Being a family-controlled company, it is common to find that the senior family members chairing the board as well as serving as the CEO, with other junior family members also taking various management positions. Unlike the companies with diffused ownership, these family-controlled companies have their decision-making and operation concentrated in identifiable family members. Although these companies may also retain capable management team for running their business, usually it is the owner/executive and their family members or associates that form the inner circle for strategic decisions and operations.

Cross-shareholding has also developed as another salient feature of many emerging companies. The ultimate owner or business entity may set up subsidiaries with pyramid ownership structure as described in Berle and Means (1937). This pyramid structure allows the ultimate owner or business entity to maximize their equity in the formation of business groups. Current laws and regulations in Chinese Taipei do not prohibit this type of companies from going public. Therefore, it is likely that the board of directors of this type of companies is controlled by the ultimate owner or business entity.

CONSTRAINTS OF CORPORATE DEVELOPMENT IN EXISTING BOARD STRUCTURE

The existing board structure with the characteristics of family control, overlapping of ownership and management, and cross-shareholding has led to several problems in corporate development, especially after a company has become public firm. These problems include moral hazard at the top, inadequate knowledge and advice within the decision making board, ineffective audit system, etc., which may eventually lead to corporate failures as exhibited in the failing companies in Chinese Taipei since mid-1997.

A tightly controlled ownership and management provides an environment that is more likely to lead to moral hazard at the top. As family members or ultimate owners have the majority control over the board of directors, together with serving at top management positions, it becomes more difficult for non-controlling shareholders to exercise check and balance. In a study of 29 failing companies in Taiwan Stock Exchange during 1996 through 1998 (Wang, 2000), a substantial number of the controlling shareholders have diverted corporate assets into or to set up other subsidiaries controlled by these shareholders, or conducted related party transactions, for their own benefits. When such schemes were carried out excessively, their companies' financial resources were exhausted and led to the failures of their companies. This pattern of corporate abuse was detected and disclosed only when the companies were rumored to have financial crisis in the market and alerted by the regulators to take investigative actions. The absence of check-and-balance in the corporate board clearly indicates the potential moral hazard in a tightly controlled board of directors.

As corporate board is charged with the decision making regarding to strategic

development of a company, the knowledge and experience possessed by the board of directors are critical to effectively shape the final strategy. However, when the boards of directors are packed with controlling shareholders, their family members or associates, the advisory function of the board are constrained. As the directors served by the family members or associates are selected more on their relationship or loyalty to the controlling shareholders, their knowledge or experience may be of secondary consideration. It is likely that their advisory expertise may be limited in terms of the need for corporate strategic development. In addition, with the Asian culture of respecting authority, if the chairperson is a powerful owner/manager, the other directors may not be able to present different views or perspectives that are important for the development of corporate strategy.

Accounting transparency is a critical element for corporate accountability and an effective financial audit is necessary to achieve transparency. When the board of directors is packed with non-independent directors, the auditor may not be able to communicate effectively with the board for his/her findings. The existing board structure in Chinese Taipei does not have audit committee. Instead, the corporation has a supervisory board, which is legally charged with monitoring the decisions and operations of the board of directors, and may play a similar role of audit committee. However, the members of supervisory board may also come from controlling shareholders or their family members, which severely restricts the function it is intended to perform. Therefore, the auditor is unable to communicate its concern with any independent body of a company should he/she has any findings involving with the misdeed committed by the controlling shareholders or top management. The auditor may resign when he/she cannot find any other way to protect his/her own integrity. However, from the cases of corporate failures in Chinese Taipei, even if the auditor resigns for his/her own protection, the damage of misdeed by controlling shareholders may continue. It is thus necessary to reexamine the role of external auditor and its relationship with the board, so that effective mechanism can be developed to achieve the objective of audit on corporate financial statements.

BOARD RESTRUCTURE AND CORPORATE DEVELOPMENT

Corporate failures in Chinese Taipei since 1997 have suggested the deficiency in board structure together with other weak corporate governance mechanisms were major contributors leading to these failures. In order for corporations to continue their development after IPO, it is necessary to restructure the corporate board so that the monitoring and advisory functions of the board can be realized.

The monitoring function can be served when the boards have directors that are independent from the controlling shareholders. When applying for IPO in Chinese Taipei, many companies still have boards closely tied to and controlled by owners' families. Although the stock exchanges in Chinese Taipei may require companies add one or two non-family related board members as a precondition for listing, such requirement can only have minimal effect on the improvement of board structure. In the

regulations of stock exchanges or securities laws, there is no definition of "independence" and there is no regulation on the selection process. As a result, the controlling shareholders are able to elect non-family related members to the boards but they are still compliant to the wishes of the controlling shareholders. Therefore, to restructure the board, there is a need to promote regulations or best practices on the definition and selection criteria of directors that are independent from controlling shareholders or from executive functions.

In addition to the monitoring function, there is a need for the board to perform advisory function in shaping the corporate strategy. This would require board directors to be knowledgeable and informative about the company. The competence requirement may be fulfilled either with the company's executives sitting as the board members, or with outside executives, professionals or retired executives. There is a wide range of candidates and the company would need to make selection to form a board of balanced directors.

For emerging companies after IPO, the constraint of their knowledge about the nature of public companies have often limited their ability to transform from private organizations into public entities. The controlling shareholders may still consider the company as their own without recognizing their responsibilities to other shareholders even though the company has been publicly traded in the stock exchange. This may have legal consequence beyond the controlling shareholders' understanding. On the other hand, the availability of public fund will allow the company to expand their operations further. However, there is a hidden risk that the company's knowledge and ability may not be able to cope with the corporate growth fuelled by the public fund. This risk can be evidenced from the data of corporate failures in Taiwan Stock Exchange during 1996 through 1999. Among 29 cases of corporate failures, 13 cases (44.8%) of failures occurred within 5 years after their IPO, 8 cases (27.6%) occurred between 6 to 8 years after their IPO, and another 8 cases (27.6%) occurred 9 years or more after their IPO. In addition, except one case in technology industry, the remaining 28 cases of failures fell into the category of traditional industries, such as food, textile, construction, metal, etc.. This suggests the volatile nature of market in recent years. The globalization of domestic and international markets, together with rapid change of technology, has increased dramatically the market competition. If a company is not able to bring in more knowledge and expertise in its process of developing corporate strategy, it is likely to experience more difficulty in its survival and growth. Therefore, a corporate board consists of competent directors is becoming more critical than before.

CONCLUSIONS

The corporate board is important for corporate development by providing monitoring and advisory services. In East Asian context, concentrated ownership in family and overlapping of ownership and management create a greater need for effective monitoring role played by the corporate board. Corporate failures since Asian financial crisis starting mid-1997 have indicated a weak corporate board will not be able to provide the

needed monitoring mechanism that protects the interest of general shareholders. On the other hand, rapidly changing technology and globalization of markets have led to fierce competition. Companies will need to bring more knowledge and expertise into their strategy formation process. The corporate board, as the final reviewer of corporate strategy, has to have wider range of competent directors in order to help a company to develop its strategies. The existing regulations and corporate culture will need to be changed so that independent and competent directors will eventually form the core of corporate boards in the Asian business communities.

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Changes in the Corporate Governance Practices after the Crisis: Korean Experience

Hasung Jang

Korea University

APEC Symposium at Taipei

October 17th, 2000

PEC-PSPD

Participatory Economy Committee

People's Solidarity for Participatory Democracy

Chair: Hasung Jang   Director: Seung-Hee Lee

Phone: 82-2-723-5052   Fax: 82-2-723-5055   email: pec@pspd.org

Four Economic Reform Policies

- Chaebol Reform: Corporate Restructuring
  - Financial restructuring: Reducing D/E ratio
  - Business restructuring: Building competence core
  - Improving transparency
  - Improving corporate governance
- Financial Reform
  - Clean up NPL & re-capitalizing banks
- Labor Reform
  - Flexible lay-off
- Public Sector Reform
  - Privatization of SOEs
  - Slim down Government

New Regulation on Corp.Governance

- Outside Director
  - Mandatory for listed companies since 1999
  - More than ¼ of the board should be filled by outside director
  - For companies with asset larger than 2tr won ($1.7bil), outside director should be more than ½ of the board
- Combined Financial Statement
  - Mandatory for companies belong to top 30 Chaebols
- Audit Committee
  - For listed company with asset larger than 2tr won ($1.7bil)
  - 2/3 of the committee should be outside directors
- More & Stricter Disclosure Requirement

New Regulation on Corp.Governance

- Foreign Equity Ownership Limit Removed
  - 14% limit until 1997
  - e.g. Samsung Electronics: from 14% in 1997 to 52% in 1998
- Hostile Takeover Barriers Removed
  - 50%+1 share rule removed
  - Mandatory tender offer is to be removed
- Cross Debt Guarantee Prohibited
- Cross Share Ownership Prohibited

New Regulation on Corp.Governance

- Fiduciary Duty of Directors
  - Introduced in the Commercial Code
- Cumulative Voting Introduced
- Stricter Regulation on Related Party Transactions
  - Capital & asset transactions
- Integrated Supervision Agency Established
  - “Financial Supervision Service”
  - Integrated supervision: Bank, Securities, Insurance

New Regulation on Corp.Governance

- Minority Shareholder Rights Strengthened

	Shares Required
– Derivative Suit against Mgt.	0.01%
– Request to Remove Director	0.5% (0.25%)
– Injunction to Stop Illegal Transaction	0.5% (0.25%)
– Proposing Agenda to S.M.	1.0% (0.5%)
– Inspecting Books	1.0% (0.5%)
– Request to Convene S.M.	3.0% (1.5%)
– Class Action suit not allowed	

( ) for company with a capital over 100billion Won

Changes Are Coming Slowly

- Old Habits and Old Structure Are Hardly Changing
- Voluntary Changes Are Rare
- Changes Are Mostly by Enforcement
- Innovative in Finding Loop Hole

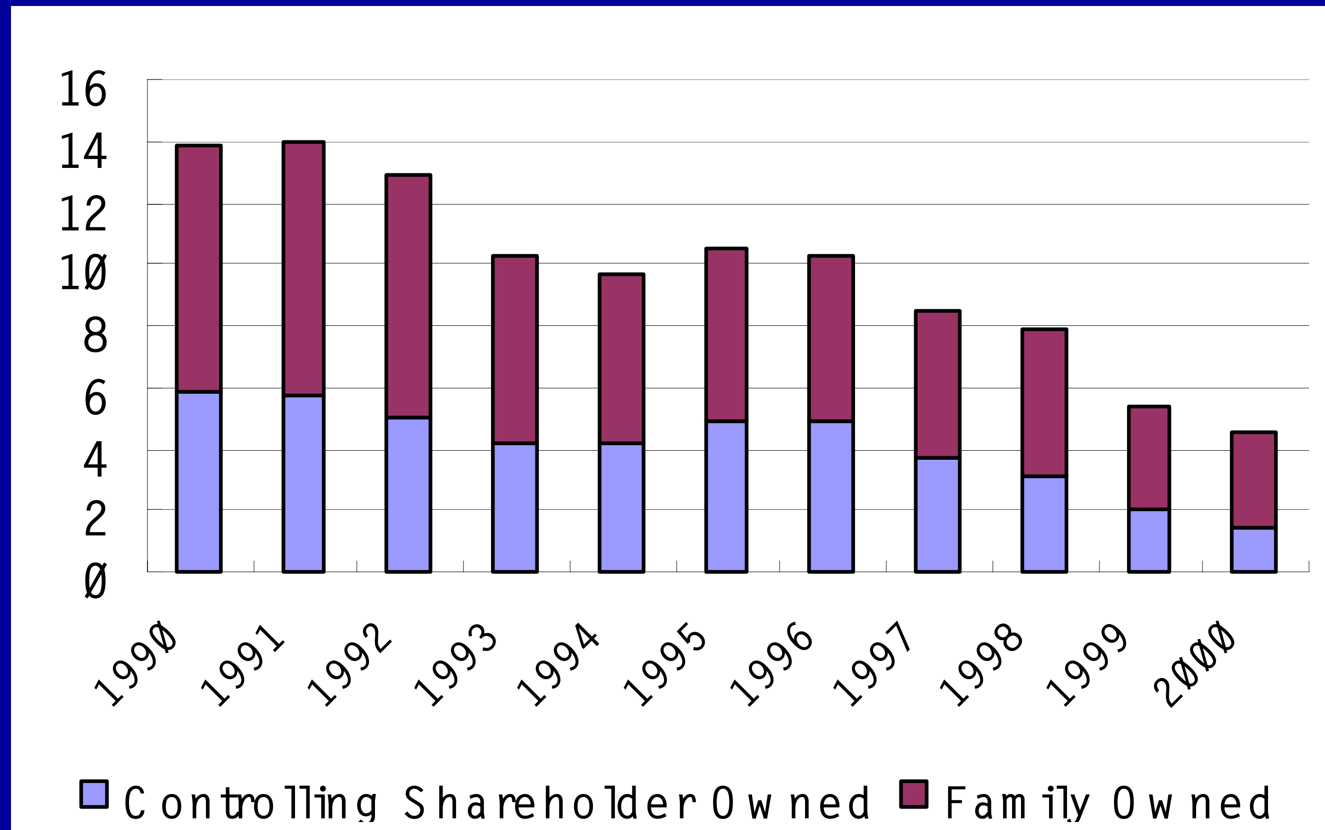
- Moral Hazard by Controlling Shareholder
- Investment Institutions under Chaebol Influence
- No Single Hostile Takeover
- Reliability of Accounting Numbers Improved

Any Substantial Changes in Practices?

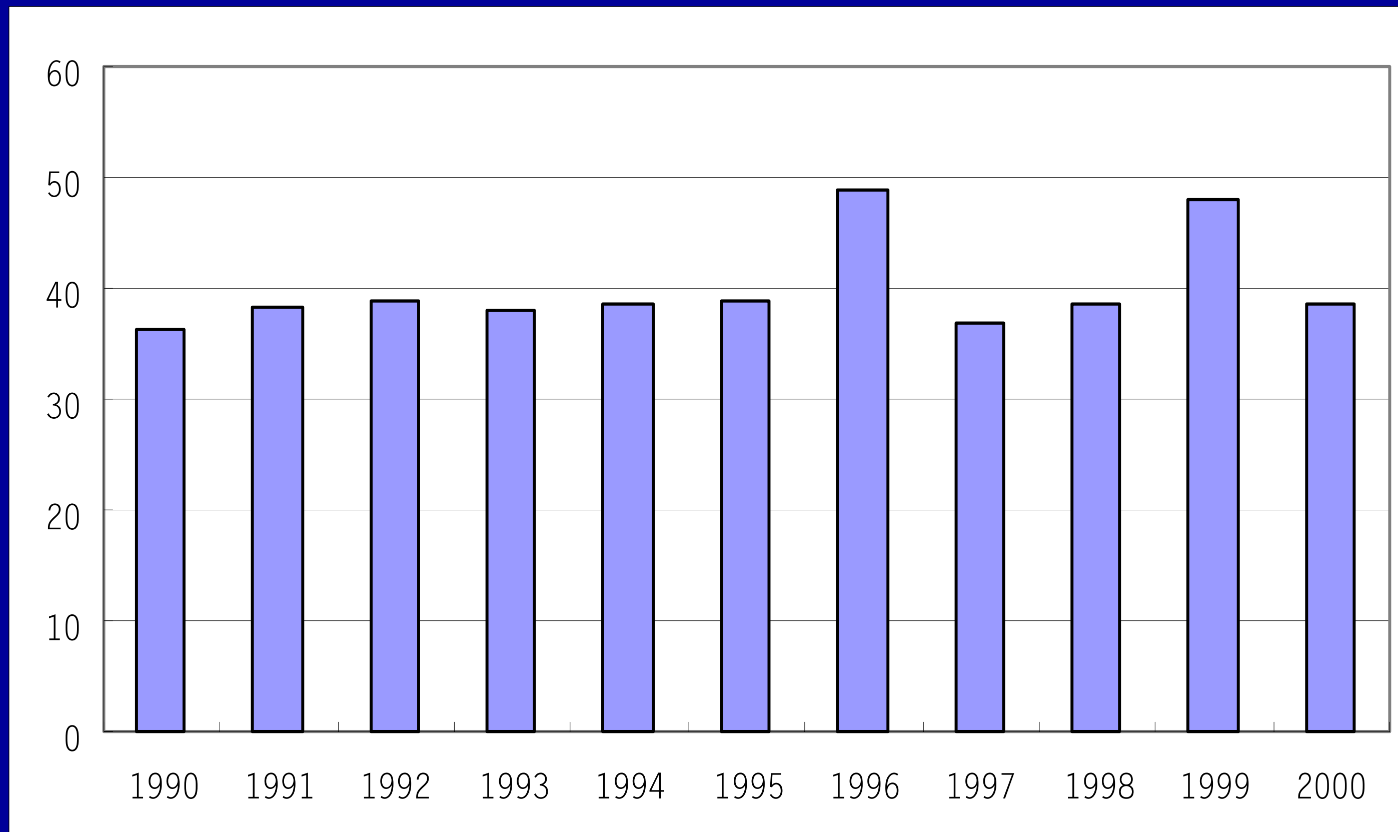
- Independence of Outside Director in Question
  - Over 90% are chosen by controlling shareholder & Mgt.
  - Resignation of Minister of Education:
  - Self dealing of outside director of Samsung Electronics
- Cumulative Voting
  - Most chaebol companies excluded by AOI
  - Top 30 Chaebols : Only 11 out of 126 listed company adapted: 91.3% excluded
  - Non Chaebols: 136 out of 576 listed. 76.4% excluded
- Management Entrenchment through Affiliates' Ownership

Shares Owned by Controlling Shareholder & family:

Average of Top 30 Chaebol

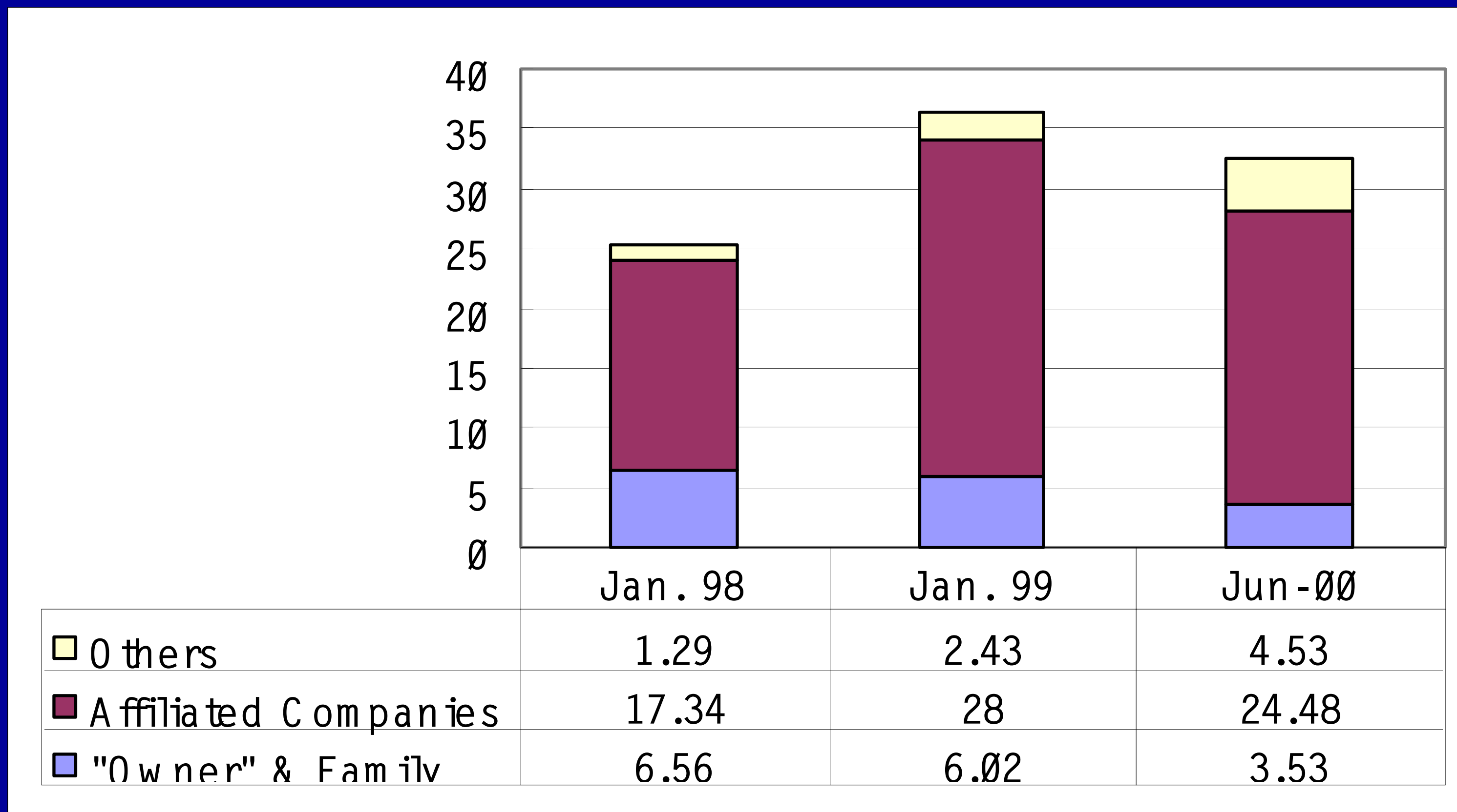


Outstanding Shares Owned by Affiliates:
Average of Top 30 Chaebol



Management Entrenchment through Ownership by Affiliates

Top 10 Chaebols: Listed Companies

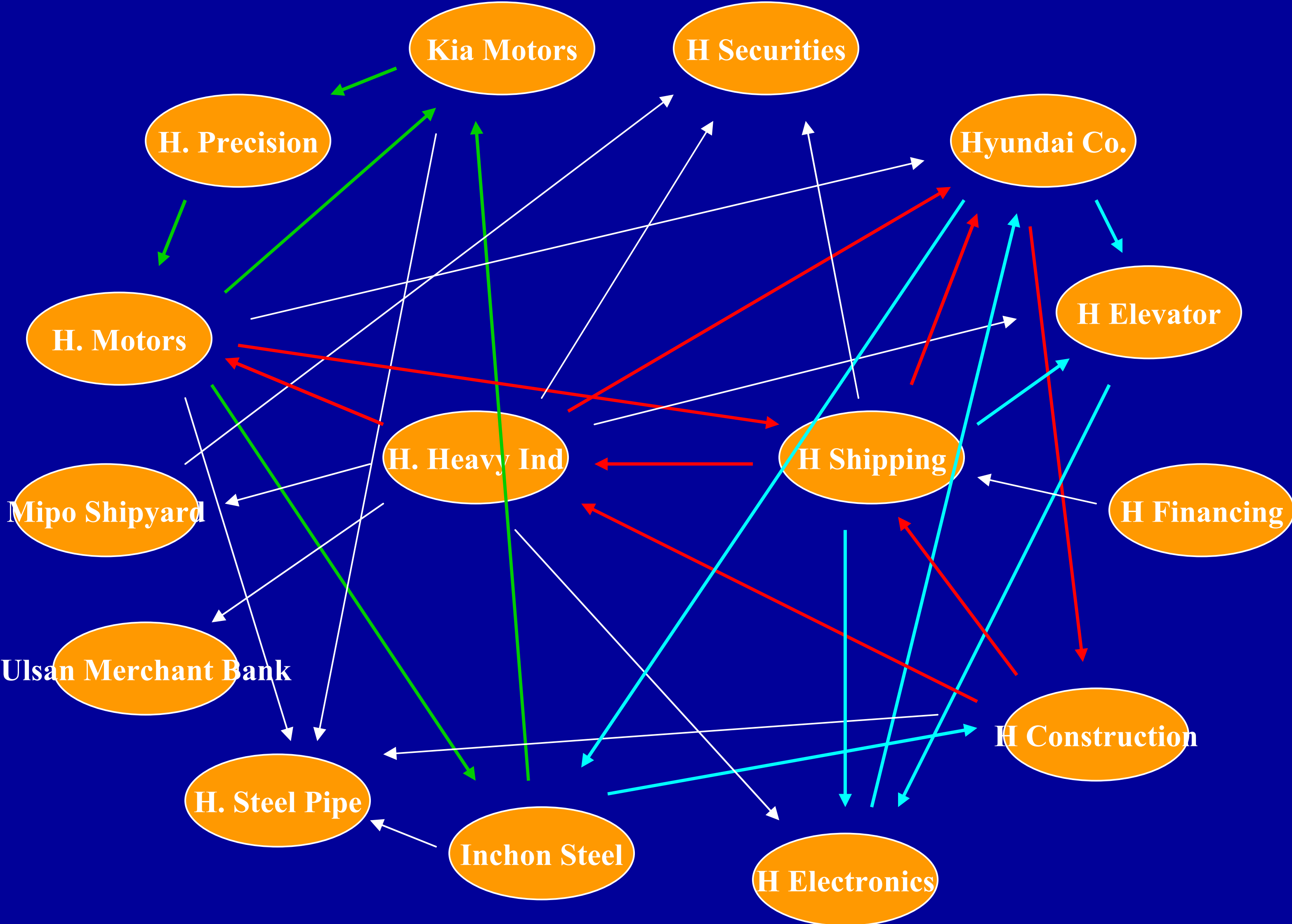


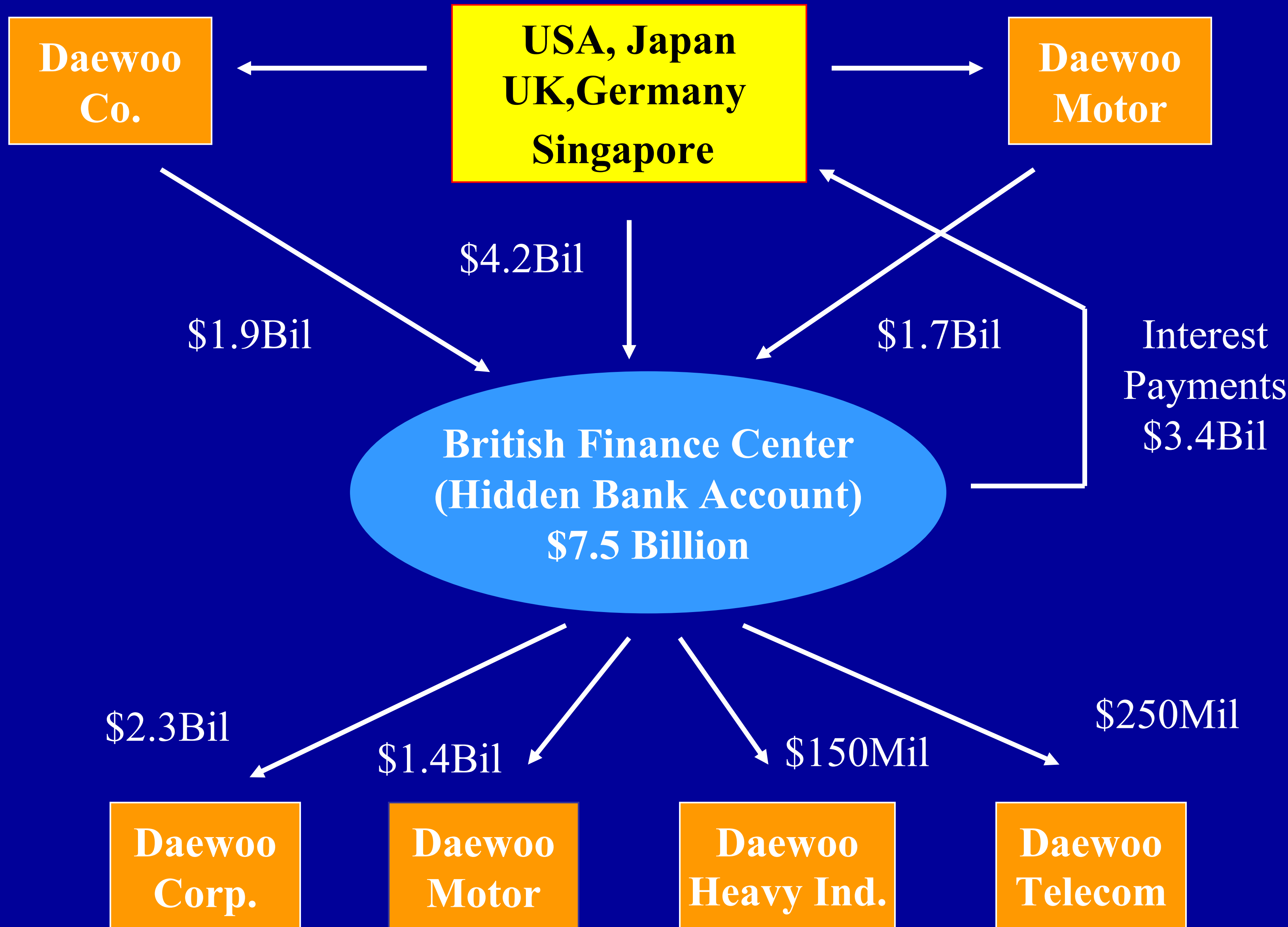
	Jan. 98	Jan. 99	Jun-00
Others	1.29	2.43	4.53
Affiliated Companies	17.34	28	24.48
"Owner" & Family	6.56	6.02	3.53

Any Substantial Changes in Practices?

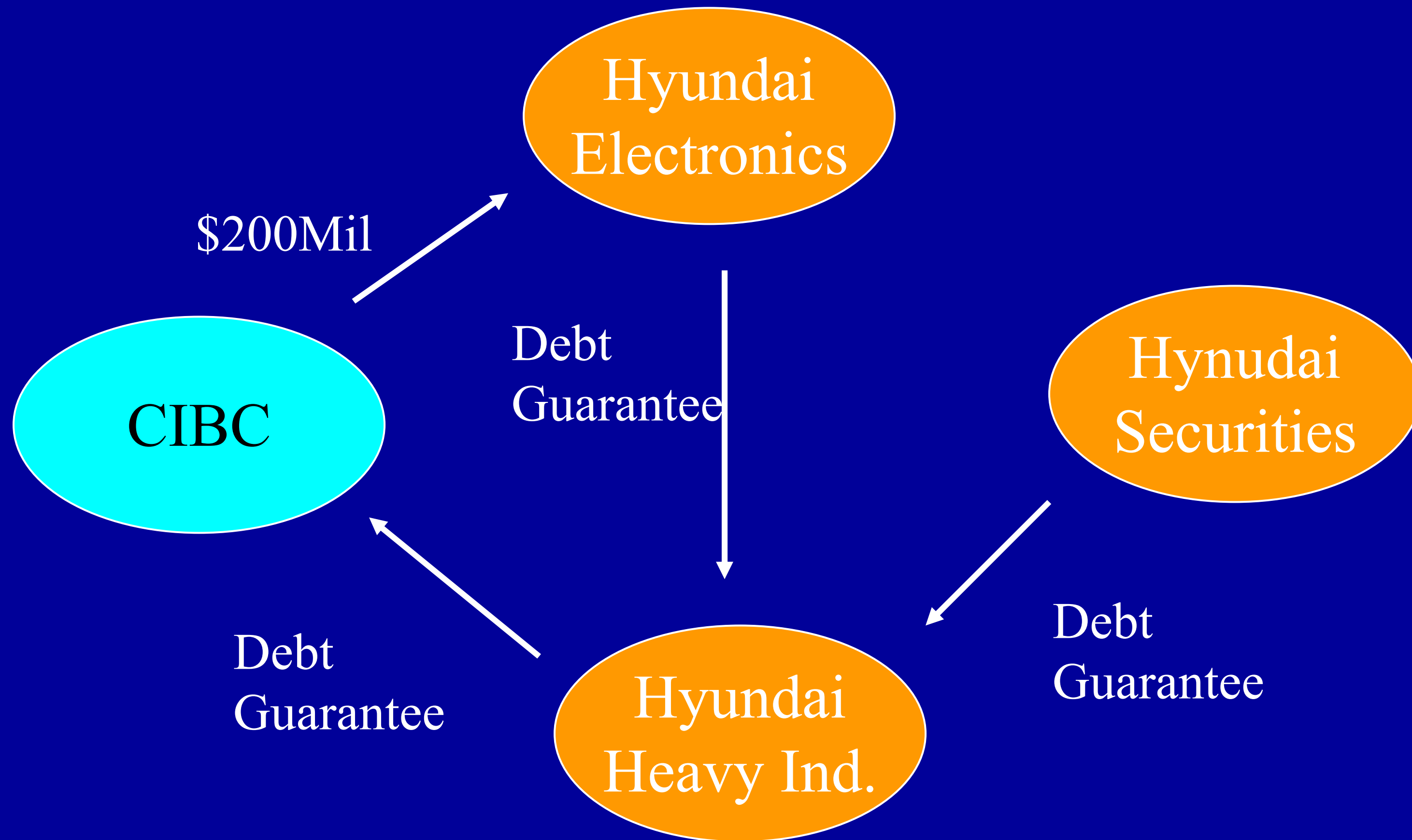
- Circular Equity Ownership
  - Circumventing prohibition of cross share ownership
- Off Shore Operation
  - Paper company established offshore
  - Debt guarantee using put option
  - Equity investment using call option
- Expropriation of Minority Shareholders
  - Using equity related derivative securities
  - Convertible Bond, Bond with Warrants
  - Capital subsidy through financial institutions
  - Asset sales at transferring price

Circular Equity Ownership: Hyundai Group




Daewoo Co.
USA, Japan
UK,Germany
Singapore
Daewoo Motor
$4.2Bil
$1.9Bil
$1.7Bil
Interest Payments $3.4Bil
British Finance Center
(Hidden Bank Account)
$7.5 Billion
$2.3Bil
$1.4Bil
$150Mil
$250Mil
Daewoo Corp.
Daewoo Motor
Daewoo Heavy Ind.
Daewoo Telecom

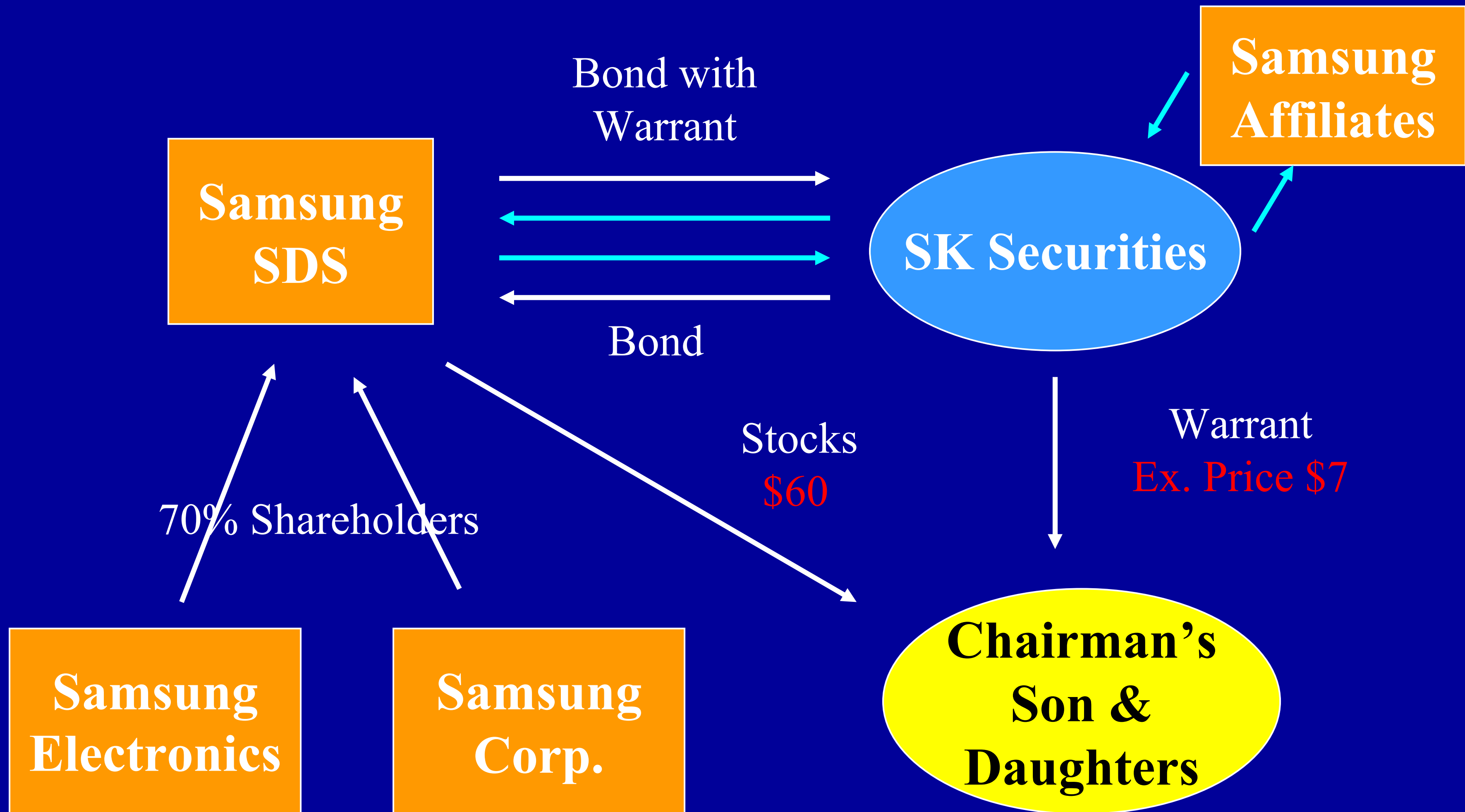
Hidden Debt Guarantee



Any Substantial Changes in Practices?

- Samsung SDS
  - Bond with Warrant Issued to Chairman's Family
  - Exercise Price = $7, Market Price = $60
  - Current Market Price = $700
  - Capital Gain in One Year = $1.4 Billion

Expropriation of Minority Shareholders



Catalyst: Shareholder Activist Emerged!

- Minority Shareholder Activist Group since 1997
  - Finance, Economics, Law professors
  - Lawyers, Certified Public Accountants
- Targets: Chaebol Companies & Financial Institutions
  - Samsung Electronics, SK Telecom, Hyundai Heavy Industry Dacom, Daewoo Corporation
  - Korea First Bank, Hyundai Investment Trust Co.
- Actions Taken
  - Legal fight: Derivative suits, Proxy fight
  - Active participation at shareholder's meeting
  - Legislations

Further Changes Necessary

- Strengthening Minority Shareholder’s Right
  - Cumulative voting: election of independent outside director
  - Class action suit
  - Derivative suit: Any shareholder should be able to file it
  - Voting procedure: internet voting, mail voting
- Active Role of Institutional Investors
  - Watchdog on corporation
  - Disclosure on governance
  - Stricter compliance rule
  - Active voting participation

Further Changes Necessary

- Board Structure
  - Active monitoring on the management
  - Outside directors should be the majority
  - Election of “independent” outside directors
  - Independent audit committee
  - Empower outside directors
  - Education & training of outside directors
- Separation of Ownership of Financial Institution
  - Chinese wall between financial & commerce companies
  - Banks, Non-bank financial institutions
  - Investment Institutions

Further Changes Necessary

- Active Market for Corporate Control
  - LBO & hostile take-over
  - Deregulate proxy procedure
  - Development of market for professional management: stock options
- Market for Corporate Governance
  - Analysis on governance issues
  - "Corporate governance information agency"

    CGIC: Corporate Governance Information Center
- Participation of Employee Shareowner

理律法律事務所
LEE AND LI
ATTORNEYS-AT-LAW

COMPETITION, ALLIANCE AND CORPORATE GOVERNANCE - A VIEW FROM TAIPEI

Lawrence S. Liu
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Professor of Law, Soochow University

APEC Symposium on
Emerging Enterprises and Corporate Governance:
New Economy and Old Rules

Lawrenceliu@leeandli.com
October 2000
Taipei

CONTENTS

I. BACKGROUND
II. MARKET FOR CORPORATE OWNERS
III. COMPETITION AND CORPORATE GOVERNANCE
IV. CHAEBOL-ENGINEER ALLIANCE
V. CORPORATE GOVERNANCE REFORM - CAPITAL STRUCTURE
VI. CORPORATE GOVERNANCE REFORM - CONTROLLING INSIDERS
VII. CORPORATE GOVERNANCE - FACILITATING ADAPTATION
VIII. CORPORATE GOVERNANCE - CAPACITY BUILDING

I. BACKGROUND

- Unique International Position and Survival Instincts (Political Economy)
- Global Competition
- Flirtations with Industrial Policy
- Civil Law System and Legal Culture
- Late Comer in Financial Market Development
- Emphasis on Education
- De-emphasis on Innovation
- Late Comer in Telecommunications Infrastructure Development
- Tax Accounting as Mixed Blessing

II. MARKET FOR CORPORATE OWNERS

- Traditional Family Controlled Enterprises
- Pressure for Technology Upgrade
- Venture Capital Investment as A Conduit
- Government Tax Concessions Geared to High-tech Development
- Engineers/Founders Seek Joint Venture Opportunity with Chaebols
- A Possible Paradigm for Other APEC Economies
- Risk-averse Financial and Capital Market Regulation

III. COMPETITION AND CORPORATE GOVERNANCE

- Suppression of Domestic Competition for Selected Sectors
- Permission of Global Competition for Export Promotion
- Cross-sectoral Linkage
- Competition as External Pressure for Improved Corporate Governance
- Offshore Listing: P/E Ratio Arbitrage and Branding
- Voting, Independent Directors, Accounting, Transparency

IV. CHAEBOL-ENGINEER ALLIANCE

- Engineers' Startup Plan constrained by Risk-averse Financial Regulation
- Tax Breaks Draw Chaebols to High-Tech Industries
- Venture Capital as A Conduit for Entrepreneurial Risk-taking
- Alliance Based on Comparative Advantages of Human and Financial Capital
- Simulating U.S.-Style Employee Stock Options
- Venture-backed Firms Having Improved Corporate Governance Practice

V. CORPORATE GOVERNANCE REFORM – CAPITAL STRUCTURE

- Rigidity of Capital Structure in Corporate and Securities Laws
- Chaebols Subsidizing Risk-Taking by Engineers/Founders
- Ineffective Corporate Registration Rules
- Infatuation with Par Value
- Developing Understanding of Equity-Linked Debts
- Developing Use of Contingent Capital — Options and Warrants
- Employees as Holders of De Facto Preferred Shares
- Offshore Listing to Bypass Rigid Corporate and Foreign Investment Regulation

VI. CORPORATE GOVERNANCE REFORM – CONTROLLING INSIDERS

- Venture Capital Investment as A Way to De-centralize Ownership
- Problematic Appointment of Corporate Representatives as Directors
- Emerging Recognition of Fiduciary Duty
- Debates over Continued Reliance on Criminal Prosecution
- Unfinished Debate of Independent Directors Replacing Supervisors
- De Facto Securities Class Actions through Piggyback Civil Actions
- Improved Regulation of Expropriating Deals (Related Party Transactions, etc.)

VII. CORPORATE GOVERNANCE – FACILITATING ADAPTATION

- Hostile Takeover Still Not A Likely Tool for Compelling Change
- Strategic Alliance and Friendly Buyouts More Likely in Short Term
- Desperate Need for M&A Rules (Triangular Mergers, Cash-outs, Splitups, etc.)
- Competitive Disadvantages of Corporate Law: No Stock Swap
- Corporate Reorganization Rules Still Underdeveloped
- Possible Catalyst: Financial Market Restructuring (Financial Holding Company)

VIII. CORPORATE GOVERNANCE – CAPACITY BUILDING

- Common-Law Foundation for Corporate Governance Regime
- Strong Markets to Enhance Legal Rules
- Form (Best Practice Rules, etc.) Not meaningful in Isolation
- Strong, Interested and Knowledgeable Judiciary Important
- Increased Foreign Portfolio Investment to Add Impetus for Reform
- Independent indigenous Portfolio Investors a Must
- Rewarding Risk Taking as A Way to Catch Up in Knowledge-based Economy

- Rapid Privatization of SOEs to Eliminate Government’s Conflicting Interest
- Arrest Co-determination Trend (Labor Directors) in Incipiency
- Vibrant Corporate Bar Crucial

APEC SYMPOSIUM ON EMERGING ENTERPRISES AND CORPORATE GOVERNANCE: NEW ECONOMY AND OLD RULES; CHINESE TAIPEI; 17 OCTOBER 2000

Comments by Mr Ken Waller, Group Economic Adviser, Asia, Commonwealth Bank of Australia.

"Governance in the Financial System"

I am honoured to be invited by the authorities in Chinese Taipei to speak to you.

The title of the Symposium recognises the importance of "new economy", knowledge-based economic activity. At the same time it proposes that this new activity ought to be governed by "old corporate governance rules".

I do not question the importance of good corporate governance. That, and good public governance, is vital to an enabling environment in which economies can grow and prosper

I wonder however, just how much of "old governance" concepts are all that relevant to "new economy" pressures.

Clearly, there are some time-honoured principles in good business practice and in the laws that govern the affairs of states.

But the reality is that "governance" is an evolving concept and which requires, particularly in the context of rules concerning international financial flows, new thinking and new governance arrangements if we are to better manage the impact of pressures that the "new economy" is creating.

I think it reasonable to view any concept of the new economy, in a broad, rather than a narrow way. We are not just thinking of small dot.com. activities, but rather we have to consider major significant forces that are shaping new economic relationships.

These forces are based on profound advances in electronic and communications systems technology, and which, when combined with economic liberalisation, are creating major new opportunities and challenges.

These are reflected in the integration of economies and in globalisation.

The challenges include those caused by massive and volatile capital flows and the attendant and often damaging impact on currency and financial stability - as seen in the financial and economic crises of 1997/98.

They are also reflected in protest movements against globalisation.

The Asian crisis highlighted a number of important lessons. Some of the most important being the weaknesses in ***public governance*** at government level in many affected economies – and I include developed and developing countries in this context.

And weaknesses in ***international public governance.*** The rules which govern the system of international architecture were clearly inadequate; largely because some of the rules that were in place, were not all that relevant to the rapid changes in financial transactions involving highly leveraged institutions and facilitated by "new economy" forces.

Similarly, there were serious weakness in the "governance" of many national and multinational private financial institutions.

If you subscribe, as I do, to a fairly simple rule which says that a bad borrowing decision is usually accompanied by a bad lending decision, then it is reasonable to argue that some international private financial institutions did stand up too well in the analysis which followed the Asian financial crisis.

So, I think it is a little misleading to accept a view that we ought to be adopting "old" rules of governance for the "new economy".

The reality is that the "new economy" is forcing a serious rethink of what governance is or ought to be at various levels of society; the individual person or company, the corporate, the national government and at supra-governmental level.

Some central and age-bound governance concepts remain totally valid, but we would be deluding ourselves if we did not recognise that we are all in a new game with new challenges.

We do have to revise and update "governance" concepts so that they are relevant to new economic forces.

I would like to look at "governance" at four levels I just mentioned.

First, governance as it applies to a modern finance group; a group which may provide financial backing to a start-up enterprise.

"Corporate governance" factors within the finance company will govern the relationships between the shareholders and the board of that firm, between the board and management, and between management and staff and with customers.

The intrinsic qualities reflected in corporate management of the finance company or group will be a key competitive determinant in that firm's position in the market place.

Those qualities will be reflected in:

- the value the firm creates for its shareholders;
- effective use of capital;
- risk assessment and capital pricing qualities; and
- understanding the SME's business and its strategies;

The benchmarks used for judging these qualities are under constant revision and the benchmarks by which firms are judged are global in nature.

New international standards are developing for accounting and auditing, and to attract and retain investor capital, the finance group must be rated highly with its global peer group in the delivery of services.

The tests of the group's quality are constant and unremitting and the group must be capable of meeting shareholder and investor expectations to-day, tomorrow and well into the future.

Deepening capital markets and globalisation, mean that investors think "global" and look to the many alternative opportunities in allocating their assets. This in turn means that finance groups have to look to new management concepts and to adopt innovative techniques to attract capital.

Inevitably these developments require the adoption of new concepts of governance by the firm.

The standards that are increasingly dictated by global forces, shape the quality of systems employed by the finance group and the attendant governance arrangements that are necessary to maintain and enhance the services provided by the financial institution.

Second, governance in the start up venture company itself.

"Governance" quality will be a primary factor in the start-up firm's capacity to attract capital from the market.

The start-up nature of the venture will equate with a higher risk factor than that of an established firm. The venture must therefore exhibit the prospect of higher than normal profit if it is to attract risk capital.

It must also be in an unambiguously growth sector with a strong commitment to maintaining a leading edge position - it must demonstrate that it has and can maintain a market advantage.

It must also demonstrate a sound management system and one with high standards of integrity in all business functions. These may include purchasing, processing, manufacturing and distribution systems and will certainly include the financial management function.

It is self evident that if the start-up business is a new economy, knowledge-based business, its capacity to attract, maintain and reward skilled people – the incentive system – will be a highly relevant component of its own system of governance. "Governance" arrangements will need to reflect changing attitudes to employment and to concepts of short-term contracts versus permanent employment.

A key factor is the strategic capacity of the start-up enterprise to analyse risk and to deal effectively with rapidly changing business conditions.

Third, governance at the level of the national government.

New companies are likely to form and succeed in a market driven, rules based environment, where public policy seeks to provide:

- a stable, low inflation growth environment;
- a firm legal framework, based on fair, impartial and expeditious judgment;
- a competitive environment which provides sound legal rules for entry and exit and which discourages monopoly behaviour;
- a skilled and innovative workforce underpinned by a high quality education system.

An open, diverse, competitive and efficient financial system will present the widest opportunity to start-up venture companies seeking access to capital.

National policies will determine the qualities inherent in a financial system. A mature and an efficient system would be expected to comprise well managed and prudentially sound banks and non-bank financial institutions; an efficient, primary and secondary capital market; an efficient debt issuance market of varying maturities, and a robust payments mechanism.

And as noted earlier, an efficient financial system is an essential and integral component of a market driven, rules based economy.

It is also highly important to achieving high levels of sustainable growth and job creation.

It is quite easy to see why this type of environment will be conducive to the growth of start up companies:

- the rules of business and the legal base is understood by the players;
- investors are encouraged to participate in the market because they can assess expected return against risk; and

- competition and diversity in financial services will broaden the range of sources of capital to the start-up company.

The “governance” arrangements applying to key parts of the financial system are under review in various international groups, such as the Basle Committee of Banking Supervision and the International Organisation of Securities Commissions.

New standards are evolving, particularly in relation to capital adequacy and risk management, and these will inevitably influence the benchmarks for banks and non-bank financial institutions in any national jurisdiction.

It is also worth noting that APEC member countries would benefit by the development of long-term debt markets and by new equity boards that are specifically aimed at equity raisings by start up ventures.

These latter issues are under discussion in various regional forums, including by APEC Finance Ministers.

Fourth, governance at the international level.

I would like to offer a few brief comments on international architecture and the governance systems which apply.

The financial crises of 1997 – in Asia, Russia and in Latin America – revealed some real flaws in the governance arrangements applying to international financial flows.

New governance arrangements are now under detailed consideration in a number of international forums.

However, while there has been much criticism of the phenomenon of capital flows, we need to be wary of adapting measures – some now under consideration - which may impede the flow of capital between markets.

Similarly, some proposals that are being advanced as a private sector contribution to crisis prevention, would, if adopted, tend to impede rather than encourage capital movements.

I am pleased to observe that these concerns are being acknowledged in APEC forums.

Where are the likely weaknesses in the APEC economies at the levels of governance just outlined?

As a generalisation, the weaknesses that occur over the quality of governance in the start-up company is likely to be less important than weaknesses at other levels of governance.

Many new companies are being created in APEC economies.

The drive and the energy displayed in new start-ups in new technology, intelligence-based companies is evident in a wide range of economies - US, China, Chinese Taipei, Hong Kong SAR, Australia and Singapore - to name a few.

As just noted, governance in the other areas discussed may well be an important reason why the pace of new start-ups may be slower in some economies.

In particular, in economies where financial system governance is weak - where prudential standards are less than adequate and where standards are not applied effectively - the prospect of systemic failure is higher and the investment environment much less conducive to support start up ventures.

Similarly, where governance is weak in major private or public financial institution, those institutions will tend to be less effective in supporting start up ventures.

The reasons are obvious enough; internal systems of credit risk management will tend to be less than adequate to meet the exacting demands of riskier loans associated with new venture start-ups.

Credit allocations will often be made on a non-commercial basis and the returns on capital employed will tend to be less than those achieved in a well managed group.

Management costs will tend to be higher than those in better run companies.

Serious problems affecting financial institutions were revealed in the Asian financial crisis; they included:

- under-capitalised banks and non-bank financial institutions;
- high levels of non-performing loans;
- weak credit assessment practices;
- excessive exposure to speculative projects;
- ownership structures which did not impart strong disciplines on boards and management.

There are linkages between governance issues at the level of the financial firm and at the public governance level, as the latter is reflected in the financial system itself.

Policies which inhibit competition, either by rules restricting entry or exit to the financial markets (including the entry of foreign equity in domestic finance groups) can place unnecessary restraints on the way in which the financial system can support start up ventures.

Rules which restrict diversity in investment can similarly impact unfavourably on the spread of risk by financial institutions and may deter investment by the community at large, rather than encourage it.

Similarly, badly designed tax policies or policies which limit the repatriation of profits may also work directly against a policy which may otherwise purport to encourage start up ventures.

It is pleasing to note that within APEC a range of initiatives are in place which seek to address the weaknesses just outlined.

However, it is also evident that significantly more adjustment will be necessary in some economies in the region.

Adjustments will involve considerable and sustained effort both in the public and private sectors.

Success will lead to governance arrangements that will make a major contribution to economic growth and prosperity. Those arrangements will certainly be instrumental in supporting start-up companies.

The conclusions to be drawn can be simply stated. Governance concepts must be constantly reviewed and they need to take account of and be responsive to new economic forces.

An effective start up venture policy will require a comprehensive and supportive environment at all major levels of governance to be sustainable over the long-term.

Generally, the policies will involve structural reforms.

I sincerely hope that this symposium will contribute to the development of governance arrangements that will strongly encourage the growth of start up venture companies.

I am most grateful to the Chinese Taipei authorities for providing the opportunity for me to talk on this important subject.

Thank you.

Asia-Pacific Economic Cooperation

Twelfth APEC Ministerial Meeting

Work Report for the Year of 2000: Building a Conducive Environment for Entrepreneurship, Start-up Companies and Venture Capital

(Chinese Taipei)

Bandar Seri Begawan, Brunei Darussalam
11-12 November 2000

**Work Report for the Year of 2000:
Building a Conducive Environment for Entrepreneurship,
Start-up Companies and Venture Capital**

A. APEC Ministers' Vision

In view of the significant role of SMEs in the APEC region, which was recognized by SME Ministers as the engine for economic growth in the knowledge-based economy, the APEC Ministers in their Eleventh Joint Statement welcomed Chinese Taipei's proposal on *"Economic Revitalization Through Start-up Companies and Venture Capital"* (99/AMM/021) and looked forward to further work in this area in the year of 2000. Such areas include, but not limited to, policy setting, educational reform, entrepreneurship cultivation, SME development, industrial innovation and corporate governance for economic revitalization.

The SME Ministers stressed in their Seventh Joint Statement that issues concerning SME financing were crucial for sustaining SME growth. A lack of funding was regarded as a major constraint for SMEs growth. Moreover, the great necessity for access to information about sources of funds and the importance of venture capital for financing start-up companies and information & communication technology (ICT) industries was also recognized. The role of private sector was emphasized in this respect. In view of the rapidly changing business environment as a result of economic globalization and ICT development, Ministers urged SMEs to embrace innovative and creative approaches to enhance efficiency and competitiveness.

Consequently, SME Ministers encouraged APEC member economies to deepen their cooperation, focusing on capacity building for SMEs, and support for new businesses so as to strengthen markets in the region. Furthermore, Ministers emphasized that governments had a role in creating a better environment for SMEs and start-up companies to access to capital markets. SME Ministers therefore affirmed in their joint statement that it was important to heed the capacity building needs of SMEs in member economies.

B. Implementation in 2000

In accordance with the APEC Ministers' Joint Statement, several APEC events to encourage start-up companies and venture capital in the APEC community were

organized in the year of 2000.

● APEC Start-up Companies and Venture Capital Survey

First of all, the "APEC Start-up Companies and Venture Capital Survey" was conducted for planning the work to be carried out in 2000. In response to this survey, almost all respondents agreed that the environment for start-up companies and venture capital needed to be further improved in the APEC region, and the top three issues that need to be addressed in priority included (1) a much easier initial funding source, (2) technological and managerial know-how, as well as (3) the generation of creative educational programs.

Concerning the concrete proposals, Chinese Taipei put forward several courses of action for member economies' assessment. The majority of APEC members showed that it was necessary for APEC to sponsor seminars to promote start-ups and venture capital. In this regard, two subjects that were favored by most member economies were: (1) Start-up Companies, Venture Capital and Corporate Governance; and (2) Securing Initial Equity Funding for Start-up Companies: Fostering the Birth of Small and Medium Sized Enterprises ("SMEs").

As to the question of regional visits to officials by venture capitalists, most member economies believed that it was desirable and the agencies in charge of SMEs were considered to be suitable for visit by such experts.

With regard to the necessity of APEC measures, the majority of respondents agreed that it was necessary to establish an APEC database for disseminating and exchanging information about start-up companies and venture capital.

● Economic Revitalization Through Start-up Companies and Venture Capital: Report on Activities for 2000

A work report, entitled "Economic Revitalization Through Start-up Companies and Venture Capital: Report on Activities for 2000" (057/SOM I), was submitted to the First Senior Officials' Meeting held in February 2000 in Brunei Darussalam, in which several APEC events were sketched out to be carried out in APEC 2000.

● **APEC Symposium on "Securing Initial Equity Funding for Start-up Companies: The Birth and Growth of SMEs in a Knowledge-based Economy**

In May 2000, the APEC Symposium on *"Securing Initial Equity Funding for Start-up Companies: The Birth and Growth of SMEs in a Knowledge-based Economy"* was successfully held in Chinese Taipei and grouped together 160 delegates in total from 16 member economies to share their knowledge, experiences as well as making policy recommendations. (The Agenda of the symposium is annexed hereto as Annex A.)

Dr. Mitsuru Taniuchi, Chair of the APEC Economic Committee, and Professor Nigel A. F. Haworth, Coordinator of the APEC HRD Working Group Capacity Building Network, also joined the symposium to speak and moderate during the sessions respectively. Furthermore, the APEC Secretariat was represented by its Program Director, Ms. Siti Nugraha Mauludiah.

This symposium was conducted by the following sessions respectively entitled "The Role of Government Funding for Start-up Companies and SMEs", "Venture Capital-Securing Initial Equity Funding for Start-up Companies and SMEs", "Investment Banking-Securing Subsequent Equity Funding for Start-up Companies and SMEs", "Developing a Healthy IPO Market" and "Case Study on Impact of Start-up Companies and SMEs on Sustainable Economic Development".

The participants in this symposium recognized the importance of SMEs in the knowledge-based economy. The topics widely covered various issues on the promotion of start-up companies and SMEs. With regard to the issue on encouraging the birth and growth of SMEs, discussions focused on the areas of securing initial equity funding (i.e., venture capital), subsequent equity funding (i.e., investment banking) and creating healthy IPO markets such as the flexible listing boards available in certain APEC member economies for high-growth companies. The role of government funding was also regarded as an important catalyst for the development of the venture capital industry.

Most participants also confirmed that the global supply chain in the knowledge-based economy would present abundant opportunities for start-up companies and SMEs in

the traditional industry as well as the high-tech sector. All the issues on culture and entrepreneurship were also addressed during the symposium in the context of the knowledge-based economy. The impact of start-up companies and SMEs on sustainable economic development was explored in the symposium both in the macro and micro economic perspectives. Moreover, the role of government was widely regarded as important in terms of fostering entrepreneurship and creating a conducive legal and institutional environment to secure equity funding for start-up companies and SMEs in various stages.

The advent of the knowledge-based economy was viewed to represent a paradigm shift toward the focus on the mechanism of encouraging entrepreneurship and innovation through start-up companies and SMEs. This is of particular significance in the process of economic revitalization in the APEC community as a whole, and APEC has been encouraged to play an important role in this area.

The necessity for close cooperation between governments and the private sectors to create a positive environment for SME development in the APEC community was expected by participants; it was particularly true for the start-up phase of SMEs and for the availability of appropriate funding for start-ups. In addition, APEC was also expected to make more contributions on information exchange and capacity building to enhance the birth and growth of the SMEs in a knowledge-based economy.

The outcome of the symposium was reported to the APEC SME Ministers, who acknowledged in their 7th Joint Ministerial Statement that the issues concerning SME financing were crucial for sustaining SME growth. (For more details of the proceedings for this symposium, please refer to the Concluding Remarks annexed hereto as Annex B.)

● APEC Symposium on "Emerging Enterprises and Corporate Governance: New Economy and Old Rules"

The APEC Symposium on *"Emerging Enterprises and Corporate Governance: New Economy and Old Rules"* was held in Chinese Taipei on October 16-17, 2000 to promote the establishment of a good corporate governance practice in the APEC community considering the global trend toward a knowledge-based economy and the

great necessity for creating a conducive environment within APEC to entertain and encourage innovation, entrepreneurship, start-up companies, venture capital and equity funding. This symposium also created a forum for policy makers and business representatives from the APEC community to contribute their expertise and experiences to exchange views on the promotion of corporate governance within the framework of the knowledge-based economy. (The Agenda of this symposium is annexed hereto as Annex C.)

The symposium brought together more than 156 delegates, including speakers and participants, from 17 APEC member economies. Dr. Mitsuru Taniuchi, Chair of the APEC Economic Committee, was also invited to speak at this symposium.

The agenda for this symposium was divided into four sessions. The first three sessions respectively entitled "Corporate Governance and Emerging Enterprises in the APEC Region", "Planting Corporate Governance Culture in Start-ups", and "Post-IPO Corporate Governance Practice for Emerging Companies". Subsequently, the last session was planned by the "Panel Discussions on Experiences and Policy Implications".

Insightful discussions were conducted during the symposium. It was widely agreed that the Asia-Pacific region needed good corporate governance to foster a desirable environment for emerging enterprises under the framework of a knowledge-based economy. Moreover, the establishment of a best practice for creating a conducive environment for entrepreneurship, start-up companies, and venture capital in APEC community was expected so as to facilitate the investment and trade activities within APEC.

The participants believed that this symposium would contribute to the development of guideline and criteria of corporate governance for emerging enterprises that would in turn strongly encourage the growth of start-up companies, venture capital and equity funding in the APEC community. (For more details of the proceedings for this symposium, please refer to the Synopsis annexed hereto as Annex D.)

C. Prospects for the future

In light of the global trend toward a knowledge-based economy, APEC, being a part of the global village, has to take initiatives to adapt to this trend. Through the "APEC Start-up Companies and Venture Capital Survey", member economies have showed the great necessity for creating a conducive environment within APEC to entertain and encourage innovation, entrepreneurship, start-up companies, venture capital and equity funding. Moreover, the Asian Crisis has resulted in the long-term implications on APEC economies that future growth would be hindered unless structural weaknesses revealed by the crisis are redressed.

Several APEC fora have been reaffirming the challenges of future growth, which require APEC to strengthen cooperation. The APEC Economic Committee identified such areas in strengthening markets, entrepreneurship and SME development, etc. The EC also reported to Ministers that the well-developed SME sector is the hotbed for new businesses.

Accordingly, APEC has to foster the establishment of best practice guidelines so as to encourage entrepreneurship, start-up companies and venture capital in a knowledge-based economy, accelerating the pace of economic revitalization in the aftermath of the financial crisis.