Title
Establishing a New Stock Market for Shareholder Value Oriented Firms in Korea

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Author
Choi, Stephen

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Establishing a New Stock Market for Shareholder Value Oriented Firms in Korea

Stephen Choi* and Kon Sik Kim**

I. Introduction

Regulators seeking to strengthen and promote Korea’s capital markets face several challenges in the upcoming century. Although trading volume and the number of listed companies on the Korea Stock Exchange (KSE) have grown rapidly over the past decade, the KOSPI index of total stock market value has in fact fallen. Individual investors inside Korea often choose not to place their money in the equity of listed companies, seeking instead to invest

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* Professor, UC Berkeley (Boalt Hall School of Law); Visiting Professor, Harvard Law School, 2002.
** Professor, Seoul National University School of Law. Thanks for helpful comments from Andrew Guzman, Un Kyung Park, and the participants of the Second Asia Corporate Governance Conference Program (Seoul, Korea 2002) sponsored by the Asian Institute of Corporate Governance (and Jack Coffee, our conference commentator).

1 SECURITIES MARKET TRENDS (As of the end of period)

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<tr>
<td>STOCKS</td>
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<td>NUMBER OF LISTED CO.</td>
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<td>866,923.5</td>
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<td>137,798.5</td>
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<td>TRADED VALUE*** (BIL. WON)</td>
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<td>843,571.8</td>
<td>2,183,071.5</td>
<td>2,142,715.7</td>
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* The Korea composite stock price index (4 JAN. 1980 = 100).
** During the period.
*** During the period; Figures in parentheses represent value traded on the stock exchange.
Source: Bank of Korea (http://www.bok.or.kr/index_e.html) (visited on March 6, 2002)
primarily in savings deposits. Good reasons may exist for the decision on the part of many Korean investors to avoid equity investments. Many of the largest Korean listed companies are in the control of large shareholders, often through membership in a Chaebol conglomerate. Despite an often minority and dwindling ownership stake, the Chairman and founding family of a Chaebol group typically maintain a firm control over all member firms through cross ownership or pyramidal devices. And private benefits of control are believed to be large in Korea. Not surprisingly, Korean companies often receive low valuations (and correspondingly

The KOSPI index as of March 1, 2002 exceeded 800 due to the recent stock market rally.

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2 As of 2000, stocks account for less than seven percent of the financial assets held by individuals, while deposits at banks and other financial institutions account for more than fifty percent. Bank of Korea, Financial Assets and Liabilities Outstanding (2000) (http://www.bok.or.kr/bokis/bokis/m_matrix_disp (last visited on March 6, 2002)

4 See Bernard Black, et al., Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness, 26 J. Corp. L. 537, 551 (2001) (noting that “[i]n 1995 the thirty largest chaebol represented 41% of total sales in the Korean domestic economy, 40% of value added, 44% of total fixed assets, and 18% of employment. The five largest chaebol – Hyundai, Daewoo, Samsung, LG (Lucky Goldstar) and SK (Sunkyoung) – represented 26% of total domestic sales, 27% of total value added, 26% of total fixed assets and 11% of total employment.”)

5 See Daehong T. Jaang, Kyung-soo Kim, Woo Tack Kim, Sangsoo Park, Cross Shareholding and Corporate Financial Policy: the Case of Korea (working paper on file with author, 2002) (available at http://biz.korea.ac.kr/~aicg/paper_2nd/Cross_shareholding_and_corporate_financial.pdf (providing evidence on cross share ownership among companies in Korean Chaebols and noting that “the founder of the group himself or one of his direct descendants in most cases . . . exerts a dominant control power primarily with [the] help of cross-held shares that do not require a supply of real capital.”).

6 Related party transactions are quite common and are often subject to the FTC’s scrutiny. Also, Chaebol firms sometimes invite criticism by issuing equity securities to the chairman’s children at below market prices. Jooyoung Kim & Joongi Kim, Shareholder Activism in Korea: A Review of How PSPD Has Used Legal Measures to Strengthen Korean Corporate Governance, 1 J. Korean L. 51 (2001). A recent paper shows that when a Chaebol firm acquires another firm the controlling shareholders rather than the firm itself benefit. Kee-Hong Bae, Jun-Koo Kang & Jin-Mo Kim (Working Paper, August 2001), Tunneling or Value Added? Evidence from Mergers by Korean Business Groups.

Anecdotal evidence exists of large private benefit controls within Chaebol firms. See Yoo Cheong-mo, Corporations Urged to Raise Governance, Transparency, Experiments, Korea Herald, May 29, 2002 (noting that “[i]n a controversial deal, LG Chemical sold 19.75 million shares in LG Petrochemical to the family of LG Group Chairman Koo Bon-Moo for 5,500 won per share prior to the firm’s listing in 1999 and bought back 6.32 million shares for 15,000 won apiece April 25 this year, bringing at least 60 billion won in capital gains to the owner family.”). Evidence exists in particular of the large amounts of private benefits of control appropriated by the now-in-hiding former CEO of the Daewoo Chaebol Kim Woo-Choong. See Yo Cheong-mo, Daewoo Founder Kim’s Concealed Assets Worth W140 Bil. Uncovered, Korea Herald, Nov. 9, 2001 (reporting that “Korea Deposit Insurance Corp. said that its inspectors have uncovered 140 billion won of Kim’s concealed assets thus far, confirming long-standing rumors of Kim’s massive cash embezzlements.”); Hwang Jang-Jin, Activists Demand Harvard Return Ex-Daewoo Chief’s Donation, Korea Herald, May 30, 2002 (describing the efforts of the People’s Solidarity for Participatory Democracy to get Harvard University to return $2.5 million of donations made by Daewoo founder Kim Woo-Choong out of Daewoo company funds while Kim’s son attended Harvard).
large discounts) relative to comparable non-Korean companies.\footnote{Korean firms are severely undervalued in terms of earnings and assets. According to Merrill Lynch data, the average P/E ratio of Korean firms is 10, while the figure for emerging market firms in general is 13. The P/B ratio and P/Cashflow ratio all show a comparable discount. Also, a survey report issued by IMD puts Korea 48th in terms of shareholder rights, behind Russia, Indonesia and Chech Republic. See also Yoo Cheong-mo, Chaebol Stocks Undervalued by Poor Governance, Korea Herald, Dec. 15, 2001 (reporting on a Zurich Scudder Investment analysis that “Samsung Electronics is estimated to be undervalued by 40 percent to 50 percent, while governance-related weaknesses are subjecting SK Telecom shares to a 22 percent shortfall.”).}

As a means of improving capital market liquidity (and in response to the Asian economic crisis during 1997), regulators in Korea moved to strengthen corporate governance protections for minority investors. An argument exists that such reforms in fact may increase the value of investments for minority investors. In a series of recent studies, La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV) provide evidence that strong formal legal protections for minority equity and debt investors as well a strong legal enforcement environment correlate with larger capital markets,\footnote{See Rafael La Porta, Florencio Lopez-De-Silanes, and Andrei Shleifer, Legal Determinants of External Finance, 52 J. Fin. 1131 (1997).} higher investor valuations,\footnote{See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, Investor Protection and Corporate Valuation (working paper 2000) (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=227583).} and common law origin countries.\footnote{See Rafael La Porta, Florencio Lopez-de-Silanes, Andri Shleifer, Robert W. Vishny, Law and Finance, 106 J. Pol. Econ. 1113, 1117 (1998).} A case therefore exists that “law matters,”\footnote{See John C. Coffee, Jr., Privatization and Corporate Governance: The Lessons from Securities Market Failure, 25 J. Corp. L. 1, 1 (1999) (coining the term “law matters”).} particularly for financial development.\footnote{See also Bernard S. Black, Hasung Jang, and Woochan Kim, Does Corporate Governance Matter?: Evidence from the Korean Market (working paper on file with author) (available at http://www.aicg.org) (providing evidence that a higher level of corporate governance protection for firms listed on the KSE results in a higher Tobin’s Q measure of valuation, among other valuation measures, for firms).} Moreover, countries with more developed financial markets tend to enjoy higher economic growth.\footnote{See Ross Levine, Law, Finance, and Economic Growth, 8 Journal of Financial Intermediation 8, 30-31 (1999) (reporting a positive and statistically significant relationship between financial intermediary development and growth in per capita GDP.).}

The observation that the law matters, however, is only a starting point. The more salient question is—if the law matters—how can we generate good law. While changing the
formal legal regime (by implementing extensive new accounting rules, mandating outside directors on the board of directors, and so on) may have some impact, empirical evidence raises cause for concern. Evidence exists, for example, that while many countries implemented formal legal prohibitions against insider trading during the 1980s and 1990s, few of such countries actually enforced these formal legal prohibitions.\(^\text{14}\) Laws obtained through “transplants” from another country are also ineffective, particularly where such laws are forced upon an unwilling country.\(^\text{15}\) A question exists therefore whether changing the formal laws alone is enough. Legality in countries depends not only on formal laws but also on both public and private institutions as well as background norms in support of the law.\(^\text{16}\) And the possible linkage between strong investor protections and the underlying legal origin of a country (common versus civil law) that LLSV identify reinforces this question. To the extent the effectiveness of a legal regime depends not only on formal laws but on legal origin, culture, institutions, and a host of other country specific factors, then mere surface changes in the legal regime may not affect large changes in the overall level of protections for minority investors. Indeed, the law itself may in fact matter less. Culture, for example, may play a larger role in how often controlling shareholders and managers expropriate value from minority investors.\(^\text{17}\)

Norms and institutions, of course, are not impervious to change. Commentators, for


example, have called for student exchanges and the establishment of U.S.-style business and law schools in other countries as a means of altering the background environment in which laws operate.\textsuperscript{18} Such methods however—even if effective—may take years to generate any noticeable effect.\textsuperscript{19} The challenge this paper addresses then is how to implement effective legal reform to protect investors within Korea leading to a stronger, more vibrant capital market in a shorter time frame.

The question of how to generate strong securities markets is particularly salient in Korea. Since the Asian economic crisis in 1997, the laws and regulations relating to corporate governance have been substantially improved in Korea.\textsuperscript{20} Although the reform efforts have generally enjoyed the public support, it was not so much the general public as international financial institutions, such as the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank), that provided the driving force.\textsuperscript{21} As the country's economy recovers from the immediate crisis, the influence of the IMF and the World Bank helps predict the cross-sectional variation in creditor rights better than a country’s openness to international trade, its language, its income per capita, or the origin or its legal system.”).\textsuperscript{20}

\textsuperscript{18} Black, for example, advises that: “Another important long-term step, if reputational intermediaries are weak or few in number, is to establish or strengthen business schools (for investment bankers and accountants) and law schools (for securities lawyers and regulators).” Black, supra note 16, at 848. Black, nevertheless, recognizes that the payoff will take “decades”. Id. See also Bernard Black, Reinier Kraakman, and Anna Tarassova, Russian Privatization and Corporate Governance: What Went Wrong?, 52 Stan. L. Rev. 1731, 1800 (2000) (suggesting that student exchanges from Russia into the United States would help raise the level of expertise within Russia on U.S.-style law and accounting).

\textsuperscript{19} Indeed, country-specific factors may induce path dependence in the types of reforms which may prove effective (if at all) in a particular country. See Lucian A. Bebchuk & Mark J. Roe, A Theory of Path Dependence in Corporate Ownership and Governance, 52 Stan. L. Rev. 127 (1999) (contending that path dependence will limit the amount of convergence across countries in corporate law regimes); Black, supra note 16 at 840 (“The cultural preconditions for strong or weak securities markets can also be self-reinforcing. In a strong market, good disclosure and limited self-dealing become self-reinforcing norms because they are how most businesspeople behave, regulators can aggressively pursue the few departures from the norm, and there is political support for the funding to maintain the enforcement that reinforces the cultural norm. In a weak market, weak disclosure and extensive self-dealing become self-reinforcing norms.”).

\textsuperscript{20} For example, outside directors and an audit committee are now required for large listed firms and minority shareholder rights have been substantially strengthened. For details, see Hwa-Jin Kim, Toward the “Best Practice” Model in a Globalizing Market: Recent Developments in Korean Corporate Governance, 5 Yearbook Lawn and Legal Practice in East Asia ?? (2002).

Bank has virtually disappeared, and evidence exists that the government's interest in undertaking further reforms now seems on the wane. Meanwhile, the voice of the business establishment denouncing the reform efforts is gaining in power, blocking or compromising serious reform proposals. It is thus not surprising that Korea recently has done little in advancing corporate governance reform.

Rather than pursue conventional (and we contend often ineffective) efforts at reform, we propose a different course. We believe that introducing more competition in how investor protections in fact are designed and implemented in Korea may prove a more effective route toward reform. Competition provides issuers with choice in regulatory protections. Once issuers are provided choice, they will select protections that maximize their own welfare. In many circumstances (such as when a company initially sells securities to the market) this will involve maximizing the value to investors to induce such investors to pay more for the securities. Regulators and private suppliers of investor protections (such as rating agencies and investment banks acting as gatekeepers) interested in expanding the scope of their authority as well as in generating fees for their services will then have an incentive to tailor investor protections toward what issuers and indirectly investors desire.

Outside of Korea, regulatory competition has proven effective at generating change. The United States, for example, adopted Rule 144A of the Securities Act, providing Qualified Institutional Buyers (QIBs) the ability to purchase unregistered securities on the secondary market under certain conditions, in large part due to the competitive pressure from foreign

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22 A good example of this environmental change is the government's failure to implement the proposals of the Ministry of Justice report on corporate governance prepared by a team of foreign experts led by Coudert Brothers. For more details on the Ministry of Justice report see Black et. al., supra note 4. See also Yoo Cheong-mo, Chaebol Call for an End to State Meddling in Corporate Governance, Korea Herald, Apr. 21. 2000 (detailing the efforts of the Chaebols to put pressure on the Korean government to stop reform efforts aimed at corporate governance).
securities markets. Significantly, the pressure for change from the market is ongoing and not subject to the possibility that the impetus for regulatory reform may diminish over time. Shifting toward a more competitive regulatory system may require the expenditure of scarce political capital; nevertheless, once the shift has occurred, a regulatory competitive system is self-supporting, providing strong incentives for regulatory innovation into the future.

Of course, the mere fact that competition is effective at generating change is not enough to favor a competitive system. Change may lead regulatory systems to a “race-to-the-bottom” as regimes compete with one another to cater to opportunistic managers. Once placed under competitive pressures, regulators may also ignore external effects to parties other than corporations as well as the benefits of market-wide standardization. While we do not think the dangers are overly great we are mindful of the risks. In addition, a shift toward a more competitive regulatory system may generate substantial opposition from large political and business groups that benefit from the present regulatory regime.

Our proposal in Korea therefore is to start small. We focus on the possibility of introducing more competition within Korea by giving firms greater choice within the existing regulatory regime. As an initial (and obtainable) goal we propose taking an approach similar to that pursued by the Brazilian Stock Exchange (Bovespa) to establish a new voluntary section for

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firms on the KSE satisfying global corporate governance standards. Another option would be to go the seemingly opposite direction and allow some firms to opt-out of any domestic regulation and instead to follow the regulatory regime of a foreign country (putting these firms in their own section of the stock market). Such an approach would allow firms the ability to choose for themselves—within limits—the level of investor protections they desire (through a listing on a foreign exchange). Firms already with large and entrenched controlling shareholders or managers and a dispersed pool of minority investors will probably not take advantage of the ability to opt into a higher level of corporate governance. Controlling shareholders will not voluntarily give up their private benefits of control unless doing so results in investment gains within the firm that outweigh the controlling shareholders’ loss of private benefits. Moreover, dispersed shareholders already receive some compensation for the expected expropriation of private benefits in the form of a discounted share price when they initially purchase their shares.26 Instead, our suggested reforms will assist primarily newer companies seeking to raise funds from the public capital markets for the first time. Also, even among more established firms, a small, yet growing, number of firms under professional management may be interested in moving into a more advanced section of the KSE. Indirectly, feedback effects through the creation of a new investor-protection environment (with accompanying norms and institutions) will impact the rest of Korea’s capital markets.

The paper will proceed as follows. Part II provides a brief discussion of the potential benefits from protecting minority investors and the empirical evidence of the efficacy of such protections. Part III surveys potential reform options and details our proposal to expand choice available to companies within the KSE. Part IV concludes.

26 The amount of the compensation of course depends on the level of information and rationality on the part of the shareholders. Where the market fails to value the level of expected expropriation on the part of
II. Protecting Minority Investors in Korea

The Korean Stock Exchange was founded in 1956.\textsuperscript{27} On a daily basis, the KSE handled 473 million shares of trading volume in 2001 (up from only 14 million shares of daily trading volume in 1991).\textsuperscript{28} Since 1997, the KSE trading system has been fully computerized.\textsuperscript{29} Despite the increase in trading volume and activity on the KSE, many Korea individual investors continue to avoid placing money into the Korean equity markets.\textsuperscript{30} One problem facing the KSE is how to increase the amount of funds investors are willing to place into the capital markets.

Regulatory protections for minority investors provide one solution. When protected from at least some risks, minority investors may gain confidence in the market, leading them to put more funds into equity investments. This Part first (A) discusses the theoretical need to use regulatory means to protect minority investors. The Part then (B) canvasses aspects of Korea’s regulatory regime, focusing in particular on the ability within the current regime for controlling shareholders, uninformed or unsophisticated minority investors may suffer a loss.

\begin{table}[h]
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\begin{tabular}{|c|c|c|c|c|}
\hline
\textbf{Year} & \textbf{Financial Assets} & \textbf{Financial Liability} & \textbf{Equity Holdings} & \textbf{Equity/FA (\%)} \\
\hline
1975 & 5,568 & 1,387 & 958 & 17.2 \\
1980 & 21,200 & 6,344 & 3,590 & 16.9 \\
1985 & 62,885 & 27,014 & 7,581 & 12.1 \\
1990 & 195,584 & 89,383 & 22,235 & 11.4 \\
1995 & 466,891 & 214,645 & 33,426 & 7.2 \\
1996 & 535,501 & 253,662 & 34,799 & 6.5 \\
1997 & 616,795 & 300,125 & 39,723 & 6.4 \\
1998 & 672,000 & 269,915 & 46,367 & 6.9 \\
1999 & 729,732 & 292,974 & 53,211 & 7.3 \\
2000 & 799,504 & 329,654 & 55,379 & 6.9 \\
1Q of 2001 & 834,644 & 350,429 & 56,299 & 6.7 \\
\hline
\end{tabular}
\caption{Korean Individuals’ Financial Assets and Liabilities}
\end{table}

\textsuperscript{25} See KSE Fact Book 2000 (viewed at \url{http://www.kse.or.kr/en_index.html}).
\textsuperscript{28} Data obtained from \url{http://www.kse.or.kr} (visited on February 15, 2002).
\textsuperscript{29} See KSE Fact Book 2000 (viewed at \url{http://www.kse.or.kr/en_index.html}).
\textsuperscript{30} The ratio of equity holdings as against financial assets has been steadily on the decline for the last two decades, from 17.2 percent as of 1975 to 6.9 as of 2000.
(source: Bank of Korea)
shareholders and managers to profit at the expense of minority shareholders.

A. The Theoretical Need for Investor Protections

Securities investments pose a significant asymmetrical information problem for investors. In particular, managers of a firm (and controlling shareholders) enjoy an informational advantage over dispersed public investors. Information on a firm’s confidential projects, cash flows, capital expenditures, and similar items are often known (at least for a time) solely by a firm’s managers and controlling shareholder (if any). Managers and controlling shareholders with an informational advantage may attempt to sell overvalued securities to the market or engage in insider trading. Dispersed shareholders face a related problem: managers and controlling shareholders may engage in opportunistic behavior, diverting corporate resources to their own personal benefit at the expense of dispersed shareholders. Private benefit expropriation, of course, may take place even when dispersed shareholders have full information on such activities. Nevertheless, the ability to expropriate value in secrecy—at least where the law formally prohibits such expropriation—increases the ability of managers and controlling shareholders to engage in such theft.  

Investors faced with the prospect of losing money either when they initially purchase shares (due to their lack of full information on the value of a company) or over time (due to managerial opportunism) may of course adjust their behavior. In particular, investors may choose either to exit the capital markets, decreasing liquidity, or to demand a discount for the securities they do purchase as compensation for the risks they face. Where investors are rational and informed on the magnitude of expropriation risk they face, they will discount (at
least on average) the securities price accurately to take into account risks. The initial entrepreneurs of a corporation seeking to take a firm public for the first time, therefore, pay the cost of this discount. Where higher value companies are unable to distinguish themselves from lower value companies and investors therefore apply the same discount, a lemon’s problem then arises. Higher value companies may exit the capital markets, exacerbating the discount investors require of the remaining lower value companies. Ultimately, companies with higher valued investment projects will then find it more difficult to raise capital to initiate such projects, resulting in fewer valuable projects receiving funds.

A response is possible to this lemon’s problem scenario. Entrepreneurs that suffer an increased discount due to the risks facing uninformed investors in the market have an incentive at the time they sell their securities to implement contractual protections. A higher level of investor protections results in investors requiring a reduced discount and thereby providing greater offering proceeds for entrepreneurs.

Despite the possibility of a contractual response to the problems of informational asymmetry and managerial opportunism, regulations may help alleviate the problem of asymmetric information and opportunism for a number of reasons. Private contract, for

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31 For a discussion of the role of mandatory disclosure in controlling agency problems within a firm see Paul G. Mahoney, Mandatory Disclosure as a Solution to Agency Problems, 62 U. Chi. L. Rev. 1047 (1995).
34 In Korea, the initial entrepreneurs still do not care very much about this discount because they invariably try to keep a control block and expect to maximize the private benefit of control. The investors want them to keep at least a substantial amount of shares to align their interest with the corporation. For the controlling shareholders of a startup company going public through the KOSDAQ, a two-year lock-up period applies. KOSDAQ Registration Regulation Art. 18(1)(i). So the lemon problem does not yet actually matter in Korea.
example, can only protect investors so much. Economies of scale may exist in detecting violations of disclosure provisions or opportunistic acts of self-dealing. Not all investors moreover are sophisticated. And unsophisticated investors may fail to discount properly for all the informational and opportunism risks they face. Benefits may also exist from standardization (in disclosure for example) that individual firms may ignore in their decision on how many investor protections to provide through contract. Positive externality benefits may also exist from disclosures that benefit external third parties not connected with a particular firm. When one firm discloses information on its production, for example, the disclosures provide benefits for competing firms not internalized by the disclosing firm.

Weighed against the positive benefits of regulation, however, are the possible negative consequences from relying too heavily on mandatory regulation. Once regulations become mandatory, the possibility exists that the very interests that are being regulated may capture regulators themselves. Moreover, regulators may have an incentive to maximize the size and importance of their own agency at the expense of social welfare. More perniciously, regulators—to the extent insulated from market pressures—have few incentives to innovate and develop regulations designed to meet the needs of an ever-changing marketplace. At the very least, without the discipline of the market, regulators may make mistakes and not necessarily generate regulations designed to maximize social welfare.

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37 See, e.g., Gary S. Becker, A Theory of Competition Among Pressure Groups for Political Influence, 98 Q.J. Econ. 371 (1983); George J. Stigler, The Theory of Economic Regulation, 2 Bell J. Econ. & Mgmt. Sci. 3 (1971). In the securities law context, the securities bar and underwriters have influenced what courts and the SEC have required for due diligence under Section 11 of the Securities Act. See Kraakman, supra note 5, at 83 (“Over the years, the securities bar and the underwriting community have honed the chief Section 11 investigation—the underwriter’s due diligence investigation—into model verification procedures.”). See also Jonathan R. Macey, Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty, 15 Cardozo L. Rev. 909 (1994).
38 See William A. Niskanen, Jr., Bureaucracy and Representative Government 114 (1971).
B. Evidence from Korea

In recent years, scholars have produced a number of cross-country empirical studies assessing the value of legal regimes that provide strong protections for minority investors. Most prominent in these studies is the work of LLSV across a series of articles, demonstrating a strong correlation between common law origin countries and countries with both high levels of investor protections and financial development. LLSV develop an “antidirector rights” score for each country as a measure of the level of minority shareholder legal protections (ranging from 0 to 6). Among other things, LLSV report that the mean antidirector rights score for common law origin countries is 4.00 while the mean for German civil-law origin countries is only 2.33. Korea, in particular, received a score of only 2.00 (based on the presence of a one-share one vote policy and a mechanism for oppressed shareholders to vindicate their rights). On the other hand, Korea performs relatively well under LLSV’s measure of creditor rights, receiving a score only insignificantly lower than the mean for common law-origin countries. Significantly, LLSV’s antidirector rights score focuses on odd aspects of corporate law (including for example cumulative voting which few large public corporations employ at

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39 See Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, Robert W. Vishny, Law and Finance, 106 J. Pol. Econ. 1113, 1127 (1998). The antidirector rights score is based on: (1) the ability to mail in a proxy vote; (2) the lack of a requirement that shares must be deposited prior to proxy voting; (3) the availability of cumulative voting; (4) the presence of “legal mechanisms against perceived oppression by directors” against minority shareholders; (5) the “preemptive right to buy new issues of stock”; (6) whether “the percentage of share capital needed to call an extraordinary shareholders meeting” is at or below 10% (represent the world median). See id. at 1127 – 28.
47 See id. at 1131.
48 Id.
49 Id. at 1136-37.
least in the U.S.) and ignore other aspects of the law more salient to the protection of investors (such as antitakeover related legal provisions).

LLSV then connect the legal origin and the antidirector rights score of a country with various measures of financial development. LLSV first examine the concentration of ownership for companies located in countries with different legal origins.⁵⁰ They report that companies from French civil law countries (but not German or Scandinavian civil law countries) generally have a higher concentration of ownership compared with common law origin countries. LLSV provide evidence that for the sample of the 20 largest publicly held corporations in Korea, 55 percent of the firms are widely held (compared with 100 percent of similar firms in Canada and 80 percent in the United States).⁵¹ For a sample of 19 firms with a stock market capitalization of at least $500 million, LLSV report that widely held firms account for only 30 percent of the Korean company sample (compared with 60 percent of similar firms in the U.K. and 90 percent in the U.S.).⁵²

Focusing on the availability of external financing, LLSV report that common law countries score have larger external capital markets compared with the civil law countries (and in particular French civil law countries).⁵³ LLSV similarly relate that countries with higher levels of antidirector rights are correlated with higher levels of external equity financing.⁵⁴ Korea follows the pattern for civil law countries. The ratio of external stock market capitalization to GNP (adjusted to take into account the fraction of shares in the hands of outside investors) in

⁵¹ See id. at 492.
⁵² See id. at 494.
⁵⁴ See id. at 1139. LLSV also write that “[b]etter law enforcement, as measure by rule of law, is associated with more domestic firms and IPOs per capita, as well as a greater ratio of private sector debt to GNP.” Id.
Korea is 0.44 compared with a mean of 0.60 for English common law origin countries (and a mean of 0.46 for German civil law origin countries).\textsuperscript{55} LLSV finally provide evidence that companies in countries with a civil law origin and a lower antidirector rights score have a lower mean Tobin’s q measure of valuation. Korean companies in the LLSV study receive a mean Tobin’s q measure of 1.0725 compare with the common-law origin country mean of 1.3724 (and the civil law origin mean of 1.2022).\textsuperscript{56}

Compared with other countries (and in particular common law origin countries), the LLSV evidence therefore lends some support for the view that Korea’s relatively weak investor protections correlate with more concentrated ownership, a smaller external financing market, and reduced stock market valuations. Related studies corroborate LLSV’s findings for Korea. Tatiana Nenova provides a broad cross-country examination using the premium for control as a proxy for private benefits.\textsuperscript{57} Nenova constructs a model for the value of control as a share of total firm value (which she terms the “vote value”). She reports that the (unadjusted) premium within Korea is equal to 28.94% (compared with a mean vote value of 0.5% for Scandinavian civil law countries and 4.5% for common law countries). Nenova then estimates OLS regressions with the vote value as the dependent variable and uses country dummies and a series of controls for differences in dividend policies and secondary market liquidity for the dual class stocks among other explanatory variables. Interpreting the coefficients on the dummy variables as the average vote values (by country), Nenova reports that Korea has a mean vote value ranging from 30.9% to 33.7% of firm value. Scandinavian civil law origin countries and the

\textsuperscript{55} See id. at 1138. On the other hand, Korea’s private debt market capitalization (defined to equal the sum of bank debt of the private sector and outstanding non-financial bonds) as a fraction of GNP is equal to 0.74 (compared with a mean ratio of 0.68 for English common law origin countries). See id.

\textsuperscript{56} See id.

U.S. on the other hand have the lowest mean vote values (at near 1%).

The results from the LLSV and related studies, of course, may be disputed. One initial criticism is that the various indices they use to proxy for the level of minority investor protection are flawed. LLSV’s direct measure of the level of formal legal protections for minority equity investors, for example, turns in part on the presence (or absence) of the right to mail in a proxy vote, the availability of (optional) cumulative voting, and the presence of preemptive rights to purchase new issues for pre-existing shareholders. Significantly, LLSV ignore the presence of antitakeover laws or the permissibility of the use of private antitakeover techniques (including poison pills). \(^{58}\) It is also unclear how many large publicly-held companies actually adopt cumulative voting policies when optional.

Focusing more directly on the legal environment within Korea, however, provides corroborative evidence that the Korean investor protection regime indeed is lagging behind other countries (including most notably the United States). Prior to the 1997 Asian economic crisis, Korean corporate governance regime differed from the United States along a number of dimensions. \(^{59}\) First, the ownership structure in Korea was (and still is) markedly different. For most large business firms, a control block was typically in the hands of the founding family, which dominated the internal decision making process. With no independent directors, the board of directors of Korean firms often acted as a mere formality. While Korean law provided for a statutory auditor expected to restrain the misconduct of management, such auditors in practice were largely ineffective in most firms. Second, fiduciary duty rules in Korea were

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58 Commentators, as well, have questioned the importance of the specific corporate law provisions on which LLSV base their antidirector rights score. See John C. Coffee, Jr., The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control, 111 Yale L. J. 1, 4 n.6 (2001). (“By no means is it here implied that [antidirector] rights are unimportant, but they seem to supply only partial and sometimes easily outflanked safeguards, which have little to do with the protection of control and the entitlement to a control premium.”).
neither well established nor well utilized due to barriers to derivative suits. Disgruntled shareholders could file a derivative action against the wrongdoing management only if they owned at least five percent of the shares. The five percent threshold requirements, moreover, is applicable to other shareholder rights. Coupled with a lack of class action suits in Korea, the large threshold ownership requirement to bring a derivative action severely curtailed the ability of shareholders to enforce their rights against management. Third, the market for corporate control was largely absent in the Korean marketplace, leaving controlling shareholders largely free from market pressures.

While the corporate governance regime in Korea had come under some pressure for reform prior to 1997, it was the 1997 economic crisis that dramatically changed the existing corporate governance environment. A consequence of the crisis was a sudden rise of foreign investors. Today, more than 30 percent of the shares of the listed firms are in the hands of sophisticated and demanding foreign investors, who tend to concentrate on a small number of blue chip companies. Also, domestic investors, both individual and institutional, have become far more conscious of the concept of shareholder value. True, the founding family of the Chaebol companies still enjoy effective control over the whole group through complicated cross-ownership and pyramiding schemes. Nevertheless, controlling shareholders are now much more subject to pressures from other shareholders.

What is most striking of the post-1997 reforms are a series of statutory reforms to strengthen shareholder rights. The reforms were largely due to pressure from the IMF and the World Bank. We point out some of the most conspicuous changes. First, outside directors...
are required for listed firms, up to 50 percent of the board in firms with assets over 2 trillion Won. For such large listed firms, an audit committee is required instead of a nominal statutory auditor. The burdensome threshold share ownership requirements for those seeking to bring a derivative suit (or to exercise other shareholder-related rights) have been substantially moderated. For example, the shareholding required for derivative suits is now down to one percent, and 0.01 percent for firms listed on KSE or KOSDAQ. Board approval and public disclosure are required for certain related party transactions involving large listed firms. Intra-group guarantees are now prohibited and exiting guarantees have been eliminated for certain large business groups. Reform has been undertaken in accounting and disclosure as well. Accounting standards were revised to bring them into substantial compliance with International Accounting Standards. Large Chaebol groups are required to prepare “combined” financial statements covering all the member companies in the group. Listed firms are required to file quarterly reports in addition to annual and biannual reports.

Despite the amount of formal legal change post-1997, substantial doubt exists whether the reforms will in fact result in a major increase in the level of protections for minority investors in Korea. From a financial performance point of view, the reforms have not done much to


61 Securities Transaction Act, Art. 191-13, Sec. 1.
63 Fair Trade Act, Art. 10-2.
64 Outside Audit Act, Art. 1-2.
65 Securities Transaction Act, Art. 186-3.
66 See Yoo Cheong-Mo, Poll Says Conglomerates’ Boards Swayed by Owners, Korea Herald, Jan. 16, 2002 (noting that “[a]ccording to a poll of 171 fund managers in Korea by the Seoul-based Hangil Research, 92.4 percent said that the chaebol’s board members are incapable of making independent decisions under the influence of the largest shareholders or top executives.”). On the other hand, evidence does exist that at least some Korean Chaebol companies have opened up their board of directors to more minority shareholder representatives. See Yoo Cheong-Mo, Corporations Urged to Raise Governance, Transparency, Experiments, Korea Herald, May 29, 2002 (reporting that “Daewoo Electronics and Seoul Mobile Telecom are now allowing their minority shareholders to appoint their favorites to the boards, while SK Telecom, Dacom and Hyundai Heavy Industries reflect the opinions of minority shareholder activists in selecting outside directors.”).
shore up the confidence on the part of the international investment community. Moreover, evidence exists that political forces (primarily from the Chaebols) are working to undo the reforms.\textsuperscript{67} Some of the existing rules restraining the Chaebol firms from further expansion have been already revised to accommodate the persistent demand from the Chaebol firms. For example, the existing limitation on the shareholdings of a firm belonging to a top-30 Chaebol under the Fair Trade Law has been significantly mitigated after heated debate.\textsuperscript{68} Given the rapid decline of willpower in the current government and the heightened voice of the united business community, it now seems that a further statutory change strengthening shareholder rights is not likely, at least for an immediate future.

III. Reform Options for Korea

With unlimited political resolve, a country interested in reforming its corporate governance system (defined broadly to include not only formal laws but institutions and norms) enjoys the luxury of being able to make several attempts at legal reform. A country may experiment with different types of regulatory protections. Moreover, the country may attempt to implement reforms incrementally. Political resolve, unfortunately, often is not unlimited. As discussed above, business interests have already begun undermining efforts toward reforms within Korea. As we move away from the Asian economic crisis of 1997, the impetus for reform will most likely drop away even further. Given the reality that only limited political capital may exist for reform, we pose the question of what types of reform may prove efficacious.

\textsuperscript{67} See supra note 22 (reporting on Chaebol resistance to corporate governance reforms in Korea).

\textsuperscript{68} Those opponents of the recent reforms come up with diverse grounds, ranging from risks involved in an excessive pursuit of the Anglo-American model to paralysis of the board due to activist outside directors. Not all of them are groundless. For example, a pillar of the corporate law reform is to require a large listed firm to fill at least 50% of its board with outside directors. The business community did and does strongly oppose to the idea, pointing out that neither the US nor the UK imposes such a requirement by law. They argue that such an organizational
over the long term in Korea.

Most commentators take a traditional approach toward reform in Korea, advocating top-down changes in corporate governance regulations applying to all firms. As we discuss in Section A, however, we remain skeptical of this approach within Korea. Going to the opposite extreme, one could imagine simply allowing the market to determine the level of investor protections, possibly through private contract. While we discuss this possibility in Section B, we remain cautious of such a radical change within Korea’s political and economic framework. Instead, Section C presents our modest proposal to take initial steps toward encouraging choice in regulatory protections – in particular the choice for strong protection of minority investors. As we discuss, not all companies will opt for stronger protections. Nevertheless, compared with the present regime, such a choice driven system provides the possibility at least for newer companies and a limited number of established firms with professional management of obtaining stronger investor protections. A choice-based regime also avoids the potential political backlash from entrenched business interests that derive rents from the expropriation of private benefits allowable under the current Korean corporate governance regime.

A. Top-Down Government Regulation

In attempting top-down corporate governance reforms, Korea is not alone. Many countries over the 1990s instituted reforms affecting governance within firms. Law professors from within the United States played an active role in propagating such reforms in countries

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decision should be best left to the private initiative of firms. They even go on to cite some research showing that the proportion of outside directors on the board does not correlate with business performance.

69 See Black et al., supra note 4, 560-608 (proposing a number of reforms to Korea’s Commercial Code focusing on strengthening the role of the board of directors, the ability of shareholders to approve certain transactions, among other measures).
including Russia, Mongolia, and others.\textsuperscript{70}

Despite the success of the United States capital markets (and economy) and the belief held by many that the U.S. system of strong investor protections is at least partially responsible for such success, several questions exist as to whether importing U.S.-style laws will provide similar results in other countries. As other commentators have recognized, for example, formal legal rules represent only a part (and perhaps not even the more important part) of the overall investor protect regime.\textsuperscript{71} Without effective public institutions (including an unbiased judiciary and regulatory enforcement officials) and private institutions (including reputational intermediaries able to protect the interests of unsophisticated investors in the market), formal legal rules may offer little real protection for investors.\textsuperscript{72} Likewise, commentators have pointed to the importance of developing a norm of compliance toward strong investor protections and more generally toward the importance of having a non-corrupt business environment governed by the rule of law.\textsuperscript{73}

Empirical evidence exists supporting the view that mere formal changes in the law often prove ineffective in transforming practices within a country.\textsuperscript{74} In large part due to efforts on the part of the SEC, for example, many countries adopted formal prohibitions against insider trading

\textsuperscript{70} Bernard Black of the Stanford Law School, for example, indicates that he worked on corporate governance reforms in Armenia, Indonesia, Mongolia, Russia, South Korea, Ukraine, and Vietnam. See Black, supra note 16, at 790 n.10.

\textsuperscript{71} See Black, supra note 16.

\textsuperscript{72} For a list of laws and institutions (arguably) important for the development of strong securities markets see Black, supra note 16. In an earlier work with Reinier Kraakman, Black proposes implementing more procedural protections (including, for example, shareholder approval of related transactions) through simple and bright-line rules for countries that lack a strong institutional framework to protect investors. See Bernard Black and Reinier Kraakman, A Self-Reinforcing Model of Corporate Law, 109 Harv. L. Rev. 1911, 1913-19 (1996). Such an approach minimizes the need to turn to official enforcement. See id.

\textsuperscript{73} LLSV, for example, provide evidence that common law countries have higher levels of enforcement and higher accounting standards compared with countries from a German or French civil law tradition. See LLSV, supra note 10, at 1141-45.

\textsuperscript{74} See also Black, supra note 16, at 816-17 (“The most basic institutions--including culture and honest, competent courts, regulators, and prosecutors--are the hardest to transplant.”).
in the 1980s and 1990s.\textsuperscript{75} Despite the presence of a formal ban against insider trading, however, few countries in fact have ever engaged in enforcement of this ban. Bhattacharya and Daouk, for example, report that prior to 1990, while 34 countries with stock exchanges prohibited insider trading, only 9 of them ever engaged in an enforcement action.\textsuperscript{76} At the end of 1998, 103 countries with stock exchanges prohibited insider trading and enforcement had taken place (at least once) in only 38 countries.\textsuperscript{77} Bhattacharya and Daouk also provide evidence that “the establishment of insider trading laws…is not associated with a reduction in the cost of equity. It is the difficult part—the enforcement of insider trading laws—that is associated with a reduction in the cost of equity in a country.”

Evidence also exists casting doubt on the efficacy of transplanting laws from one nation to another more generally. Pistor, Raiser, and Gelfer (PRG) examine a sample of transition economies, including Russia and primarily Eastern European countries, from 1990 to 1998.\textsuperscript{78} They report that from 1992 to 1998, various measures for the level of formal minority shareholder protection that they employ increased significantly from below the world average to above the average, primarily due to legal regime transplants.\textsuperscript{79} In comparison to the increase in formal legal protections, PRG also report that measures for the legality environment (including the rule and effectiveness of law and the ability of the legal system to protect private property rights and enforce contracts) of the transition economies do not increase significantly over the

\textsuperscript{75} See Harvey L. Pitt & David B. Hardison, Games Without Frontiers: Trends in the International Response to Insider Trading, 55 Law & Contemp. Probs. 199, 204-06 (1992) (discussing how Switzerland and Japan both adopted insider trading prohibitions under pressure from the United States).


\textsuperscript{77} Bhattacharya and Daouk identify countries with a stock exchange through internet searches. They then determine the presence of insider trading laws and whether enforcement has ever taken place through inquiries made both to the stock exchanges and to government.


\textsuperscript{79} PRG also construct a number of measures for creditor rights and find a similar increase in the level of formal legal protections.
same time period. PRG then provide evidence that while the legality environment is significantly correlated with a larger capital market (as measured by the ratio of stock market capitalization to GDP), variables related to the level of formal legal protections are only insignificantly related.

On a similar note, Berkowitz, Pistor, and Richard (BPR) report evidence that the path through which a country obtains its laws is important in determining the effectiveness of such laws. Using LLSV’s sample of 49 countries, BPR divide the countries into non-transplant countries (including countries that received their law through a transplant but followed an idiosyncratic development such as the United States) and transplant countries. BPR then provide evidence that indirect (through another transplant country) and unreceptive transplants result in a lower level of legality within the transplant country.

Korea’s experience fits well with this proposition. For example, fiduciary rules in the Korean Commercial Code, although not as comprehensive as the U.S. counterparts, were first adopted forty years ago in 1962. Nonetheless, until recently such rules have been only rarely enforced (due for among other reasons the 5% share ownership requirement to initiate a derivative suit). The operation of the board of directors in Korea serves as another example. Before the economic crisis, the board was a mere formality except in a small number of joint venture firms or government-owned enterprises. Directors were widely regarded as executives in the corporate hierarchy and not as members of an organ in charge of monitoring corporate

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80 See id.
81 PRG, nevertheless, report that their variable for a country’s stock market integrity (“measuring the quality of securities markets regulations”) has “marginal significance”.
decision making. Large companies, including for example Samsung Electronics, used to have up to sixty directors. And board meetings for the large companies often took place only on the books.

Of course, new legal rules often can have an impact on the underlying norms and institutions within a country. Within the United States, the passage of the federal securities laws during the 1930s both created the SEC and dramatically changed how companies offer securities and provide information to the marketplace. Significantly in the United States, however, the passage of the federal securities laws closely followed the stock market crash of 1929 and occurred while the public held a widespread belief that fraud and market manipulation lead to the crash. Stuart Banner, for example, has put forth the argument that significant legal changes often occur following major scandals.84

Despite the effectiveness of some scandal-driven law reform, two problems exist with relying on scandals to lead to reform. First, lawmakers in the wake of a scandal may overreact in implementing new far-reaching regulatory reform. Once reforms are in place, moreover, it may take decades to remove the legal changes. For example, the United States only recently removed barriers under Glass-Steagell keeping the businesses of commercial banks and securities firms separate.85 Second, when scandals are absent, the political capital for reform may diminish rapidly. Relying solely on lawmakers to generate new investor protections may therefore (depending on the immediate presence of a scandal) result in either too strident new regulations or too few changes to the regulatory regime.

The Korean experience with corporate governance reform fits into the pattern of scandal

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driven reform. After the Asian economic crisis of 1997, numerous corporate governance reforms took place. Now, several years after the reforms, the prospects of future reform efforts appear dim at best. Rather than wait for another scandal, regulators instead may wish to consider reforms to the process of how regulations are created to provide an ongoing and persistent level of impetus for reforms that benefit investors.

B. Private Contract

Where regulation fails to provide necessary investor protections, market participants may turn to substitute mechanisms of protecting the interests of minority investors. The market, of course, will not choose to adopt all forms of protections. Some protections, for example, are simply not cost effective. It may be the case that forcing a full-blown audit of all of a corporation’s business on a daily basis may deter hidden forms of self-dealing and fraud—but the costs of conducting such a daily audit may far outweigh the expected benefits from doing so. But where protections are in fact cost effective, participants in the market will have strong incentives to adopt such protections. When investors are protected, they will pay more for securities up front, raising the proceeds possible from an offering to initial promoters of a company.86

What are the possible substitute mechanisms available in Korea? Companies may use contractual means to protect investors. A firm, for example, may adopt provisions in its articles of incorporation. Provisions requiring a majority of outside directors on the board of directors or the approval of outside directors for self-dealing transactions involving controlling

86 See Jensen and Meckling, supra note 35, at 305-07.
88 At least one listed firm has a provision in the articles of incorporation requiring the approval of outside directors for self-dealing transactions of significant size.
shareholders are possibilities. Nevertheless, some residual uncertainty exists as to what extent Korea’s Commercial Code in fact gives firms the ability to bind themselves through the corporate charter.

Even without resorting to private contract, firms seeking to protect minority investors may attempt to associate with market-based reputational intermediaries. Investors, of course, may not have the ability to distinguish among different intermediaries, allowing lower level intermediaries to free ride off the reputation of higher quality intermediaries. Free riding, in turn, may lead higher quality intermediaries to reduce their own investment in quality. On the other hand, many high quality intermediaries are well known to Korean investors. It is unclear, for example, the extent to which investors will fail to distinguish between the Goldman Sachs and Morgan Stanleys of the market and lesser known firms.

Firms may also choose to engage in voluntary disclosures to benefit their investors. In response to the possibility that upcoming earnings were distributed widely among employees, Cisco Systems, for example, made the decision to accelerate disclosure of the earnings more broadly to the entire market. Empirical studies provide evidence that companies that list on securities exchanges in more than one country tend to disclose a significant amount of information voluntarily (particularly for firms from Continental Europe).

Private contract, nevertheless, has its limits. Private actors may ignore external impacts from their decisions on other parties not related through contract to the actors. Firms choosing the level of information to disclose to the market, for example, may ignore the positive benefit

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88 Although this issue is not well settled, it is a majority scholarly view that most provisions in the Commercial Code are mandatory in nature. So a clause in the articles of incorporation changing the effect of a Code provision may be held invalid by the court.
89 See Black, supra note 16, at 787-88.
from such disclosures to third parties that value more accurate securities prices.  

Dispersed shareholders are at risk that managers may engage in a “mid-stream” shift, changing the level of investor protections well after investors have put money into a firm.  

The government may also enjoy a comparative advantage in providing some forms of investor protections. Governments, for example, may employ criminal penalties. Regulatory agencies may enjoy economies of scale in enforcing existing regulations. The fact that governments enjoy a comparative advantage, however, does not necessarily lead to the conclusion that government regulation must be mandatory. Regulators may instead allow firms to choose for themselves whether to opt into protections in which the government enjoys a comparative advantage in providing through a new high corporate governance section in the KSE.

Lastly, private contract may bind market participants. Nevertheless, purely private contract cannot bind the government itself from engaging in expropriating activities. In Russia, for example, Black, Kraakman, and Tarassova note that the government—through the tax regime—has frequently engaged in confiscatory behavior with respect to private companies within the Russian government’s reach.

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96 See id.


98 See Black, Kraakman, Tarassova, supra note 18, at 1758 (“The confiscatory [tax] rates produce derisory revenues, because almost no one pays them. Instead, everyone hides income as best they can and bribes the tax
C. Expanding Choice

Responses are possible to the arguments that private contract may not provide a socially desirable level of investor protection. As discussed above, top-down mandatory regulation often is ineffective. Moreover, private contract is not the only means to generate choice; a regime where investors are able to choose from among different regulatory regimes in competition with one another is possible. Corporations in the United States, for example, are presently able to choose their own state of incorporation. Evidence from the state competition for corporate charters inside the U.S. provides some support for the notion that competition may lead to a race-to-the-top, benefiting investors. Expanding choice through regulatory competition may also benefit Korean investors (and thereby the liquidity of the Korean capital markets). Where the choice is provided through regulatory competition, issuers and investors will enjoy both the benefits of government-supplied investor protections as well as the responsiveness and innovation that comes from competition.

Two considerations, nevertheless, cause us to pause in recommending too great a level of choice for the Korean situation. First, government officials within Korea are accustomed to a large degree of intervention in the financial markets. A large degree of political resistance, therefore, may exist to moving toward a full choice regime.

Second, while evidence exists that choice may work generally well for the state competition for corporate charters in the U.S., Korea may pose a different situation. Investors within Korea may lack the same level of sophistication as U.S. investors. At the very least, inspectors to reduce whatever initial assessment the inspectors make. An important reason for Russia’s development of an extensive barter economy is that cash in a bank account invites the tax inspectors to seize it.”).

99 For evidence on the possibility of a race-to-the-top see Romano, supra note 25, at 2383-88. For sources providing an exposition of the race-to-the-top argument see supra note 24.

100 For an argument that issuers and investors should enjoy choice in the form of securities regulation that applies to their securities transactions see Stephen J. Choi and Andrew T. Guzman, Portable Reciprocity: Rethinking the Reach of International Securities Regulation, 71 S. Cal. L. Rev. 903 (1998).
Korea investors run the risk of confusion to the extent companies with different regimes are allowed to trade concurrently on the KSE.\textsuperscript{101} Multiple different regimes may also undermine the ability of investors in Korea to compare companies against one another.\textsuperscript{102} The large number of pre-existing companies with entrenched controlling groups (through the Chaebol structure) poses a different problem. Managers in such firms may abuse the ability to shift regime to remove the few investor protections Korea presently provides.

Korea therefore faces a dilemma. While a full-blown regulatory competition choice regime may prove politically infeasible (at least today) and pose a number of problems, the present top-down approach to regulation may pose just as large (if not larger) problems. At the very least, the prospects for future reform within Korea appear bleak. Some degree of choice in regulatory regimes, therefore, may prove effective in generating the impetus for positive changes to improve the welfare of investors. Without resorting completely to a full choice regime, we contend that more limited moves to increase the choice available to Korean issuers may obtain many of the benefits from regulatory competition without incurring the risks related regulatory competition and the political costs of shifting toward such a regime. Success in providing for limited competition may then eventually lead to increasing the amount of choice.

Little choice exists today for Korean companies seeking to adopt different protections for investors. While some countries allow firms to incorporate in foreign countries, Korea does not. Under the Commercial Code, a firm incorporated in a foreign jurisdiction is subject to all

\textsuperscript{101} See John C. Coffee, Jr., The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications, 93 Nw. U. L. Rev. 641, 694 (1999) (noting that “the existing listed firms in a market share a common interest that newcomers not injure or erode the reputational capital surrounding the market that they may have created”).

\textsuperscript{102} See id. (“As issuers conform to common disclosure, accounting, and listing standards, investors gain the ability to compare securities in a common language and scoring system. Inherently, investors need to compare security A against security B, and this task becomes quicker and easier as more issuers converge to comply with the dominant market’s accounting and disclosure standards.”).
the provisions of the Code if it has its head office or main operation in Korea. 103 We propose two alternative methods of increasing choice (and thereby competition) in regulatory protections for investors trading in companies listed on the KSE. First (1) we discuss the possibility of the KSE implementing a new market specifically for companies that opt into a higher level of disclosure and investor protections. Second (2) we discuss the possibility of a new KSE market for firms that may elect to follow the regulatory regime of another country.

1. Establishing a High Corporate Governance Market

Some ability to opt into a greater level of investor protection already exists for Korean companies. A Korean firm, for example, may enter into an agreement with a foreign securities exchange to become listed on the exchange. In return for becoming listed, firms typically must comply with the foreign exchange’s listing requirements. Firms listing on the NYSE, for example, must meet minimum distribution and size requirements (relating to minimum number of shareholders and trading volume among other criteria) and various financial criteria (based on earnings, cash flow, and global market capitalization) among other quantitative requirements.105 In addition, the NYSE provides a variety of corporate governance related listing requirements.106 Firms that list on the NYSE are also exposed to the U.S. federal securities regulations, including

103 See Korean Commercial Code, Art. 617.
105 The NYSE’s detailed listing requirements can be found on the internet at http://www.nyse.com/listedhome.html.
106 The NYSE company manual provides listing standard relating to “independent audit committees, ownership interests of corporate directors and officers, shareholders' voting rights, and other matters affecting shareholders' ownership interests and the maintenance of fair and orderly markets in listed securities....” See NYSE Listed Company Manual, § 301.00 Introduction (1999), available at http://www.nyse.com/listed/listed.html. Among other provisions, the NYSE listing requirements provide for the election of independent directors and the solicitation of proxies. See id. Nonetheless, foreign firms may opt out of the NYSE’s corporate governance standards if “the company provides the Exchange with written certification from independent counsel of the company's country of domicile stating that the company's corporate governance practices comply with home country law and the rules of the principal securities market for the company's stock outside the United States.” NYSE Listed Company Manual Sec. 303.00 (2002).
both antifraud and mandatory disclosure provisions. Listing on the NYSE, among other
global securities exchanges, therefore demonstrates a commitment on the part of management
toward transparency. As part of its offering prospectus prepared in connection with an initial
public offering on the NYSE, for example, the Russian company Wimm-Bill-Dann made
disclosure of ties between some of its shareholders and directors and organized crime.

Significantly, however, many exchanges will often waive many of their listing
requirements for foreign issuers. Regulators, moreover, will make exceptions for foreign
issuers not available for domestic issuers within the securities regulatory regime. Even
where foreign securities exchange and regulators may attempt to implement stringent investor
protections, enforcement problems exist. Where the officers and assets of a listed company are
located in a different country from an exchange, the exchange (and regulatory authorities such as
the SEC) may have a difficult time obtaining information and seeking enforcement.

Evidence, nevertheless, exists that foreign firms that seek to obtain an exchange listing

107 For a description of how U.S. federal securities laws apply to foreign companies that list on an
exchange in the U.S. under either a Level II or III ADR facility see John C. Coffee Jr., The Coming Competition
109 The NYSE, for example, allows foreign issuers to either meet the NYSE’s domestic firm quantitative
listing requirements or separate foreign issuer quantitative listing requirements. See
http://www.nyse.com/listedhome.html. Roberta Karmel writes that “Foreign issuers can obtain a waiver from
many NYSE corporate governance requirements if an independent counsel licensed in the issuer's home country
opines that its practices are not prohibited by the issuer's domicile. This means, in effect, that if the laws in the
issuer's home country are silent or do not explicitly require the standard, the foreign issuer will be able to obtain a
waiver.” Roberta S. Karmel, The Future of Corporate Governance Listing Requirements, 54 SMU Law Review 325,
333 (2001); see also NYSE Listed Company Manual, § 103.00 Non-U.S. Companies.

The SEC allows exchanges to waive certain listing requirements for foreign issuers on a case-by-case basis
to the extent the foreign issuer complies with its home country “laws, customs, and practices.” See
Self-Regulatory Organizations, Order Approving Proposed Rule Changes by the American Stock Exchange, Inc.
and New York Stock Exchange, Inc. to Amend the Exchanges' Listing Standards for Foreign Companies, Exchange
reporting and disclosure requirements for listed companies are much more onerous than those required by a foreign
issuer's home country, it is very common for foreign issuers to seek waivers. Waivers are routinely granted as long
as the practices of the issuer do not violate the law of the issuer's home country.”).
110 The SEC, for example, allows foreign issuers to make periodic disclosures under the less stringent
Form 20-F (in comparison with Form 10-K disclosures required of domestic issuers in the United States). See
Form 20-F.
(or a listing on NASDAQ) inside the United States come disproportionately from countries with weak investor protections (as proxied through French civil law origin and LLSV’s antidirector rights score).\textsuperscript{111} Listing on a U.S. exchange, therefore, may provide substitute investor protections to fill the void left by an issuer’s home country’s laws. Evidence also exists that foreign firms that list on a U.S. exchange typically enjoy higher Tobin’s $q$ measure of valuation than firms from the same country that do not list.\textsuperscript{112}

Despite the possibility of listing on an established foreign securities exchange, establishing a high corporate governance standard market within Korea will provide several advantages for domestic Korean companies and investors. First, companies may face higher transaction costs with listing overseas. Domestic investors already may be aware of a company in ways that foreign investors are not. Language translation problems and the need to deal with foreign counsel may also increase the costs of listing securities overseas. Korea may therefore have a “home field” advantage with respect to retaining the listing of domestic Korean firms.\textsuperscript{113}

More firms, therefore, may select into a Korean high corporate governance standard market compared with a foreign securities exchange. Second, the KSE (and the Korean government) may provide investor protections and enforcement at a lower cost for Korean companies than foreign exchanges due to the local proximity of Korean companies. Lastly, the KSE may tailor its investor protections specifically for Korean investors and, moreover, employ corporate governance devices (with the help of the Korean government) not presently required on overseas


\textsuperscript{113} Studies of state corporate law incorporations within the U.S. find a similar home field advantages for states in retaining incorporations of firms located physically within the state. See Lucian Ayre Bebchuk and Alma
The concept of establishing a new high corporate governance market is not new. Other securities exchanges have taken the route of actively providing investor protection as a selling point of their market. We propose applying a similar approach in the Korean Stock Exchange. The Neuer Markt in Germany, a subsidiary of the Deutsche Bourse, has actively made it a policy to provide disclosure standards similar to U.S. G.A.A.P. accounting and other strong investor protections.\textsuperscript{114} Over a three year period, providing stringent investor protections allowed the Neuer Markt to grow from 2 to 302 listed companies.\textsuperscript{115} Among other things, the Neuer Markt requires its listed companies to “report earnings within two months after each quarter, in English and German; sell only common, not preferred, shares; and use U.S. or international accounting standards, not the laxer German alternative. Original shareholders may not sell shares for the first six months after an initial public offering.”\textsuperscript{116} Such requirements are absent for firms that belong to the DAX index on the Deutsche Bourse.\textsuperscript{117} The value of high corporate governance listing standards, moreover, is not lost on companies listed on the Neuer Markt. After a wave of bankruptcies and insider trading scandals involving listed companies, several of the top companies listed on the Neuer Markt demanded tougher listing requirements.\textsuperscript{118} Based on private contract between the Deutsche Boerse and listing companies, the stringent listing requirements of the Neuer Markt are being duplicated in growth stock markets located in

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\textsuperscript{114} See Vanessa Fuhrmans, Playing By the Rules: How Neuer Markt Gets Respect, Wall St. J., Aug. 21, 2000 at C1 (noting that the Neuer Markt portrays itself as “the most regulated market in Europe”).
\textsuperscript{115} See id. Although the Neuer Markt’s market capitalization grew rapidly, it has recently experienced both scandals and a large drop in this market capitalization.
\textsuperscript{116} Id.
\textsuperscript{117} See id.
Amsterdam, Brussels, Paris and Milan.\(^{119}\)

Similarly, in Latin America, the San Paolo Exchange (Bovespa) in Brazil established a new section, the Novo Mercado, for firms with corporate governance structure providing strong minority investor protections. As with the Neuer Markt, the Novo Mercado targets smaller companies that otherwise would have few options to raise capital (aside from development banks).\(^{120}\) Such companies include high technology startups as well as closely held pre-existing companies.\(^{121}\) The Novo Mercado makes both stringent minority investor protection and U.S. accounting standards part of its listing requirements.\(^{122}\) Firms listed on the Novo Mercado, for example, must only issue voting shares (excluding the possibility of a controlling block forming through ownership of a large fraction of voting shares but not of the residual cash flows represented in non-voting shares).\(^{123}\) Listed firms must also give minority shareholders the right to appoint members of a company's supervisory board.\(^{124}\) After an initial public offering, controlling shareholders must also agree to a six-month lockup period.\(^{125}\) In addition, to generate liquidity, the Novo Mercado requires companies to have at least 25% of its equity publicly-traded.\(^{126}\) To date, the Novo Mercado has signed up only 2 listed companies.\(^{127}\) On the one hand, this small number may indicate that even higher corporate governance standards may fail to attract firms to an otherwise illiquid market. Nonetheless, even where higher corporate governance standards fail to jump start a market such as the Novo Mercado, such

\(^{119}\) See Fuhrmans, supra note 114.

\(^{120}\) See Craig Karmin, Brazil Prepares Launch of Market to Encourage Foreign Investment Through Good Governance, Wall St. J., Dec. 12, 2000, at C16.

\(^{121}\) See id.

\(^{122}\) See id.

\(^{123}\) See id.

\(^{124}\) See id.

\(^{125}\) See id.

\(^{126}\) See id.

standards may work in countries with larger overall capital markets such as in Germany (with the Neuer Markt). As well, the Novo Mercado experiment is still too early to judge completely.

Following the lead of the Neuer Markt and the Novo Mercado, a new section of the Korea Stock Exchange could set itself up as leader in investor protections. Without going too far into the details, the high corporate governance section of the KSE could provide for compliance with U.S. accounting standards or further reconciliation with the IAS. In addition, minority investor protections including a majority of outside directors, independent audit, compensation and nomination committees, cumulative voting and more elaborate and strengthened fiduciary rules comparable to those suggested in the ALI Principles could be (potentially) required of listed firms (and more significantly enforced under the threat of de-listing). Higher corporate governance standards imposed through the KSE have no basis under the Commercial Code. Significantly, however, the KSE’s optional higher standards would be imposed through private contract and only on firms that voluntarily choose to list on the new market. Implementing higher corporate governance standards through private contract therefore reduces the need to obtain the cooperation of the various regulatory agencies that implement other aspects of private company law in Korea (including for example the Ministry of Justice which oversees the Korean Commercial Code).

Not all firms in Korea, of course, will take advantage of a new high corporate governance market. In particular, pre-existing firms where managers and controlling shareholders already enjoy high levels of private benefits will almost certainly avoid the high corporate governance market (at least initially). Managers of pre-existing firms that elect to increase the level of corporate governance protection (and thereby reduce their own private benefits of control) transfer value from themselves to dispersed minority shareholders. Where a
firm has a large value project that requires additional outside capital to finance, managers may choose to opt for higher corporate governance standards to reduce their cost of capital to the extent the managers gain more (as shareholders) from the ability to pursue the new project than the loss they experience in reduced private benefits. Firms lacking such high value new projects will choose not to adopt the new standards.

The failure on the part of all (and in particular firms with a large pre-existing base of minority shareholders) to take advantage of a new high corporate governance market is not a large problem for our proposal. Minority investors are not directly harmed to the extent they already paid a large discount when they initially purchased their shares. To the extent investors did not anticipate the creation of a high corporate governance market in the past, they would have discounted the shares for the very likely possibility that managers would expropriate large levels of private benefits. The low mean Tobin’s q scores for Korean firms compared with firms in common law (and indeed other civil law countries) reported by LLSV support the notion that minority investors already have been compensated through a higher discount for shares.129 Indeed, the failure on the part of companies with large contingent of pre-existing minority shareholders is precisely what gives our proposal feasibility. Once large, entrenched business interests (dependent on expropriating large private benefits of control) are not forced into our regime, they will have less reason to oppose establishing such a market.

In comparison, we predict that many firms without a large base of pre-existing shareholders will elect into a new high corporate governance market. Firms about to go public for the first time, for example, will receive a lower discount on their shares (and a correspondingly larger offering proceeds) to the extent they elect into protections which

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128 Compare with the Securities Transaction Act
129 See supra text accompanying notes 54-56.
investors value. Moreover, the provision of a standardized set of investor protections through a new market on the KSE alleviates many of the concerns raised by those opposed to regulatory competition. Because only one high corporate valuation option is offered, investors may easily identify those firms adopting such protections (based on their listing on the new market). Investors, as well, will have the ability to easily compare disclosures across firms on the new market, relying on standardization enforced through the higher listing requirements.

The KSE (and government regulators behind the KSE) may also take into account positive external benefits from disclosure requirements imposed in the new market. While easy to state as an abstract matter, it is more difficult to determine precisely what disclosure investors would not value (given the private cost of disclosure) but third parties in the market would find significant. Roberta Romano has put forth the argument that even if such information exists, the mandatory disclosure regime as administered by the SEC in the U.S. fails to take such externalities into account.130 Nevertheless, where such information exists, the KSE may force firms in the new market to make disclosures. Of course, some firms on the margin may find that the additional cost of disclosures outweigh the private benefit from protecting investors and choose therefore to remain outside the new market. Given the present low level of corporate governance protection for investors in Korea, the benefit to investors from the new market will likely be significantly positive and few firms that opt into the market will therefore be on the margin. Additionally, because the option offered is to only increase the amount of investor protections, the danger of managerial opportunism resulting in a further “race-to-the-bottom” is absent.

130 See Roberta Romano, The Need for Competition in International Securities Regulation, 2 Theoretical Inquiries L. 387, 446-458 (2001) (putting forth the argument that “the SEC’s mandated disclosure does not, and cannot, in practice require firms to disclose private proprietary information such that the released information will significantly assist competitors.”).
Other firms in addition to IPO firms may voluntarily select into the new high corporate governance market. Firms, for example, where managers already have a culture of looking out for investors (and thus the private benefit levels are low already) may select into the high corporate governance market. We predict that at least some current well-established firms under professional managers (such as banks, POSCO, and the recently privatized Korea Telecom) may elect initially into the new market.

Over time, the growth of a high governance market will then place competitive pressure on non-listed firms along a number of dimensions. First, firms listed on the new market will have strong incentives to maximize share value. One method of doing so is to hire professional managers focused on maximizing share value. The demand for professional managers will in turn affect the norms within business schools in Korea as well as standards of conduct for managers generally (in a much faster way that simply importing U.S.-style business schools into Korea). Spillover effects on managers at firms choosing not to list on the KSE new market are therefore possible. Firms initially resistant to the new market may then eventually opt into the market.

Second, domestic investors in new high corporate governance firms will come to expect a certain level of protection. In addition, foreign investors are more likely to invest in firms that provide more credible investor protections. Such investors may choose to avoid firms that choose not to list on the new market, reducing the liquidity of such firms and thereby further depressing the share price of non-listing firms. After the controlling family of the LG Group engaged in an internal stock deal that netted the family $46 million, for example, foreign investors sold off the shares of companies in the LG group, resulting in a large decline in the
share prices of the companies. Investor-oriented institutions – including U.S.-style business schools, sophisticated investment banks, and attorney firms – already present to a limited degree will also find an increased demand for their services, leading to a growth in these institutions within Korea. With a rise in the presence of investor-oriented institutions will come a change in the business norms toward investor-protection goals.

To the extent the new market provides more effective avenues for shareholder activism, as well, shareholder groups may form to collectivize the interests of shareholders. Once such groups achieve economies of scale, they may then focus attention on firms that choose not to list on the exchange. Already in Korea the People’s Solidarity for Participatory Democracy (PSPD), a shareholder activist group, has initiated fiduciary duty-related lawsuits, pushed for representation on the board of directors of various companies, and openly questioned management decisions at shareholder meetings.

Third, if the migration to the new section turns out to favorably affect the stock price, the other firms remaining in the old section will feel strong pressure from the investors to move, thereby accelerating the change in the corporate governance practice.

A possibility exists that present business establishments (including in particular the

131 See also Coffee, Jr., supra note 101, at 696 (contending that “where legal forces exist to protect the minority shareholder, an institutional and cultural infrastructure—composed of such important actors as security analysts, rating agencies, and business journalists—soon follows.”).
133 See Jooyoung Kim and Joongi Kim, Shareholder Activism in Korea: A Review of How PSPD Has Used Legal Measures to Strengthen Korean Corporate Governance, 1 J. Korean L. 51 (2001) (describing the PSPD’s shareholder-oriented activities).
134 See Yoo Cheong-mo, Activist Group Seeking Court Injunction to Have Samsung Chairman Pay Damages, Korea Herald, Jan. 11, 2002 (reporting the efforts on the part of the PSPD to obtain a “temporary court injunction to implement a recent court ruling ordering Samsung Group Chairman Lee Kun-hee to pay Samsung Electronics 7.5 billion won in damages . . . .”).
135 See Kim & Kim, supra note __, at __.
136 See Kim Ji-hyun, PSPD to Sit in On Korea Exchange Bank Shareholders’ Meeting, Korea Herald, Feb. 5, 2002 (detailing the plans of the PSPD to “sit in at the coming shareholders meeting of Korea Exchange Bank (KEB) to raise questions about its past management decisions . . . .”).
Chaebols) – although not directly threatened under the article’s choice-based proposal – may nonetheless not welcome an experiment that may lead other firms in Korea toward a higher corporate governance regime. Although the Chaebols may not denounce the proposal openly, they may try to block this experiment from behind. Moreover, despite the various benefits associated with implementing a new high corporate governance section of the KSE, we do not foresee the KSE voluntarily implementing such a market without government approval. Although the growing competition among global stock markets for capital will change the incentives placed on the KSE, presently the KSE enjoys a near monopoly over Korean investors seeking to put money into equity investments.\(^{137}\) Within such a monopoly position, the KSE has few incentives to pursue change. Moreover, officials in charge of the KSE today may care little about the competitive environment the KSE may encounter in the near future from global competition to the extent the impacts affect primarily future officials at the KSE.

Korea’s MOFE may therefore have a role in establishing the new KSE market and setting standards for listing on the market. As with all forms of mandatory regulation, the initiation of a new high corporate governance market may run into problems related to industry capture and non-responsiveness over time on the part of regulators, among others. Significantly, however, we envision the MOFE’s role as most important only at the start of the new market.\(^{139}\) Once the new market gains scale and investor support, further changes to the new market’s

\(^{137}\) Already the growing presence of foreign securities firms in Korea has led scholars to note the growing possibility of Korean investors putting their funds into foreign securities. See Kwang-Rok Kim, The New Arena for Investors in the Korean Securities Market: An Analysis of Mutual Funds From the Perspective of Investor Protection, 23 Whittier L. Rev. 95, 104 (2001) (noting that “it is also expected that domestic investors will be faced with a flood of opportunities to invest in foreign securities . . . .”).

\(^{139}\) The MOFE could, of course, maintain some regulatory role. As the new market gains scale and market volume, regulators may move, for example, to make it easier for shareholders to force firms into the new market. One possible reform, for example, would be to give shareholders the unilateral right (voting as a majority) to opt into the new market.
listing standards will derive from private initiatives. In particular, we recommend giving the KSE direct incentives to ensure the listing standards on the new market continue to cater to the interest of investors. One possible structural reform would be therefore to make the new market a for-profit subsidiary of the KSE (presently the KSE is a non-profit membership organization). Alternatively, the MOFE could have the KSE sell off the new high corporate governance part of the KSE as a separate for-profit entity, demutualizing the KSE in part.

Politically, efforts toward demutualization may prove impossible in Korea. The MOFE would never accept such a proposal directly compromising their authority. Even without any explicit domestic effort to generate regulatory competition within the KSE, nevertheless, the growing globalization of the world capital markets will generate a large degree of background competitive pressure. As Korean investors are faced increasingly with choices on where to invest (whether in the NYSE, the LSE, and so on), the KSE will face increasing pressure to cater to the interests of investors to maintain trading volume. Providing for higher corporate governance protections in a new separate market of the KSE will allow the KSE both to meet the preferences of investors in the global competitive marketplace while avoiding the political backlash from entrenched business interests (unwilling to part with their present level of private benefits of control). Having the MOFE push such change ahead today will better position the KSE in the near future to engage in the such competition.

In the upcoming global competition between securities markets, relatively smaller

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141 For a discussion of the recent trend toward demutualization for securities exchanges see Roberta S. Karmel, Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges, 53 Hastings L.J. 367 (2002).
142 For a discussion of the competition between global securities exchanges see John C. Coffee, Jr., The Coming Competition Among Securities Market: What Strategies Will Dominate? (working paper, 2001) (arguing that competition may generate a separating equilibrium among securities exchanges based on the level of investor protections provided).
countries may have an advantage in providing protections which investors value. Delaware has “won” the competition for corporate charter perhaps, in part, because of its small size. A small state may focus on maximizing the value of its rules for corporations without fearing the political impact on other constituencies. As well, the large proportion that incorporation fees represent of Delaware’s total fiscal intake helps make credible the implicit promise on the part of Delaware lawmakers to adjust continually the corporate law rules to maximize corporate welfare. Korea may adopt a similar tactic. Through a high corporate governance exchange with credible enforcement built up over time, the KSE may provide a welcome avenue for both investors and firms seeking to raise capital.

2. A Dual-Listed Section of the KSE

While establishing a high corporate governance section of the KSE will provide choice and competition (particularly to the extent the new market is for-profit) in the provision of investor protections in Korea, the amount of competition is limited. Within Korea, the competition will be between the traditional KSE and the new high corporate governance section. Where the standard setters for the new high corporate governance section of the KSE do not capture entirely the benefit from establishing new investor protections (or at the very least are not separate from the regulators of the traditional section of the KSE), the level of competition

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143 See Jonathan R. Macey and Geoffrey P. Miller, Toward and Interest Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469, 490 (1987) (“Because the physical assets of most large Delaware corporations are located in other states, Delaware lawmakers ordinarily are not subject to pressures from unions, environmental groups, local communities, or other special interests associated with the corporation's physical plant or assets. Accordingly, corporate managers know that their legislative influence, relative to that of other interests, is likely to be greater in Delaware than in many other states.”).

144 See id. at 490-491.
may be inconsequential. As an alternative reform, we therefore suggest creating a new market within the KSE specifically designated for firms that choose to follow the listing standards and accounting disclosures of select, alternative foreign regimes. Within the new dual-listed market, Korean investors may then free ride on the competition among global exchanges without having to leave the Korean capital markets.

We imagine that such a system would entail providing automatic listing on the new dual-listed section of the KSE for any company that lists on any one of several approved exchanges. The Korean government, for example, could approve the NYSE, NASDAQ, the LSE, and other similar large securities markets for automatic dual-listing status on the new section of the KSE. Within the dual-listed section of the KSE, firms may then “piggyback” onto the global competition between the NYSE, NASDAQ, the LSE, and other markets for trading volume without ever having to leave the Korean market. Korean investors may then benefit from more stringent investor protections (generated through competition among the regimes of foreign markets) without having to leave the domestic Korean equity market.

While radical, the KSE would not be alone in following such a free-riding approach toward regulatory competition. Since 2000, the Israeli government has allowed firms that list in the U.S. securities markets to gain automatic dual listing privileges on the Tel Aviv Stock Exchange. Firms that dual list in the U.S. and the Tel Aviv Stock Exchange are exempted

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145 As discussed above, however, global competition from other securities exchanges may nevertheless place large competitive pressures on the KSE. Providing for a separate high corporate governance section of the KSE may provide an effective vehicle for meeting this global competition.

146 See The Dual Listing Law: A New Era on the TASE (http://www.tase.co.il/shows/dual/dualistfinal.pdf). Amir Licht, on the other hand, has argued that the ability to obtain listing on the TASE automatically with a listing in the U.S. securities market may lead to a “race-to-the-bottom”. See Amir N. Licht, David’s Dilemma: A Case Study of Securities Regulation in a Small Open Market, 2 Theoretical Inquiries L. 673 (2001). As evidence, Licht points to the fact that the Israeli securities disclosure regime is often more stringent than in the U.S. See id. at 691, 702-03. As well, Israeli firms cross-listing on the NYSE are able to disclose less information than U.S. domestic firms using Form 20-F (rather than the more stringent Form 10-K). See id. at 696. However, stronger securities regulations are not necessarily the same as better securities protection. Securities regulations are not without there costs – so the mere fact that the
from any additional listing or maintenance requirements as well as listing fees.\textsuperscript{147} Along a similar vein, the U.S. SEC for the past decade has allowed Canadian firms to raise capital inside the United States while following primarily the disclosure (but not the antifraud) rules of Canada under the multijurisdictional disclosure system.\textsuperscript{148}

Several criticisms are possible against our KSE dual-listed section proposal. First, a greater possibility for investor confusion may result. In particular, unsophisticated investors lacking good information may fail to price accurately the selection of a particular regime. To reduce the possibility of unsophisticated investors in the new free market section, regulators may wish to restrict access to only more sophisticated investors. Much like Rule 144A in the United States, the MOFE could establish that the free market is only accessible for sophisticated investors. As with Rule 144A, regulators may use bright-line numerical criteria based on wealth, income, and invested assets to determine what investors qualify as sophisticated. Unlike Rule 144A, Korean regulators may also establish that resales to unsophisticated investors may not occur even with the passage of time from the initial offering by the issuer outside of the new free market section.

We are agnostic, however, on the need to restrict access to the dual-listed market only to sophisticated investors. Simply placing the dual-listed status firms in a separate and readily-identifiable section of the KSE helps reduce the possibility of investor confusion. Where the firm trades in an efficient market, moreover, the value of a selected regulatory regime will become incorporated in the market price, indirectly protecting the interests of

\textsuperscript{147} See id.

\textsuperscript{148} See id.
unsophisticated investors. Regulators, as well, may curtail the regulatory choice available to firms to reduce the risk facing unsophisticated investors. Having a selection of hundreds of different regimes may simply increase the cost of determining the value of particular regulations without increasing the competitive pressure placed on the rest of the KSE. The MOFE, therefore, may designate four country regimes as acceptable substitutes for the KSE’s listing standards (including the United States, Great Britain, France, and Germany for example).

Second, one could of course question the value of regulatory protections provided from a foreign source. The NYSE, for example, may lack the information necessary to enforce its listing requirements on a Korean company. Moreover, obtaining judgment against Korean nationals and assets located in Korea may be difficult for both the NYSE and the U.S. SEC. U.S. regulatory officials, as well, may not care about the impact of their actions on Korean investors, focusing primarily on the welfare of U.S. investors. The NYSE itself has instituted a lower level of listing requirements for foreign firms—perhaps in recognition of the difficulties in obtaining compliance on the part of foreign firms to more stringent requirements.¹⁴⁹ Particularly where the dominant market (in terms of trading volume) remains within Korea,¹⁵⁰ U.S. regulators may choose not to pursue instances of market manipulation and other acts harming uninformed investors that occur for Korean firms despite listing inside the U.S.

Several responses are possible to the problem of enforcement, however. Korean companies will have an incentive to select only those regimes that are able to enforce their laws against the Korean companies. Firms that actively opt into the dual-listed market and select a regime where enforcement is weak will face a large discount from investors. Moreover, Korea

¹⁴⁹ See supra notes 109-110 and accompanying text.
and the KSE do not have to remain passive with regards to enforcement even in the new dual-listed market. Regulators in Korea may work with specific countries to provide information and other assistance to reduce the cost of enforcement for foreign regulators. Korea may also, at least for certain country laws, choose to enforce the laws as its own with respect to a particular company. To the extent the U.S. allows for class actions, for example, Korea may allow Korean investors to pursue class actions against firms that opt to list on the dual-listed market by way of a listing in the U.S. markets.\textsuperscript{151} Of course, Korea (and the KSE) may lack the institutional structure and political will to implement all forms of enforcement corresponding to the enforcement available in the selected foreign regimes. Nevertheless, even if investors in Korea are able to obtain a partial level of higher enforcement through a dual listing issuer on the KSE, they will benefit (and have an increased incentive to place their investment dollars within the KSE).

The lack of norms and institutions geared toward investor protection may limit the effectiveness of the KSE and the Korean government in providing more stringent enforcement of investor protection norms even for firms on the new dual-listed market that opt into a foreign regime with a higher level of investor protection.\textsuperscript{152} Institutions, nevertheless, may cross international borders. Several prominent U.S. investment banks—including Goldman Sachs and Morgan Stanley for example—have offices in Seoul. Firms that use the dual-listed market in the KSE to opt into U.S.-style protections will provide a natural clientele for U.S.-based investment banks (and attorneys) familiar with the operation of U.S. listing standards and securities regulation. To the extent Korea is serious about developing a stronger securities

\textsuperscript{150} Amir Licht, for example, has noted that for dual-listed stock on the Tel Aviv Stock Exchange (TASE), the majority of trading volume is not in the U.S. but rather on the TASE. See Licht, supra note 146, at 688.

\textsuperscript{151} Although chances of eventually passing into law are not high, a bill for introducing class action in certain securities disputes is now pending in the National Assembly.
market, moreover, it must start somewhere. Providing a new, optional market removes many of
the pressure against reform on the part of entrenched business interests, leaving newer firms the
ability to generate stronger protections for investors (and thereby profit from the corresponding
reduced cost of capital). New norms and institutions may then generate around this core group
of new firms opting into the dual-listed market.

IV. Conclusion

Prior to the Asian economic crisis of 1997, Korea experienced rapid growth in many
sectors in its economy. Korea’s government played an active role in this growth, providing
subsidies and guaranteed financing for favored business sectors, including particularly heavy
industry and chemical manufacturing. One consequence of the Korean government’s
heavy-handed intervention into the market was the shift by many large Chaebol companies into
(often ill-advised) debt financing. Ultimately, the large levels of debt (and in particular foreign
debt) put the Chaebol companies in a precarious financial state and accelerated the foreign
exchange depletion leading to the 1997 crisis.

Throughout the buildup of debt financing, the needs of minority equity shareholders in
Korean companies were often simply ignored. Founding families of the Chaebol companies
enjoyed absolute control of their connected business empire through interlocking share positions.
Minority investors essentially lacked any real means of disciplining managers to reduce the level
of private benefits of control. Of course, where minority investors were able to demand a
discount in the share price, they were not directly harmed from the high private benefits. And
the Chaebol companies’ past reliance on debt financing (sanctioned through the government)

152 See Black, supra note 16, at 816-831 (questioning the ability of a country to “piggyback” onto the
enforcement norms and institutions of another country).
reduced the importance of equity financing. Nevertheless, the lack of protections for minority equity investors made it more difficult for new, upstart companies to obtain financing. Moreover, in today’s post-Asian economic crisis world, even the Chaebol companies can no longer look exclusively to debt financing.

Changing the level of a country’s investor protections, however, is not an easy assignment. Top-down reform may prove ineffective and the impetus for change may gradually dissipate. Student exchanges may change (perhaps) the underlying social norms within a country, but may take years to have any effect. Not only may deep-rooted norms and institutional barriers exist, but also – perhaps more significantly – specific interest groups in society may actively push against change. Controlling founders of Chaebols, for example, will not easily relinquish their private benefits of control. Indeed, the founders may draw upon considerable resources (derived in part from their private benefits) to sway regulators and the public against reforms designed to protect existing minority investors.

Rather than press for reforms that affect all Korean companies, therefore, we choose to start on a smaller scale, recommending that the KSE establish a new section of the market for firms that choose to opt into a different level of protections for investors compared with under the present Korean regime. Modest efforts at introducing some amount of choice, and thereby competition, in the provision of regulatory protections within the Korean Stock Exchange may provide the most promising and feasible step at improving investor protections.

Establishing a new section of the KSE has the added benefit of potentially increasing the amount of competitive pressure placed on regulators of the remaining portions of the KSE. Significantly, explicit moves to increase the incentives of the KSE to develop value-maximizing investor protection devices may not be necessary. Even without explicit incentives,
competition will eventually arrive in Korea through the growing integration of the global capital markets. To the extent Korean investors are increasingly able to invest their funds overseas, the KSE will lose volume if it does not provide protections which investors desire. Establishing a separate high corporate governance section allows the KSE the freedom to engage in competition for investors dollars without facing the political constraints imposed from pre-existing controlling blocks in companies with high levels of private benefits.

Second, competition may occur to the extent Korea establishes a new dual-listed market in the KSE on which issuers may automatically list after complying with the listing standards from a group of select foreign securities exchanges. The new dual-listed then provides a forum for Korean investors to benefit from regulatory competition between different global securities exchanges without leaving the Korea. Of course, the possibility of added listing fees and trading volume from Korean companies may not increase the present level of competition between the NYSE, NASDAQ, the LSE, and other exchanges. Nevertheless, the dual-listed section would allow Korean firms to “piggyback” on the present, already considerable level of competition. Moreover, the KSE may supplement the enforcement of foreign exchange listing provisions within Korea to increase the value to Korean investors of having a Korean firm select the protections provided in a foreign jurisdiction.

Ultimately, we care most about establishing a competitive environment that provides some degree of ongoing choice and competition in the investor protections provided through the KSE. With the limited political capital remaining after the Asian economic crisis, directing reform toward establishing a limited competitive regulatory system may generate further reforms into the future that investor find valuable. The enduring nature of such a reform, moreover, may give Korea the incentive and time to develop institutions and norms to support a strong
investor protection regime.