

9-1-2002

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### Recommended Citation

Choi, Stephen J. and Kim, Kon S. (2002) "Establishing a New Stock Market for Shareholder Value Oriented Firms in Korea," *Chicago Journal of International Law*: Vol. 3: No. 2, Article 4.

Available at: <http://chicagounbound.uchicago.edu/cjil/vol3/iss2/4>

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

Stephen J. 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 the trading volume and number of listed companies on the Korea Stock Exchange ("KSE") have grown rapidly over the past decade, the Composite Stock Price Index ("KOSPI") of total stock market value has, in fact, fallen. Individual investors inside Korea often choose to invest primarily in savings deposits, rather than place their money in the equity of listed companies.<sup>1</sup> Korean investors may have good reasons for avoiding equity investments. Many of the largest Korean-listed companies are members of conglomerate groups ("*chaebol*"). Although the Chairmen and founding families of *chaebol* often own a dwindling minority ownership stake, they typically maintain firm control over all member firms through cross shareholding arrangements,<sup>2</sup> and the private benefits of control are large in Korea.<sup>3</sup>

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1. Bank of Korea, *Financial Assets and Liabilities Outstanding [2000]*, available online at <[http://www.bok.or.kr/bokis/bokis/m\\_matrix?code=D&i\\_current=00000186&i\\_lang=eng](http://www.bok.or.kr/bokis/bokis/m_matrix?code=D&i_current=00000186&i_lang=eng)> (visited Sept 21, 2002) (In 2000, stocks accounted for less than seven percent of the financial assets held by individual Koreans, while deposits at banks and other financial institutions accounted for more than fifty percent.).
2. See Daehong T. Jaang, et al, *Cross Shareholding and Corporate Financial Policy: the Case of Korea 2*, AICG Working Paper (2002), available online at <[http://biz.korea.ac.kr/~aicg/paper\\_2nd/Cross\\_shareholding\\_and\\_corporate\\_financial.pdf](http://biz.korea.ac.kr/~aicg/paper_2nd/Cross_shareholding_and_corporate_financial.pdf)> (visited Sept 20, 2002).
3. See Yoo Cheong-mo, *Corporations Urged to Raise Governance, Transparency; Experiments Still Underway with Outside Director, Class Action Suit, Corporate Split, Holding Company Systems*, Korea Herald (May 29, 2002) ("In 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

As a means of improving capital market liquidity, and in response to the 1997 Asian economic crisis, regulators in Korea moved to strengthen corporate governance protection for minority investors. There is reason for at least limited optimism on the effectiveness of such reforms. Legal reform can have an impact on investors and financial markets. The passage of the federal securities laws and the establishment of the SEC during the Great Depression in the United States helped to restore confidence in the markets; as some commentators have put it, the “law matters.”<sup>4</sup>

The observation that the law matters is only a starting point, however. The more salient issue is how to generate good law. While changing the formal legal regime may have some impact, overall legality depends not only on formal laws but also on public institutions, private actors, and the background norms that support the law.<sup>5</sup> Indeed, the law itself may have only marginal significance. Culture, for example, may play a larger role in determining the extent to which controlling shareholders and managers expropriate value from minority investors.<sup>6</sup>

Norms and institutions, of course, are not impervious to change. Commentators, for example, have called for student exchanges and the establishment of US-style business and law schools in other countries, as a means of altering the background environment in which laws operate.<sup>7</sup> However, such methods, even if effective, may take years to generate any noticeable effect. The challenge this paper addresses is how to implement effective reform to protect investors within Korea, leading to a stronger, more vibrant capital market in a shorter time frame.

The question of how to protect investors is particularly salient in Korea. Although the post-1997 crisis reforms have generally enjoyed public support, governmental 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.<sup>8</sup>

Rather than pursue conventional (and we contend often ineffective) efforts at reform, we propose a different course. We believe that introducing more competition in the provision of investor protection may prove to be a more effective route toward

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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.”).

4. See John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J Corp L 1, 1–2 (1999) (coining the term “law matters”).
5. See Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets*, 48 UCLA L Rev 781, 790–803, 807–15 (2001).
6. See Amir N. Licht, Chanan Goldschmidt, and Shalom H. Schwartz, *Culture, Law, and Finance: Cultural Dimensions of Corporate Governance Laws*, SSRN Working Paper (2001), available online at <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=277613](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=277613)> (visited Sept 20, 2002).
7. Black, 48 UCLA L Rev at 848 (cited in note 5).
8. See Yoo Cheong-mo, *Chaebol Call for an End to State Meddling in Corporate Governance*, Korea Herald (Apr 21, 2000).

reform. Competition among regulators will provide an incentive to regulators interested in expanding the scope of their regulatory authority and generating listing fees to tailor their regulations toward what issuers—and indirectly, investors—desire. Shifting toward a more competitive regulatory system may require the expenditure of scarce political capital; nevertheless, once the shift has occurred, a system of regulatory competition 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.<sup>9</sup> Once placed under competitive pressures, regulators may also ignore external effects on third parties, as well as the benefits of market-wide standardization. While we do not think the dangers are great, we are mindful of the risks.<sup>10</sup> 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 by giving firms greater choice within the existing regulatory regime. As an initial, obtainable goal, we propose taking an approach similar to that pursued by the Brazilian Stock Exchange (“Bovespa”) to establish a new voluntary section for firms on the KSE satisfying global corporate governance standards. We also explore a second option to introduce competition by allowing some firms to opt out of domestic regulation in favor of the regulatory regime of a foreign country. Such an approach would allow firms the ability to choose for themselves—within limits—the level of investor protection they desire through a listing on a foreign exchange. Firms with large, 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, because controlling shareholders will not voluntarily forsake their private benefits of control. Moreover, dispersed shareholders already receive compensation for the expected expropriation of private benefits in the form of a discounted share price at purchase. Instead, our suggested reforms will primarily assist newer companies seeking to raise funds from

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9. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv L Rev 1435, 1445 (1992) (summarizing the “race to the bottom” theory espoused by William Cary and others).
  10. Empirical evidence from state competition for corporate charters provides some support for the alternative “race to the top” hypothesis. For a review of the empirical literature, see Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 Yale L J 2359, 2383–88 (1998).

the public capital markets.<sup>11</sup> Indirectly, the creation of a new investor-protection environment with accompanying norms and institutions will impact the rest of Korea's capital markets.

In the discussion that follows, part II provides an overview of the potential benefits from protecting minority investors and the empirical evidence of the efficacy of such protection. Part III surveys potential reform options and details our proposal to expand the choices available to companies within the KSE.

## II. PROTECTING MINORITY INVESTORS IN KOREA

The KSE handled 473 million shares of daily trading volume in 2001—up from only 14 million shares of daily trading volume in 1991.<sup>12</sup> Since 1997, the KSE trading system has been fully computerized, thus enabling greater trading activity.<sup>13</sup> Despite the increase in trading volume and activity on the KSE, many Korean individual investors continue to avoid the Korean equity markets. When at least partially protected from the risk of opportunistic managers and controlling shareholders, minority investors may gain confidence in the market, leading them to invest more funds. Section A of this part discusses the theoretical need for regulation to protect minority investors. Section B then canvasses aspects of Korea's investor protection regime.

### A. THE THEORY OF INVESTOR PROTECTION

Information on a firm's confidential projects, cash flows, capital expenditures, and similar items are often known (at least for a time) solely by the firm's managers and controlling shareholders. Managers and controlling shareholders with an informational advantage may attempt to sell overvalued securities to the market or engage in insider trading.

Faced with the prospect of losing money due to either lack of information or managerial opportunism, investors may adjust their behavior. In particular, securities investors may choose to either exit the capital markets, decreasing liquidity, or demand a discount as compensation for the risks they face. Where investors are rational and informed on the magnitude of expropriation risk they face, they will on average accurately discount securities prices to take this risk into account. Entrepreneurs that suffer an unduly high discount, due to the risks facing uninformed

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11. Nonetheless, 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.

12. Compare <[http://www.kse.or.kr/eng/stat/past/daily\(1991\).txt](http://www.kse.or.kr/eng/stat/past/daily(1991).txt)> (listing daily trading volume data for 1991), with <[http://www.kse.or.kr/eng/stat/past/daily\(2001\).txt](http://www.kse.or.kr/eng/stat/past/daily(2001).txt)> (listing daily trading volume data for 2001) (visited Sept 20, 2002).

13. See Korea Stock Exchange, *KSE Fact Book 2000* 13, available online at <[http://www.kse.or.kr/eng/intr/intr\\_book01.htm](http://www.kse.or.kr/eng/intr/intr_book01.htm)> (visited Sept 20, 2002).

investors in the market, may then have an incentive at the time they sell their securities to implement contract-based forms of investor protection. A higher level of investor protection results in a reduction in the discount demanded by investors, thereby providing greater offering proceeds for entrepreneurs.<sup>14</sup>

Despite the possibility of a contractual response, regulations may be better suited to help alleviate the problem of asymmetric information facing investors. Regulations may involve greater economies of scale, thus assisting in the detection of violations of disclosure provisions or opportunistic acts of self-dealing. Not all investors, moreover, are sophisticated. Less sophisticated investors may fail to discount properly for all the informational and opportunism risks. Benefits may also exist from standardization—for example, in disclosure—that individual firms may ignore in their decision on which investor protection measures to provide through contract. Disclosure may also generate positive externalities that benefit unrelated third parties. 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 of relying too heavily on mandatory regulation. Once regulations become mandatory, the possibility exists for regulatory capture.<sup>15</sup> 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 they are 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.

## 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 protection of minority investors. Compared with countries of common law origin (such as the United States and the United Kingdom), La Porta, Lopez-de-Silanes, Shleifer, and Vishny (“LLSV”) provide evidence across a series of articles that the relatively weak investor protection of Korea (and other civil law countries) correlates with more concentrated

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14. See Bernard S. Black, Hasung Jang, and Woochan Kim, *Does Corporate Governance Matter?: Evidence from the Korean Market*, KDI Working Paper No 02-04 (2002), available online at <<http://www.kdischool.ac.kr/library/w2002.htm>> (visited Sept 16, 2002) (providing evidence that greater corporate governance protection for firms listed on the KSE result in a higher measure of valuation).
  15. For a public choice critique of the SEC in the United States, see Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 *Cardozo L Rev* 909, 913–14 (1994).

ownership, a smaller external financing market, and reduced stock market valuations.<sup>16</sup> One initial criticism of the LLSV studies is that the various indices they use as a proxy for the level of minority investor protection are flawed. LLSV's direct measure of the level of formal legal protection 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 preexisting shareholders. Significantly, LLSV ignore the presence of antitakeover laws or the permissibility of the use of private antitakeover techniques, including poison pills.<sup>17</sup> 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, nonetheless, provides corroborative evidence that the Korean investor protection regime indeed is lagging behind other countries, most notably the United States. Prior to the 1997 crisis, the Korean corporate governance regime differed from the United States along a number of dimensions.<sup>18</sup> First, the ownership structure in Korea was markedly different. For most large business firms, a control block was typically in the hands of the founding family, which dominated the internal decisionmaking 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 were largely ineffective. Second, fiduciary duty rules in Korea were neither well established nor well utilized due to barriers to derivative suits. Disgruntled shareholders could file a derivative action only if they owned at least 5 percent of the shares.<sup>19</sup> Coupled with a lack of class action suits in Korea, the large threshold share ownership requirement 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.

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16. See Rafael La Porta, et al, *Legal Determinants of External Finance*, 52 J Fin 1131 (1997); Rafael La Porta, et al, *Law and Finance*, 106 J Pol Econ 1113 (1998); Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, *Corporate Ownership Around the World*, 54 J Fin 471 (1999); Rafael La Porta, et al, *Investor Protection and Corporate Valuation*, NBER Working Paper No W7403 (1999), available online at <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=227583](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=227583)> (visited Sept 20, 2002).
  17. See also 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 [LLSV's measured] 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.").
  18. See Kon Sik Kim, *Chaebol and Corporate Governance in Korea* (1995) (unpublished PhD dissertation, University of Washington) (on file with the University of Washington library).
  19. The 5 percent threshold requirement, moreover, was applicable to other shareholder rights.

While the corporate governance regime in Korea had come under some pressure for reform prior to 1997, it was the 1997 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 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. Although the founding families of the *chaebol* companies still enjoy effective control through complicated cross-ownership, controlling shareholders are now much more subject to pressures from other shareholders.

The most striking of the post-1997 reforms is a series of statutory reforms enacted to strengthen shareholder rights. The reforms were largely due to pressure from the International Monetary Fund and the World Bank. We point out some of the most conspicuous changes.<sup>20</sup> First, outside directors are required for listed firms. For large listed firms, an audit committee is required, instead of a nominal statutory auditor. The burdensome 5 percent threshold share ownership requirement for bringing a derivative suit or exercising other shareholder-related rights has been substantially moderated. For example, the share ownership required for derivative suits is now down to 1 percent, and 0.01 percent for KSE-listed firms.<sup>21</sup> Board approval and public disclosure are required for certain related party transactions involving large listed firms.<sup>22</sup> Intra-group guarantees are prohibited and existing guarantees have been eliminated for certain large business groups.<sup>23</sup> Accounting standards were revised to bring them into substantial compliance with International Accounting Standards. Large *chaebol* groups are now required to prepare "combined" financial statements covering all the member companies in the group.<sup>24</sup> Listed firms are required to file quarterly reports in addition to annual and biannual reports.<sup>25</sup>

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20. For a more extensive survey of the reforms, see Hwa-Jin Kim, *Toward the "Best Practice" Model in a Globalizing Market: Recent Developments in Korean Corporate Governance*, SSRN Working Paper (2001), available online at <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=282051](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=282051)> (visited Sept 20, 2002) (describing changes in Korean corporate governance and Korean governance adaptation to global standards by analyzing data from 2000 and 2001).
  21. Securities and Exchange Act, art 191-13, § 1 (S Korea), available online at <<http://www.moleg.go.kr/mlawinfo/english/htms/html/law19.html>> (visited Sept 20, 2002); Commercial Act, art 403, § 1 (S Korea), available online at <<http://www.moleg.go.kr/mlawinfo/english/htms/html/law08.html>> (visited Sept 20, 2002).
  22. Securities and Exchange Act, art 191-19 (cited in note 21).
  23. Monopoly Regulation and Fair Trade Act, art 10-2 (S Korea), available online at <<http://www.moleg.go.kr/mlawinfo/english/htms/html/law10.html>> (visited Sept 20, 2002).
  24. Act on External Audit of Stock Companies, art 1-2 (S Korea), available online at <<http://www.moleg.go.kr/mlawinfo/english/htms/html/law09.html>> (visited Sept 20, 2002).
  25. Securities and Exchange Act, art 186-3 (cited in note 21).



Despite these formal legal changes, substantial doubt exists as to whether the reforms will result in a major increase in protection for minority investors in Korea.<sup>26</sup> The reforms have done little to shore up the confidence of the international investment community. Moreover, evidence exists that political pressures—primarily from the *chaebol*—are working to undo the reforms.<sup>27</sup> Given the rapid decline of willpower in the current government and the heightened voice of the united business community, it now seems that further statutory change strengthening shareholder rights is unlikely.

### 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. Moreover, the country may attempt to implement reforms incrementally. But political resolve, unfortunately, is limited. As we move away from the 1997 crisis, the impetus for reform will most likely decline even further. Given the reality of limited political capital for reform, we pose the question of what types of reform may prove efficacious 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.<sup>28</sup> As we discuss in section A, however, we remain skeptical of this approach within Korea. At the opposite extreme, one could imagine simply allowing the market to determine the level of investor protection, 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 proposal for encouraging limited choice within the context of the Korea Stock Exchange.

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26. See Yoo Cheong-mo, *Poll Says Conglomerates' Boards Swayed by Owners*, Korea Herald (Jan 16, 2002) ("According 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.").

27. See Yoo, *Chaebol Call for an End to State Meddling in Corporate Governance*, Korea Herald (cited in note 8) (reporting on Chaebol resistance to corporate governance reforms in Korea).

28. See Bernard Black, et al, *Corporate Governance in Korea at the Millennium: Enhancing International Competitiveness*, 26 J Corp L 537, 560-608 (2001) (proposing a number of reforms to Korea's Commercial Code focusing on strengthening the role of the board of directors, and the ability of shareholders to approve certain transactions, among other measures).

## A. TOP-DOWN GOVERNMENT REGULATION

In attempting top-down corporate governance reforms, Korea is not alone. Many countries throughout the 1990s instituted reforms affecting governance within firms. Despite the success of the United States capital markets (and economy) and the belief held by many that the US system of strong investor protection is at least partially responsible for such success, major questions exist as to whether importing US-style laws will provide similar results for other countries. Formal legal rules represent only a part (and perhaps not even the most important part) of the overall investor protection regime. Without effective public institutions, including an unbiased judiciary and regulatory enforcement officials, and similarly effective 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.<sup>29</sup>

Evidence exists supporting the view that mere formal changes in the law often prove ineffective in transforming practices within a country. In large part due to efforts on the part of the SEC, for example, many countries adopted formal prohibitions against insider trading in the 1980s and 1990s.<sup>30</sup> Despite the presence of a formal ban on insider trading, however, few countries have ever engaged in enforcement of this ban.<sup>31</sup> At the end of 1998, 103 countries had stock markets, 87 of those countries prohibited insider trading, but enforcement had taken place at least once in only 38 countries.<sup>32</sup>

Korea's experience fits well with these propositions. For example, fiduciary rules in the Korean Commercial Code, although not as comprehensive as their US counterparts, were first adopted forty years ago in 1962. Nonetheless, until recently enforcement of the rules was rare due to, among other reasons, the 5 percent 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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29. For a discussion of laws and institutions (arguably) important for the development of strong securities markets, see Black, 48 UCLA L Rev 781 (cited in note 5).

30. See Harvey L. Pitt and David B. Hardison, *Games Without Frontiers: Trends in the International Response to Insider Trading*, 55 L & Contemp Probs 199, 204-06 (1992).

31. See Utpal Bhattacharya and Hazem Daouk, *The World Price of Insider Trading*, 57 J Fin 75, 75 (2002) (prior to 1990, only nine of thirty-four countries with prohibitions on insider trading ever engaged in an enforcement action).

32. Id. See also Katharina Pistor, Martin Raiser, and Stanislav Gelfer, *Law and Finance in Transition Economies 2*, EBRD Working Paper No 48 (2000), available online at <<http://www.ebrd.com/pubs/econ/workingp/48.pdf>> (visited Sept 22, 2002) ("legal environment" is much more important than formal legal protection).

decisionmaking. Large companies, such as Samsung Electronics, had up to sixty directors, yet board meetings often took place only on the books.

Of course, new legal rules often have an impact on the underlying norms and institutions within a country. Within the United States, the passage of federal securities laws during the 1930s dramatically changed how companies offer securities and provide information to the marketplace. Of significance is the fact that the passage of 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 led to the crash.<sup>33</sup>

Despite the effectiveness of some scandal-driven law reform, two problems exist with relying on scandals as a catalyst for reform. First, lawmakers in the wake of a scandal may overreact in implementing new far-reaching regulatory reform. Once reforms are in place, it may take decades to remove the legal changes. For example, the United States only recently removed barriers under Glass-Steagall, which kept the businesses of commercial banks and securities firms separate.<sup>34</sup> Second, when scandals are absent, the political capital for reform may diminish rapidly. Relying solely on lawmakers to generate new investor protection measures may therefore result in either too strident new regulations, or too few changes to the regulatory regime.

The Korean experience with corporate governance reform fits the pattern of scandal-driven reform. After the Asian economic crisis, numerous corporate governance reforms took place. Now, several years after the reforms, the prospect of future reform efforts appears dim at best. Rather than wait for another scandal, regulators may wish to consider reforms to the *process* of how regulations are created, in order to provide an ongoing and persistent level of impetus for reforms that benefit investors.

## B. PRIVATE CONTRACT

Where regulation fails to provide necessary investor protection measures, market participants may turn to substitute mechanisms of protecting the interests of minority investors. The market, of course, will not choose to adopt all possible types of protection. Some forms of protection, for example, are simply not cost-effective. It may be the case that forcing a full-blown audit 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 far outweigh the expected benefits from doing so. When protective measures are cost-effective, participants in the market will have strong incentives to

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33. See generally Stuart Banner, *What Causes New Securities Regulation?: 300 Years of Evidence*, 75 Wash U L Q 849, 850 (1997) (observing that significant legal changes often occur following major scandals).

34. See Michael Schroeder, *Clinton Signs Financial-Services Bill, But Cautions About Privacy Shortfalls*, Wall St J A41 (Nov 15, 1999).

adopt such measures. When investors are protected, they will pay more for securities up front, raising the value of the offering proceeds for the initial promoters.

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 may require a majority of outside directors on the board of directors or the approval of outside directors for self-dealing transactions involving controlling shareholders. 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.<sup>35</sup> 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. Empirical studies show that companies that list on securities exchanges in more than one country tend to disclose a significant amount of information voluntarily.<sup>36</sup>

Private contract nevertheless has its limits. Private actors may ignore the external impact of 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 from such disclosures to third parties who value more accurate securities prices. Dispersed shareholders are at risk that managers may engage in a "mid-stream" shift, changing the level of investor protection well after investors have put money into a firm.

The government may also enjoy a comparative advantage in providing some forms of investor protection. Governments may employ criminal penalties, while private parties may not. Regulatory agencies may also enjoy economies of scale in enforcing existing regulations. But the fact that governments enjoy a comparative advantage does not necessarily lead to the conclusion that government regulation must be mandatory. As suggested in the next section, regulators could achieve the same

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35. See Black, 48 UCLA L Rev at 787-88 (cited in note 5).

36. See Gary K. Meek, Clare B. Roberts, and Sidney J. Gray, *Factors Influencing Voluntary Annual Report Disclosures By U.S., U.K. and Continental European Multinational Corporations*, 26 J Intl Bus Stud 555, 566 (1995) ("Listing status is important in explaining voluntary strategic and financial, but not nonfinancial, disclosures.").

comparative advantage by creating an optional high corporate governance section of the stock exchange.<sup>37</sup>

Lastly, private contract may bind market participants. Nevertheless, purely private contract cannot bind the government itself from engaging in expropriating activities. For example, Russia, through its tax regime, has frequently engaged in confiscatory behavior.<sup>38</sup>

### C. EXPANDING CHOICE

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, choose their own state of incorporation. Evidence from the state competition for corporate charters inside the US provides some support for the notion that competition may lead to a race to the top, benefiting investors.<sup>39</sup> 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 protection as well as the responsiveness and innovation that come from competition.<sup>40</sup>

Two considerations, nevertheless, give us 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, leading to potential resistance to moving toward a full choice regime. Second, while evidence exists that choice may generally work well for state competition for corporate charters in the US, Korea may pose a different situation. Investors within Korea may lack the same level of sophistication as US investors. At the very least, Korean investors run the risk of confusion to the extent companies with different regimes are allowed to trade concurrently on the KSE. Multiple regimes may also undermine the ability of investors in Korea to compare companies with one another. Managers may also abuse the ability to shift regimes, thereby removing the few investor protection measures Korea presently provides.

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37. For a discussion of "self-tailored" liability, see Stephen Choi, *Market Lessons for Gatekeepers*, 92 Nw U L Rev 916, 951-58 (1998).

38. See Bernard Black, Reinier Kraakman, and Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 Stan L Rev 1731, 1758 (2000).

39. For evidence on the possibility of a race to the top, see Romano, 107 Yale L J at 2383-88 (cited in note 10). For sources providing an exposition of the race to the top argument, see Bebchuk, 105 Harv L Rev at 1445-46 (cited in note 9).

40. 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 International Reach of Securities Regulation*, 71 S Cal L Rev 903, 906-08 (1998).

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 is equally problematic. 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 to regulatory competition and the political costs of shifting toward such a regime. Success in providing for limited competition may then eventually lead Korea to increasing the amount of choice.

Little choice exists today for Korean companies seeking to adopt different types of protection 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 the provisions of the Code if it has its head office or main operations in Korea.<sup>41</sup> We propose two alternative methods of increasing choice in regulatory protection. First, we discuss the possibility of the KSE implementing a new market specifically for companies that opt into a higher level of disclosure and investor protection. Second, 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. Korean firms listing on the New York Stock Exchange ("NYSE"), for example, must meet certain listing requirements, including a minimum number of shareholders and average trading volume, and quantitative requirements relating to earnings, cash flow, and global market capitalization. In addition, the NYSE provides a variety of corporate governance related listing requirements. Firms that list on the NYSE are also exposed to US federal securities regulations, including both antifraud and mandatory disclosure provisions. Listing on the NYSE, along with other global securities exchanges, therefore demonstrates the management's commitment to transparency.

Significantly, however, exchanges will often waive many of their listing requirements for qualifying foreign issuers.<sup>42</sup> Regulators will also make exceptions for foreign issuers, which are not available for domestic issuers within the securities regulatory regime. Even where foreign securities exchanges and regulators attempt to implement stringent investor protection, enforcement problems exist. Where the officers and assets of a listed company are located in a different country from an

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41. See Commercial Act, art 617 (cited in note 21).

42. Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L Rev 325, 333 (2001).

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 (or a listing on NASDAQ) inside the United States come disproportionately from countries with weak investor protection.<sup>43</sup> Listing on a US exchange, therefore, may provide substitute forms of investor protection to fill the void left by the laws of the issuer's home country.

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 face higher transaction costs when 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 also increase the costs of listing securities overseas. More firms, therefore, may select into a Korean high corporate governance standard market than would list on a foreign securities exchange. Second, the KSE may provide investor protection and enforcement at a lower cost due to the local proximity of Korean companies. Lastly, the KSE may tailor its provision of investor protection specifically for Korean investors and, moreover, employ corporate governance devices not presently required on overseas exchanges.

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. The Neuer Markt in Germany, a subsidiary of the Deutsche Boerse, adopted disclosure and accounting standards on par with US standards, rather than the laxer German standards.<sup>44</sup> Over a three-year period, these stringent forms of investor protection allowed the Neuer Markt to grow from 2 to 302 listed companies.<sup>45</sup> 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.<sup>46</sup> Based on private contract between the Deutsche Boerse and listing

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43. See William A. Reese, Jr. and Michael S. Weisbach, *Protection of Minority Shareholder Interests, Cross-listings in the United States, and Subsequent Equity Offerings*, SSRN Working Paper (2000), available online at <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=194670](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=194670)> (visited Sept 16, 2002).

44. See Vanessa Fuhrmans, *Playing By the Rules: How Neuer Markt Gets Respect*, Wall St J C1 (Aug 21, 2000) (noting that the successful Neuer Markt portrays itself as "[t]he most regulated market" in Europe). The Neuer Markt was closed down and merged into the Frankfurt Stock Exchange in September 2002, during the last stage of editing for this article.

45. See *id.* Although the Neuer Markt's market capitalization grew rapidly, it has recently experienced both scandals and a large drop in market capitalization.

46. See Neal E. Boudette and Alfred Kueppers, *Frustrated Neuer Markt Members Push for Tightening Listing Rules*, Wall St J C12 (July 11, 2001).

companies, the stringent listing requirements of the Neuer Markt are being duplicated in growth stock markets located in Amsterdam, Brussels, Paris and Milan.<sup>47</sup>

Similarly, the Bovespa in Brazil established a new section, the Novo Mercado, for firms with a corporate governance structure that provides strong minority investor protection. As with the Neuer Markt, the Novo Mercado targets smaller companies that otherwise would have few options to raise capital (aside from development banks).<sup>48</sup> Such companies include high technology startups as well as closely held preexisting companies. The Novo Mercado makes both stringent minority investor protection and US accounting standards part of its listing requirements. Firms listed on the Novo Mercado, for example, must only issue voting shares and give minority shareholders the right to appoint members of the supervisory board.<sup>49</sup> The Novo Mercado requires companies to have at least 25 percent of their equity publicly-traded. After an initial public offering, controlling shareholders must also agree to a six-month lockup period. To date, the Novo Mercado has signed only two listed companies.<sup>50</sup> On the one hand, this small number may indicate that higher corporate governance standards may fail to attract firms to an otherwise illiquid market. Nonetheless, even where higher corporate governance standards fail to jumpstart a market such as the Novo Mercado, such standards may work in countries with larger overall capital markets such as in the case of Germany and the Neuer Markt.<sup>51</sup>

Following the lead of the Neuer Markt and the Novo Mercado, a new section of the Korea Stock Exchange could set itself up as a leader in investor protection. Without elaborating on the details here, a high corporate governance section of the KSE could provide for compliance with US accounting standards or further reconciliation with the International Accounting Standards. In addition, minority investor protection could potentially be required of listed firms, and more significantly enforced under the threat of de-listing.<sup>52</sup> Significantly, 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 reduces the need to obtain the cooperation of the various regulatory agencies that implement other aspects of private company law in Korea.

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47. See Fuhrmans, *Playing By the Rules*, Wall St J at C1 (cited in note 44).

48. See Craig Karmin, *Brazil Prepares Launch of Market to Encourage Foreign Investment Through Good Governance*, Wall St J C16 (Dec 14, 2000).

49. See *id.*

50. See the current list of Novo Mercado companies on the Bovespa web site at <[http://www.bovespa.com.br/fra\\_cialistnmi.htm](http://www.bovespa.com.br/fra_cialistnmi.htm)> (visited Sept 20, 2002).

51. Furthermore, the Novo Mercado experiment is still too new to critique fairly.

52. Minority investor protection could potentially include provisions for a majority of outside directors, independent audit, compensation and nomination committees, cumulative voting, and more elaborate and strengthened fiduciary rules.



Not all firms in Korea, of course, will take advantage of a new high corporate governance market. In particular, preexisting 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. But where a firm has a large value project that requires additional outside capital, managers may choose to opt for higher corporate governance standards to reduce their cost of capital. This will occur to the extent the managers gain more, as shareholders, from the ability to pursue the new project than they lose 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 some firms, particularly those firms with a large preexisting 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, they would have discounted the shares for the very likely possibility that managers would expropriate large levels of private benefits. Indeed, the ability of companies with a large contingent of preexisting minority shareholders to ignore a new high corporate governance market is precisely what gives our proposal feasibility. Once large, entrenched business interests 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 preexisting minority 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 correspondingly larger offering proceeds—to the extent they elect into types of protection that investors value. Moreover, the provision of a standardized set of investor-protection measures through a new market on the KSE alleviates many of the concerns raised by those opposed to regulatory competition. Because only one high corporate governance option is offered, investors may easily identify those firms adopting such a level of investor protection based on their listing on the new market. Investors, as well, will have the ability to 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 information investors would not want disclosed given the private costs, but that 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 US fails to take such third-party

externalities into account.<sup>53</sup> Nevertheless, there is the potential for the KSE to force firms to make such disclosures in the new market. Of course, some firms on the margin may find that the additional cost of disclosure outweighs the private benefit from protecting investors, and will 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 only increases the amount of investor protection, the danger of managerial opportunism resulting in a further "race to the bottom" is absent.

Other firms, in addition to firms going public, may voluntarily select into the new high corporate governance market. Firms that already maintain a culture of managers looking out for investors may select into the high corporate governance market, because the already low private benefit levels of the managers are unlikely to be affected. We predict that at least some current well-established firms under professional managers, such as banks, POSCO, and recently-privatized firms like 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 than simply importing US-style business schools into Korea. Spillover effects on managers at firms choosing not to list on the KSE new market are therefore possible, as managers migrate across different firms and the general management culture shifts in Korea. 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 investor protection. In addition, foreign investors are more likely to invest in firms that provide more credible investor protection. Such investors may 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. 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, after the controlling family of the LG Group engaged in an internal stock deal that netted the family \$46 million.<sup>54</sup>

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53. See Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 *Theoretical Inquiries L* 387, 446-64 (2001).

54. See, for example, Yoo Cheong-mo, *LG Group's Owner Family Draws Bitter Criticisms for Dubious Stock Transactions*, *Korea Herald* (Apr 26, 2002).

Investor-oriented institutions already present to a limited degree—including US-style business schools, sophisticated investment banks, and law firms—will also find an increased demand for their services, leading to a growth in these institutions within Korea and a change in the business norms toward investor-protection goals.

To the extent the new market also provides more effective avenues for shareholder activism, 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"),<sup>55</sup> a shareholder activist group, has initiated fiduciary duty-related lawsuits,<sup>56</sup> pushed for the appointment of outside directors,<sup>57</sup> and openly questioned management decisions at shareholder meetings.<sup>58</sup>

Third, if the migration to the new section turns out to affect the stock price favorably, firms remaining in the old section of the KSE will feel strong pressure from investors to move to the high corporate governance section, thereby accelerating changes in corporate governance practices.

A possibility exists that present business establishments (including in particular the *chaebol*)—although not directly threatened under the Article's choice-based proposal—may nonetheless resist an experiment that may lead other firms in Korea to adopt a higher corporate governance regime. 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 ultimately change the incentives placed on the KSE, presently the KSE enjoys a near monopoly over Korean investors seeking to put money into equity investments. 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 to the extent the impact primarily falls on future officials at the KSE.

Korea's Ministry of Finance and Economy ("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-

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55. 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, 53 (2001) (describing the PSPD's shareholder-oriented activities).

56. See Yoo Cheong-mo, *Activist Group Seeking Court Injunction to Have Samsung Chairman Pay Damages*, Korea Herald (Jan 11, 2002).

57. See Kim and Kim, 1 J Korean L at 59 (cited in note 55).

58. See Kim Ji-hyun, *PSPD to Sit in on Korea Exchange Bank Shareholders' Meeting*, Korea Herald (Feb 5, 2002).

responsiveness over time on the part of regulators, among others. Significantly, however, we envision the MOFE's role as important only at the start of the new market.<sup>59</sup> Once the new market gains scale and investor support, further changes to the new market's 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 interests of investors. One possible structural reform would be to make the new market a for-profit subsidiary of the KSE; presently the KSE is a non-profit membership organization.<sup>60</sup> 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.<sup>61</sup>

Politically, efforts toward demutualization may prove difficult in Korea. The MOFE may be reluctant to accept a proposal directly compromising its authority. Nevertheless, even without any explicit domestic effort to alter the incentives of officials in the new KSE market, the growing globalization of the world capital markets will eventually generate a large amount of background competitive pressure. Short-sighted KSE officials may resist initiating a new high corporate governance market. Nonetheless, future KSE officials, once the market is in place and faced with growing capital market competition, will have the incentive and ability to cater to 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. Such changes, moreover, take time. If the MOFE promotes these reforms today, the KSE will be better positioned in the near future to engage in such competition.

In the upcoming global competition between securities markets, relatively smaller countries may have an advantage in providing protection that investors value. Delaware "won" the competition for corporate charters 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.<sup>62</sup> Also, the fact that incorporation fees represent a large proportion 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

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59. 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.

60. See Korean Stock Exchange, Articles of Incorporation (2001), available online at <<http://www.kse.or.kr/upload/rule/reg011.doc>> (visited Sept 20, 2002).

61. For a discussion of the recent trend toward demutualization of securities exchanges, see Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 *Hastings LJ* 367 (2002).

62. See Jonathan R. Macey and Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 *Tex L Rev* 469, 490 (1987).

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 in the provision of investor protection in Korea, the amount of competition is limited. Within Korea, the competition will be between the traditional KSE section 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 forms of investor protection, or at the very least are not separate from the regulators of the traditional section of the KSE, the level of competition may be small (at least absent global financial market competition).<sup>63</sup> 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.

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, and the London Stock Exchange ("LSE"), among others, as eligible markets for firms seeking automatic dual-listing status. Within the dual-listed section of the KSE, Korean investors may then benefit from more stringent investor protection, 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 US securities markets to gain automatic dual-listing privileges on the Tel Aviv Stock Exchange.<sup>64</sup> Firms that dual list in the US and the Tel Aviv Stock Exchange are exempted from any additional listing or maintenance requirements as well as listing fees.<sup>65</sup> Along a similar vein, the SEC for the past decade has allowed Canadian firms to raise capital inside the United States while following

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63. 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.

64. See Tel Aviv Stock Exchange ("TASE"), *The Dual-Listing Law: A New Era on the TASE*, available online at <<http://www.tase.co.il/shows/dual/duallistfinal.pdf>> (visited Sept 20, 2002). Amir Licht, on the other hand, has argued that the ability to obtain listing on the TASE automatically with a listing on a US 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, 702-03 (2001).

65. See TASE, *The Dual Listing Law: A New Era on the TASE* (cited in note 64).

primarily the disclosure (but not the antifraud) rules of Canada under the multijurisdictional disclosure system.<sup>66</sup>

Providing for a degree of choice within the new dual-listed section of the KSE will then generate competitive pressures on the traditional portion of the KSE to provide investor protection that firms and investors jointly desire. As with the high corporate governance section, competition will have an effect only if those in charge of establishing investor protection within the KSE are affected directly. For example, to the extent volume is drawn off of the traditional KSE and the role for regulators on the KSE is correspondingly diminished, KSE officials will have at least some incentive to modify their provision of investor protection to better suit the needs of investors.

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 investor confusion, 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 section is only accessible to sophisticated investors. As with Rule 144A, regulators may use bright-line numerical criteria based on wealth, income, and invested assets, to determine which investors qualify as sophisticated. But in contrast to the US securities laws, Korean regulators may also wish to establish that securities purchased in the free market section may not be resold to unsophisticated investors, even with the passage of time from the initial offering by the issuer.

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 unsophisticated investors. Regulators may also reduce the risk facing unsophisticated investors by limiting the choice of alternative regulatory regimes, for example, to the NYSE, NASDAQ, and the LSE.

Second, one could question the value of regulatory protection provided by a foreign source. The NYSE, for example, may lack the information necessary to enforce its listing requirements against a Korean company. Moreover, obtaining judgment against Korean nationals and assets located in Korea may be difficult for both the NYSE and the SEC. United States regulatory officials, as well, may not care about the impact of their actions on Korean investors, focusing primarily on the welfare of US investors. The NYSE itself has instituted a lower level of listing

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66. See Multijurisdictional Disclosure and Modifications to the Current Registration and Reporting System for Canadian Issuers, Exchange Act Release No 33-6902, [1991 Transfer Binder] Fed Sec L Rep (CCH) ¶ 84,812 (June 21, 1991).

requirements for foreign firms, perhaps in recognition of the difficulties in obtaining the compliance of foreign firms with more stringent requirements.<sup>67</sup>

Several responses are possible to the problem of enforcement. Korean companies will have an incentive to select only those regimes that are able to enforce their laws against 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 and the KSE do not have to remain passive with regard 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 choose to enforce certain applicable laws of another country. To the extent the US allows for class actions, for example, Korea may allow Korean investors to pursue class actions against firms that opt to adopt US standards.<sup>68</sup>

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. Institutions, nevertheless, may cross international borders. Several prominent US investment banks—including Goldman Sachs and Morgan Stanley—have offices in Seoul. Firms that use the dual-listed market in the KSE to opt into US-style protection will provide a natural clientele for US-based investment banks and attorneys familiar with the operation of US listing standards and securities regulation. Providing a new, optional market removes many of the pressures against reform from entrenched business interests, leaving newer firms the ability to opt for stronger investor protection and thereby profit from the corresponding reduced cost of capital. New norms and institutions may then generate around this core group of 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, 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

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67. 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/listed/intnlstandards.html>> (visited Sept 20, 2002).

68. Although its chances of eventually passing into law are not high, a bill for introducing class action in certain securities disputes is now pending in Korea's National Assembly.

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 empires through interlocking share positions. 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. Nevertheless, the lack of protection for minority equity investors made it more difficult for new startup 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 protection, however, is not an easy assignment. Top-down reform may prove ineffective and the impetus for change may gradually dissipate. 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 *chaebol*, for example, will not easily relinquish their private benefits of control.

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

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 sections 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 the types of protection that 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 by preexisting controlling blocks in companies with high levels of private benefits.

Competition may also 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 of one of a group of select foreign securities exchanges. The new dual-listed market thus enables Korean investors to invest in domestic securities, while benefiting from regulatory competition between different global securities exchanges. 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 protection 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 forms of investor protection provided through the KSE. With the limited political capital remaining after the Asian economic crisis, directing current reform efforts toward the realistic goal of establishing a limited competitive regulatory system may generate more valuable future reforms. A competitive regulatory system, once established, will provide the impetus for the development of institutions and norms in support of a strong investor protection regime.