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The Change of Corporate Governance Structure in the United States and Taiwan

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**THE CHANGE OF CORPORATE GOVERNANCE STRUCTURE
IN THE UNITED STATES AND TAIWAN:
THE IMPACT ON THE FOREIGN PRIVATE ISSUERS
LISTED ON THE NYSE AND NASDAQ**

by

Tseng, Yi-Fan

(Under the Direction of Major Professor Charles R.T. O'Kelley)

ABSTRACT

This thesis is discussed corporate governance issues in different legal schemes, mainly about the latest legal reforms in the United States, and Taiwan. And it is also talked about what kinds of impacts of the latest legal reforms of corporate governance in the United States on the foreign private issuers listed their securities in the NYSE or Nasdaq. Different corporate governance structures are derived from different legal basis and there is no perfect corporate governance model, however, with globalization and integration of financial and capital markets, the stronger the markets are, and the more influential their corporate governance structures would be.

Index words: Corporate governance, Foreign private issuer, Taiwan, NYSE,
Nasdaq

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Partial Fulfillment of the Requirements for the Degree**

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Dedication

To My Mother

With Love and Appreciation

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Chapter I

Introduction

Recently, the issue of corporate governance has caught much more attention from companies and investors, to government authorities, organizations and securities exchanges across countries. There are several reasons for this attentiveness. One is the recent proliferation of corporate and accounting scandals aroused around the world. And the other is as a research indicates: better corporate governance frameworks would benefit firms through greater access to financing, lower cost of capital, better firm performance, and more favorable treatment of all stakeholders.¹ And this gives corporations great incentives to establish and maintain good mechanism of corporate governance structure for business operation.

Generally, the U.S. corporate governance structure in large public companies, which is based on the separation of corporate control² and ownership³ and derived from an independent and objective manager-overseeing responsibility of the board of directors, is deemed as a good model of corporate governance for foreign countries and companies to follow. It is also deemed a better way to develop a sound corporate governance system and to maximize shareholders' wealth.

¹ See Stijn Claessens, Corporate Governance and Development, Global Corporate Governance Forum, 2003, available at http://www.gcgf.org/library/Discussion_Papers_and_Focus%20Notes/Focus_1_Corp_Governance_and_Development.pdf.

² See Am. L. Inst., Principles of Corporate Governance: Analysis and Recommendations § 1.27. "Corporation control" refers to the active executive management of the corporation.

³ Id. "Corporation's ownership" refers to its shareholders.

However, the recent high-profile corporate and accounting scandals that have erupted in the U.S., such as Enron, WorldCom, and other companies, have shaken investors' confidences in the U.S. securities markets. These breaches of trust, failures of responsibility, breakdowns in governance, and lack of candid disclosure of directors, officers and corporations seriously undermine the corporate governance structure in the U.S. They also imperil the basic structure of corporate capitalism, which is that investors entrust their assets to management while boards of directors oversee management so that the potential for conflict of interest between owners and managers is minimized.⁴ Since these scandals, there is a renewed attention and reflection to amend the corporate governance regulatory scheme in the U.S.

Facing such financial frauds and trying to restore investors' confidence led Congress to rapidly pass the renowned Sarbanes-Oxley Act of 2002 ("S-O Act")⁵, which was promptly signed by the President.⁶ The S-O Act is one of the most significant federal corporate and securities legislation concerning the U.S. corporate governance structure in recent years. One of the main goals of the S-O Act is to improve investors' confidence in the financial integrity of the public companies in the U.S., which in turn will promote confidence in the markets for these companies' securities. In response to the directive provided by the S-O Act, the Securities and Exchange Commission ("SEC") has undertaken rulemaking in a number of areas. Furthermore, the SEC has requested that the self-regulatory organizations ("SRO") revise and tighten their listing requirements. Hence, the New York Stock Exchange, Inc. ("NYSE") and the National Association of Securities Dealers, Inc ("NASD") through its subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq") filed

⁴ See Peter Jarrett, the United States Corporate Governance: the Market as Monitor, the OECD Observer, No. 203 (1997), available at <http://www1.oecd.org/publications/observer/203/037-039a.pdf>.

⁵ The Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act of 2002), Pub. L. No. 107-204, 116 Stat (2002).

⁶ S-O Act was passed by Congress on July 25, 2002, and signed by the President the following weeks.

with the SEC to amend their listing rules to meet the new requirements of the S-O Act and the SEC rules to decrease the potential for future financial failures.

However, some requirements of the new legislation have already been implemented by public companies before the enactment of new legislation.⁷ For example, most large public corporations now already had a majority of independent directors on the board and had audit committees composed primarily of independent directors.⁸ Enron and WorldCom are no exception. In fact, Enron seems to have a model board in that respect, since only two of its fourteen directors are insiders.⁹ Nevertheless, it is still hypothesized under new legislation that the independence of the board is the best means to minimize the risk of future financial misstatements and accounting frauds. Thus, the independence and oversight function of board of directors is emphasized.

This major regulatory transition of the U.S. corporate governance regulations has already made a great impact on U.S. public companies, which have complained about the increasing costs of complying with the new corporate governance regulations¹⁰ and the greater difficulties in

⁷ See e.g. Statement of the New York Stock Exchange on Audit Committee Policy (Jan. 6, 1977). NYSE added a requirement, approved by the SEC, that as of June 30, 1978 each domestic company listed on the NYSE must establish and maintain "an audit committee comprised solely of directors independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with its exercise of independent judgment as a committee member."

⁸ See Sanjai Bhagat & Bernard Black, The Uncertain Relationship Between Board Composition and Firm Performance, 54 Bus. Law. 921, 922 (1999)

⁹ A number of studies show that firms with a majority of independent directors do not perform any better than firms without such boards, and the firms with only one or two inside directors may actually perform worse. See Bhagat & Black, *supra* note 8, at 923; James P. Walsh & James K. Seward, On the Efficiency of Internal and External Corporate Control Mechanism, 15 Acad. Mgmt. Rev. 421, 434 (1990)

¹⁰ See Deborah Solomon and Cassell Bryan-Low, Companies Complain about Cost of Corporate-Governance Rules, Wall St. J. February 10, 2004, at A1. A survey of 321 companies shows that businesses with more than \$5 billion in revenue expect to spend an average of \$4.7 million each implementing Section 404 of the Sarbanes-Oxley Act of 2002 this year, according to Financial Executives International, which represents top corporate officers. Much of the money is being spent on consultants, lawyers, auditors, and new software.

locating qualified outside directors due to the increased responsibilities and potential liability of directors, more stringent definitions of “independence” and “financial expert”, as well as greater time commitment demanded for directors.¹¹ It also catches significant attention from foreign countries. Since the U.S. is one of the biggest capital markets in the world, not only has its corporate governance system been partly followed by many countries and securities exchanges, but there are also many foreign companies listed on the U.S. national securities exchanges. In this manner, although corporate governance structure is based on different legal systems and historical contexts from country to country,¹² recent amendments of the U.S. corporate governance regulations still have a very significant impact on foreign countries.

Moreover, with globalization, internationalization of securities and finance markets, and the stronger influence of institutional investors nowadays, cross-border investment has been increasing and is more common. Most countries relying on foreign investments and finance would orient their corporate governance system to the international main stream, which now is the U.S. shareholder-centered corporate governance system and to amend their corporate governance legal frameworks. By accommodating the U.S. corporate governance system, it is more favorable for foreign companies to raise capital by cross issuing securities or cross listing on U.S. and their home countries’ securities markets. And by entering into the U.S. securities market, it will also increase the reliability and confidence of both institutional and individual investors. We can find this fact in Taiwan’s latest revision of corporate law in 2001. The

¹¹ See Kemba J. Dunham, Reforms Turn Search for Directors Into a Long, Tedious Task, Wall St. J. August 29, 2002, at B1 (one CEO says a director search that used to take 3 to 8 months now may take 12 to 18 months).

¹² There is a two-tier board structure, which includes board of directors and supervisory board found in some countries, especially when their legal system is transplanted from European continent.

revision is to some extent an accommodation of the U.S. corporate governance system into their legal system.

In the following sections, Part II first talks about the background of corporate governance. Part III indicates the main topic of this thesis, the latest amendment of corporate governance regulatory scheme in the United States, mainly the S-O Act, SEC Rules and the NYSE and Nasdaq listing rules. Part IV presents the latest transition of corporate governance in Taiwan. Part V discusses how the latest development of the regulatory scheme of corporate governance in the United States might impact foreign private issuers listed on the NYSE and Nasdaq. Finally, Part VI is the conclusion of the thesis.

Chapter II

Corporate Governance

The term “corporate governance” first appears to have arisen and entered into prominent usage in the mid-to-late 1970s in the U.S. in the wake of the Watergate scandal, the discovery that major American corporations had engaged in secret political contributions at home and corrupt payments abroad.¹³ There are a wide variety of definitions for the term “corporate governance”. Simply put, “corporate governance” is a framework set by law and regulations of jurisdictions, by stock exchanges, and by companies’ interior charters and by-laws. This framework is a process, not a state, which would continue evolving in its shape and contents over time throughout social and economic developments. Since “corporate governance” is a framework set by laws and regulations of different jurisdictions, it is naturally different from country to country, and owes much to different history and cultural backgrounds of the region. Despite its rather fashionable use in the modern times, a detailed and unified definition of the globally accepted term “corporate governance” does not exist.

There are also different definitions of “corporate governance” in different domains. Economists and social scientists have a broader definition of “corporate governance” as “the institutions that influence how business corporations allocate resources and returns”¹⁴ and “the organizations and rules that affect expectations about the exercise of control of resources in firms.”¹⁵

Legal academics, however, tend to develop a narrower definition of corporate governance.

¹³ See E. Norman Veasey, *The Emergence of Corporate Governance as a New Legal Discipline*, 48 *Bus. L.* 1267 (1993).

¹⁴ See Mary O’Sullivan, *Corporate Governance and Globalization*, 570 *Am. Acad. Pol. & Soc. Sci.* 153, 154 (2000).

¹⁵ World Bank, *World Bank Development Report : Building Institutions for Markets* (2002), at 68, available at <http://www.worldbank.org/wdr/2001/fulltext/fm.pdf>

Corporate governance is defined as a system of rules that determines the control and direction of the corporation and the power allocation among shareholders, directors and officers in order to maximize the shareholder values and stakeholders rewards as well. This definition has been central to public policy discussions about corporate governance in the U.S. and some international organizations.

In sum, “corporate governance” refers to structures and processes by which companies are directed and managed and the accountability of directors and management is thus stressed. It is also meant to solve the principle-agent problems in the case of a company, that is, how the owners (shareholders) as principles can make sure in the lowest cost that their agents (managers) will act in their best interests.

In the U.S., corporate governance issues have been a topic of discussion for the past 40 years. In particular, some U.S. organizations like the Business Roundtable, the Conference Board’s Commission on Public Trust and Private Enterprises, and pension funds like California Public Employees’ Retirement System have adopted their own corporate governance standards or principles to provide companies a model of corporate governance and to assess the potential investment opportunities. Such entities and some international organizations like Organization for Economic Co-operation and Development (“OECD”) and the World Bank have also suggested corporate governance reforms and set up principles and best practices of corporate governance. These entities are calling for changes in corporate board compositions and

structures, especially focusing on the function of independent directors with more effective oversight over management.¹⁶

Even though these principles and recommendations presented by such institutions are not legally binding, they still provide a significant reference for national legislation and regulation, as well as guidance for stock exchanges, investor groups, corporations and other parties to achieve a good corporate governance structure. In fact, the recent corporate governance reforms of the U.S., such as the S-O Act, SEC rules and SROs listing rules have embodied some of the requirements set out in these principles and recommendations.

¹⁶ See CalPERS, Corporate Governance Core Principles & Guidelines (1998), available at <http://www.calpers-governance.org/principles/domestic/us/page01.asp>.

Chapter III

Corporate Governance in the United States

A. Regulatory Scheme

1. State Corporation Law

In the U.S., which has a federal legal system, each state has its own corporation code. Though each state code might have a high degree of similarity, they are not identical. Hence, U.S. corporations are governed and regulated mainly by state corporation law with federal law in a supporting role.¹⁷ Only if the financing of the corporation is in connection with public offering of securities, must the corporation comply with both federal and state laws.¹⁸

Generally, state corporation law is the principal law for corporations, setting regulations from the establishment to the dissolution of a corporation, including interior structures and functions of a corporation, the relationship between shareholders, board of directors, and officers, and their rights, authorities, responsibilities, and duties. In addition, judicial decisions by different state courts have also developed some important legal doctrines governing corporate activities, such as "the business judgment rule" and the "fiduciary duty" of corporate officers and directors to the corporations.

¹⁷ Robert B. Thompson, Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation, 38, *Wake Forest L. Rev.* 961, 961, (2003).

¹⁸ Charles R.T. O'Kelly & Robert B. Thompson, *Corporations and Other Business Associations*, 175 (4th ed. 2003).

Pursuant to the corporation code of Delaware¹⁹ and the Model Business Corporation Act, all corporate power is exercised by or under the direction of the board of directors,²⁰ and shareholders do only three things: vote, sell, or sue.²¹ Theoretically, shareholders can exercise ultimate control over the board and the management through directors' elections and removals. They also can resolve major issues of corporations initiated by the board. While in reality, as shareholders have to act through collective action, individual shareholders, and especially minority shareholders have often been unable to exert their shareholders rights effectively.²²

Given the complexities of a corporation's day-to-day activities and the inefficiency of directors overseeing daily operations of business, officers, as agents of the corporations, exercise the most important corporate powers. Nevertheless, in legal theory they are clearly subordinate to the board of directors and are barely mentioned in most corporate statutes.²³ Hence, in practice, the boards' primary function has turned to be selection, engagement and replacement of officers, namely monitoring management's action.

As stated, U.S. corporations basically are governed by state laws. Regarding the debates of whether corporate governance should be a federal or state function, federal government until now did not choose to pass a federal corporate statute that would have federalized the

¹⁹ Delaware is the home state of about 60 percent of the Fortune 500 companies in the U.S.

²⁰ See, eg., Del. Code Ann. Tit. 8, § 141(a)(1999) (all corporate power to be exercised by or under the direction of the board of directors).

²¹ See Robert B. Thompson, Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue, 62 Law & Contemp. Probs. 215, 216 (2000).

²² With the increasing concentration of the institutional investors' holdings, however, stockholders may be gaining a renewed influence.

²³ The corporation statutes defer almost completely to a corporation's bylaws or board resolutions as to what officers might do, how they are chosen, and how vacancies are filled, except for minimal default provisions.

corporation laws.²⁴ However, with the enactment of the S-O Act and accompanying SEC rules, some might think we are now in a federalism crisis²⁵ and fear significant federal intrusion into the state law area.²⁶ Most of the reason for the fear is because the S-O Act is not like other federal securities laws which mainly address the mandatory disclosure requirements. The S-O Act also addresses the interior structures and function mechanisms of companies, such as audit committees, interior and disclosure controls, and prohibited acts of directors and officers, which are usually the core of the governance system regulated by state laws.

However, there may be some explanation for some states' inactiveness in facing such dramatic regulatory changes both in federal regulations and SROs rules of corporate governance since 2002. One explanation may be that the recent corporate scandals are so specific to the unique characteristics that there is no need to change the state law dramatically.²⁷ Besides, though the S-O Act, the SEC rules, and even the SROs' listing standards may largely influence the U.S. corporate governance structures and bring huge challenges to state laws, they are not dominant and eventually not a replacement of state laws either. State corporation laws will still govern the basic structure of corporate governance and continue to evolve.

2. Federal Regulation

Since the 1930s, federal laws concerning corporate governance are in the supporting status while state laws are in the leading role as stated before. Unlike state laws, federal laws focus mainly

²⁴ Supra note 18, at 197.

²⁵ See William B. Chandler, III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. Pa. L. Rev. (2003).

²⁶ See E. Norman Veasey, *Corporate Governance and Ethics in the Post-Enron Worldcom Environment*, 38 Wake Forest L. Rev. 839, 848. (2003).

²⁷ See Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 Wake Forest L. Rev. 961, 966, (2003).

on the functioning of capital markets, addressing disclosure obligations upon public companies whose securities are offered, sold, or traded in the U.S. securities market. From the late 1970s, the SEC began to set normative standards for corporate governance through its disclosure requirements. It requires disclosures regarding whether issuers have standing audit, nominating or compensation committees. Besides, companies subject to the proxy rule of Section 14 of the Securities Exchange Act of 1934 are required to disclose in the proxy statement when directors are to be elected, (i) if the company has an audit committee, (ii) the names of each audit committee member, (iii) the number of audit committee meetings held, and (iv) the functions performed by the committee. With major federal regulatory changes since 2002, however, federal laws now provide more corporate governance structure norms than ever. Some even say that federal law now occupies the largest part of the legal corporate governance infrastructure in the twenty-first century.²⁸

In short, though there is no fundamental change in the legal principles applicable to the duties and responsibilities of board of directors and officers in the S-O Act,²⁹ it specifies new and broader responsibilities of officers, particularly the chief executive officer (“CEO”) and the chief financial officer (“CFO”) of public companies. For example, these officers must certify financial statements, which are also checked by the company’s internal and disclosure control system to ensure an accurate result.³⁰ Besides the emphasis on officers, the S-O Act also includes provisions specifying the structures and compositions of audit committees and the qualification

²⁸ See Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 *Vand. L. Rev.* 859, 861-62 (2003).

²⁹ The S-O Act does not change the business judgment rule or other fundamental tenets of corporation law applicable to boards of directors and officers. For example, directors can continue to rely on statutory exculpation from personal liability for breaches of the duty of care if it is provided in the charter pursuant to Section 102(b)(7) of the Delaware Corporation Code and other similar statutes in other states.

³⁰ See *supra* note 5, §401(a)(i). This followed SEC action pursuant to its investigatory powers that required top officers of almost 1000 companies to certify their financial results.

and role of independent directors. Moreover, like past federal regulations used a mandatory disclosure system as a traditional mechanism to regulate corporate governance, the S-O Act also takes it as a significant method of regulation.

3. SROs Rule

There were stock exchanges before enactment of state corporation codes and federal securities laws.³¹ Though corporate governance of listed companies was not the central part of securities exchanges' function in their early era, which was to attract and protect investors, it is required that listed companies issue financial statements and earning report periodically in the first place.

In 1998, the NYSE and the NASD sponsored a committee to study the effectiveness of audit committees. This committee became known as the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees ("Blue Ribbon Committee"). In its 1999 report, the Blue Ribbon Committee recognized the importance of audit committees and issued ten recommendations to enhance their effectiveness.³² In response to these recommendations, the NYSE and the NASD as well as other exchanges revised their listing standards, requiring listed firms to have audit committees composed mostly or exclusively of independent directors.³³

In February 2002 in light of several high-profile corporate failures, the SEC's Chairman at that time requested that the NYSE and the NASD, as well as other exchanges, review their listing

³¹ The NYSE traces its origins to 1792. See Stuart Banner, *Anglo-American Securities Regulation, Cultural and Political Roots, 1690-1860*, 250-51 (1998).

³² See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (February 1999). The Blue Ribbon Committee Report is available at www.nyse.com

³³ See Securities Exchange Act Release Nos. 42233 (December 14, 1999), 64 FR 71529 (December 21, 1999) (NYSE); 42231 (December 14, 1999), 64 FR 71523 (December 21, 1999) (NASD); 42232 (December 14, 1999), 64 FR 71518 (December 21, 1999) (American Stock Exchange); and 43941 (February 7, 2001), 66 FR 10545 (February 15, 2001) (Pacific Exchange).

standards with an emphasis on all listing standards concerning corporate governance.³⁴ After reviewing their listing standards about corporate governance, the NYSE and the NASD, through Nasdaq, filed corporate governance reform proposals and amendments with the SEC.³⁵ For example, the NYSE amended Section 303(A) of the NYSE's Listed Company Manual to implement significant changes of corporate governance (NYSE Corporate Governance Proposal). The Nasdaq amended NASD Rule 4200 and 4350(c) and (d) to modify requirements relating to board independence and independent committees (Nasdaq Independent Director Proposal). It also amended NASD Rule 4350(b) to add a requirement for issuers to announce publicly any audit opinions with going concern qualifications (Nasdaq Going Concern Proposal), NASD Rule 4350(h) to require an issuer's audit committee or another independent body of the board of directors to approve related party transactions (Nasdaq Related Party Transactions Proposal), NASD Rule 4350(a) to require foreign issuers to disclose any exemptions they may receive from Nasdaq's corporate governance listing standards (Nasdaq Issuer Applicability Proposal), and NASD Rule 4350(n) to require listed companies to adopt a code of conduct for all directors, officers, and employees (Nasdaq Code of Conduct Proposal). On November 4, 2003, the SEC approved the NYSE and Nasdaq proposals as well as amendments listed above.³⁶

In reality, the NYSE and Nasdaq corporate governance rules are as important, if not more important, as any provisions in the S-O Act and the SEC rules. These new adopted listing rules have made listed companies review and modify their interior corporate governance structures.

³⁴ See SEC Press Release No. 2002-23.

³⁵ See SEC Release File Nos. SR-NYSE-2002-33, SR-NASD-2002-77, SR-NASD-2002-80, SR-NASD-2002-138, SR-NASD-2002-139, SR-NASD-2002-141.

³⁶ See SEC Release No. 34-48745.

B. Summary of New Corporate Governance Requirement

The S-O Act and accompanying corporate governance rules adopted by the SEC, the NYSE, and the Nasdaq have generally imposed new wide-range requirements of corporate governance in the U.S., requiring public companies (or listed companies) to step back and analyze their entire corporate governance structure to meet the newly enacted regulatory requirements.

The following subchapter is not a complete summary of the new legislation but an overview of some major and influential requirements. It is important to note that the S-O Act applies to public companies whose securities are registered under Section 12 of the Securities Exchange Act of 1934, companies required to file reports under Section 15(d) of that Act, or companies that file or have filed registration statements that have not yet become effective under the Securities Act of 1933, which have not yet been withdrawn.³⁷ Whereas, if a public company is also a NYSE or Nasdaq listed company, it also has to observe NYSE or Nasdaq standards.

1. Independent Directors

To strengthen the oversight function of the board, to have a majority of independent directors on the board,³⁸ to tighten and narrow the definition of independent directors,³⁹ and to require the board to affirmatively determine that directors are independent⁴⁰ are the emphases and the most focal points of the new legislation.

³⁷ See Supra note 5, § 2(7).

³⁸ See NYSE rule Section 303A(1); NASD Rule 4350(c)(1).

³⁹ See NYSE rule Section 303A(2)(b); NASD Rule 4200(a)(15).

⁴⁰ See NYSE rule Section 303A(2)(a); NASD Rule 4350(c)(1).

However, the S-O Act does not specifically address the role and authority of independent directors except in the context of the audit committee. There are also different definitions and criteria to “independent directors” in the new legislation.

a. Independence of Majority of Board Members

In the new legislation, the NYSE and the Nasdaq rules require each listed company to have a majority of independent directors on its board, though the S-O Act doesn’t affirmatively require each public company to have a majority of independent directors on its board.⁴¹

b. Definition of Independence

Under Section 301(3)(B) of the S-O Act, every audit committee member must be “independent”. The criteria of “independence” of directors under the S-O Act prohibit directors from accepting a consulting, advisory, or other compensatory fee from the company other than director and committee fees and from being affiliated persons of the company or its subsidiaries.

But for listed companies of national securities exchanges, SEC Rule 10A-3 of the Securities Exchange Act of 1934 (“Rule 10A-3”) provides that it is prohibited for independent directors to “*directly or indirectly*” accept a *compensatory fee* from the company. Unless the securities exchanges rules provide otherwise, however, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed company (provided that such compensation is not contingent in any way on continued service). Nevertheless, Rule 10A-3 also provides that it would not preclude

⁴¹ See NYSE rule Section 303A(1); NASD Rule 4350(c)(1).

independence on the basis of ordinary course commercial business relationships between the company and an entity with which a director had a relationship.

As for NYSE and Nasdaq rules, they emphasize both corporate self-governance and disclosure with respect to the independence of directors. The boards should first affirmatively determine that the independent director has no material relationship with the company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company) and then disclose the basis for such determination of independence in its annual proxy statement or in the annual report on Form 10-K filed with SEC.

In order to provide clarity to investors and listed companies and to facilitate uniform application of the rules, NYSE rule Section 303A(2)(b) and NASD Rule 4200(a)(15) respectively set up a bright line test to determine “independence” of the directors, such as the relationship of employment, receiving in excess of amount of compensation or payment from the company. However, to be more flexibly applied, some suggest that it should be designed as a rebuttable presumption, rather than a bright line rule.⁴²

Since the concern of “independence” is to be separated from management, the S-O Act, NYSE, and Nasdaq rules do not disqualify independent directors from stock ownership of even a significant amount of stock.⁴³ However, none of them explicitly recognize or encourage stock ownership by independent directors. Nevertheless various non-government entities have called

⁴² See Letter from Charles M. Nathan, Committee on Securities Regulation of the Association of the Bar of the City of New York, to Secretary, the SEC, dated April 25, 2003.

⁴³ See commentary to NYSE rule Section 303A(2)(a) and NASD Rule 4200 Interpretive Materials

for further governance reforms of the recognition of the importance of stock ownership of independent directors as an incentive to exercise their objectivity.⁴⁴

c. Separate Meetings of Non-management Directors

In order to improve the independence and objectivity of the board, NYSE and Nasdaq rules require the non-management directors to meet at regularly scheduled executive sessions without management.⁴⁵ However, this may create some problems. First, without critical information available to management, decisions made by the non-management directors may not be informed decisions and could be harmful to the company or not in its best interests, thus raising liability issues.⁴⁶ Besides, what is the difference and relationship between non-management director meetings and the meetings of audit and other committees? Once non-management directors make a resolution or recommendation and submit it to the boards, is there any restriction to the boards to accept the resolution made by the non-management directors?

2. Audit Committee

Even though some empirical studies have shown that the presence of an audit committee does not effectively affect and prevent the likelihood of accounting fraud,⁴⁷ one of the most significant aspects of the S-O Act is requirement of an audit committee comprised of only independent directors and the expansion of the functions and responsibilities of the audit committee. However, it is not mandatory under the S-O Act to require each public company to establish an

⁴⁴ See Charles M. Elson and Christopher J. Gyves, The Enron Failure and Corporate Governance Reform, 38 Wake Forest L. Rev. 855, 881, (2003).

⁴⁵ See Commentary to NYSE rule Section 303A(3); NASD Rule 4350(c)(2).

⁴⁶ See Letter from Charlotte M. Bahin, Senior Vice President, Regulatory Affairs, America's Community Bankers, to Jonathan G. Katz, Secretary, Commission, dated May 8, 2003.

⁴⁷ See Mark S. Beasley, An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud, 71 Acct. Rev. 443 (October 1996).

audit committee of the board. Under Section 2(a)(3) of the S-O Act, if no audit committee exists in the company, the entire board would be deemed as the audit committee.

However, with respect to listed companies, it is mandatory to set up an audit committee of the board. Section 301 of the S-O Act explicitly provides that the SEC should direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not have an audit committee composed solely of independent directors. In words, securities exchanges would de-list companies, which do not satisfy the S-O Act's audit committee requirements.

Under the new legislation, the audit committee would be given new responsibilities and duties, including actively involvement in the accounting decision-making and processes, appointment and oversight of the outside auditors, and approval of both audit and non-audit services provided by outside auditors. At the same time, the committee would be given additional resources, like funding from companies to access outside counsels. The following discusses the composition, qualification, responsibilities and duties of an audit committee and its members under the new legislation.

a. Composition

i. Minimum number of members

Pursuant to NYSE rule Section 303A(6) and (7) and NASD Rule 4350(d), each listed company must have a minimum three-person audit committee, composed entirely of independent directors.

ii. Audit Committee Charter

NYSE rule Section 303A(7)(c) and NASD Rule 4350(d) also require that each audit committee have a written audit committee charter that addresses the committee's purpose and an annual performance evaluation of the audit committee. The duties and responsibilities of the audit committee at minimum must include those set out in Rule 10A-3(b)(2), (3), (4), and (5), and other requirements set forth in NYSE or Nasdaq rules.⁴⁸

iii. Separate Meetings

In order to help perform oversight functions of the audit committee more effectively, NYSE rule Section 303A(7)(c)(iii)(E) requires the audit committee to meet separately and periodically with management, with internal auditors and with independent auditors.

b. Qualification of Membership

i. Independent Director

Under Section 301 of the S-O Act and Rule 10A-3(b)(1)(i), all members of audit committees must be independent directors. In addition, NYSE rule Section 303A(7)(b) and NASD Rule 4350(d)(2) also require listed companies to have an audit committee with members that satisfy the requirements of independence stipulated in Rule 10A-3 and their own listing standards.

ii. Financial Literacy and Financial Expert

NYSE rule Section 303A(7)(a) and NASD Rule 4350(d)(2) require that each member of the audit committees of listed companies must be financial literate, as interpreted by the company's board in its business judgment, or must become financial literate within a reasonable period of time after his or her appointment to the audit committee. NASD Rule 4350(d)(2) further provides that "financial literate" includes being "able to read and understand fundamental

⁴⁸ See NYSE rule Section 303A(7)(c); NASD Rule 4350(d).

financial statements, including a company's balance sheet, income statement, and cash flow statement.”

With respect to a financial expert, neither the S-O Act nor the SEC rules compulsorily require members of audit committees to be financial experts. However, Section 407 of the S-O Act requires companies to disclose in their annual reports, whether, or if not the reasons therefore, the audit committee is comprised of at least one member, who is a financial expert as defined in the S-O Act and the SEC rules.⁴⁹ The SEC rules further require the companies to disclose the name of the audit committee financial expert and affirm that the expert is independent of management, as determined by the company's board of directors, or provide why the expert is not independent.⁵⁰

While under NYSE and Nasdaq rules, it is mandatory to have at least one financial expert on the audit committee. Under commentary to NYSE rule Section 303A(7)(a), a financial expert has accounting or related financial management expertise, as the board interprets such qualification in its business judgment. Under NASD Rule 4350(d)(2)(a), a financial expert has past employment experience in finance or accounting, the requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO, CFO, or other senior officer with financial oversight responsibilities.

⁴⁹ See Supra note 5, §407, to qualify as a financial expert “the Commission shall consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer” sufficient experience. See also SEC Release Nos. 33-8177; 34-47235.

⁵⁰ See SEC Release NOS. 33-8177; 34-47235.

iii. Dedication

Recognizing that time and effort commitment would be necessary for an effective audit committee member's satisfaction of the demanding role and responsibilities, the commentary to NYSE rule Section 303A(7) requires that each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting the job. Besides, if an audit committee member simultaneously serves on the audit committee of more than three public companies and the listed company doesn't limit the number of audit committees on which its audit committee member serves, then each board would be required to determine that such simultaneous service would not impair the ability of the member to serve effectively on the listed company's audit committee. Such determination must be disclosed in the company's annual proxy statement or in the company's annual report filed with the SEC, if the company does not file annual proxy statement.

c. Responsibility

i. Oversight of Outside Auditors

Under Section 301 of the S-O Act and Rule 10A-3(b)(2), the audit committee is directly in charge of the appointment, compensation, retention and oversight of the work of outside auditors, including resolution of disagreements between management and the auditor regarding financial reporting. To carry out the responsibility of monitoring outside auditors, Section 204 of the S-O Act and Rule 10A-3(b)(2) provide that outside auditors shall timely report directly to the audit committee about all critical accounting policies and practices to be used, all alternative treatments of financial information within generally accepted accounting principles ("GAAP") that the auditor has discussed with the management officers of the company, the ramifications

and the auditor's preferred alternative, and any other material written communication between the auditors and management officers of the company.

And to ensure the independence and objectivity of the outside auditors, Section 201(a) and Section 202 of the S-O Act also provide that the audit committee must pre-approve both audit and permissible non-audit services provided by the outside auditors in advance. In practicing, the SEC suggests that audit committees may establish policies and procedures for pre-approval provided they are consistent with the S-O Act, detailed as to the particular service, and designed to safeguard the continued independence of the outside auditors.⁵¹ It is important to notice that some non-audit services are now specifically prohibited under Section 201(a) of the S-O Act.⁵² But for other permitted non-audit service, like tax services, unless they are qualified under the De-minimus exceptions provided in Section 202, the services must be pre-approved by the audit committee and be disclosed to the shareholders in periodic reports. Besides, disclosure is required by the SEC rules to investors of information related to audit and non-audit services provided by, and fees paid to, the auditor in the companies' proxy statement or annual reports.⁵³

In addition to the responsibilities and duties of audit committees with respect to the outside auditors stated above, NYSE rule Section 303A(7)(c)(iii) also requires audit committees to discuss the annual and quarterly financial statements with the outside auditors, periodically meet

⁵¹ See SEC Release NO. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103, FR-68.

⁵² The S-O Act creates the Public Company Accounting Oversight Board (PCAOB) to oversee the auditing of public companies. Each public accounting firm must register with the PCABO, and according to the S-O Act Section 201(a), registered public accounting firms will be prohibited from performing certain services to clients, including: bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind report; actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; and legal services and expert services unrelated to the audit.

⁵³ Supra note 51.

separately with them, and review with them any audit problems or difficulties and management's response, to make the audit committees better understand the financial situation of the company,.

ii. Establishment of Internal Procedure for Oversight

Under the new legislation, the audit committee has a duty to establish internal procedures to oversee the corporation's financial compliance situation. According to Section 301 of the S-O Act and Rule 10A-3(b)(3), the audit committee must establish procedures for two purposes, one of which is for receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters, and the other is for the confidential, anonymous submission by employees of the company of concerns regarding questionable accounting or auditing matters.

iii. Other Responsibilities

In addition to the responsibilities of an audit committee stated above, under NYSE rule Section 303A(7)(c)(iii), the audit committee's responsibilities also include discussing the company's earnings press releases, as well as financial information and earnings guidance to analysts and rating agencies, discussing policies with respect to risk assessment and risk management, and reporting regularly to the board of directors.

d. Engagement of Outside Counsels

In order to enhance the efficient oversight function of the audit committee, the audit committee has the authority under Section 301 of the S-O Act to engage independent counsels and other advisors as it determines necessary to carry out its duties. Such costs to hire counsels or advisors

will be funded by the company. In this way, the audit committee may obtain adequate and correct information to make informed decisions without entirely relying on the unilateral information provided by officers or inside directors of the company. On the other hand, independent directors are able to rely on the advice of outside advisors in order to exercise their business judgment in a manner that they reasonably believe to be in the best interests of the company and the shareholders. Thus, the right to retain outside advisors by the audit committee can also help establish a reasonable basis for reliance of members of audit committees as well as help members carry out their duties.

3. Nominating/Corporate Governance Committee

The S-O Act does not require public companies to establish or address the role or composition of any other committees of the board other than audit committees. However, NYSE rule Section 303A(4) requires that companies *must* have a nominating/corporate governance committee composed entirely of independent directors. It also requires such committee to have a written charter that addresses the committee's purpose and responsibilities and an annual performance evaluation of the nominating/corporate governance committee.

NYSE rule Section 303A(4) further provides that the nominating/corporate governance committee would be required to identify individuals qualified to become board members, consistent with the criteria approved by the board, and to select or to recommend that the board select the director nominees for the next annual meeting of shareholders. However, if the right to

nominate a director legally belongs to a third party by contract or otherwise, the nominating committee's selection and recommendation are not required.⁵⁴

Under NASD Rule 4350(c)(4), it is not mandatory for Nasdaq listed companies to set up a nominations committee of the board. However, if set up, the nominations committee must be comprised solely of independent directors. The rule requires that the director nominees either be selected or recommended for the board's selection either by the majority of independent directors or by a nomination committee comprised solely of independent directors under NASD Rule 4350 (c).

4. Compensation Committee

In addition to the mandatory requirement of the establishment of nominating/corporate governance committees in listed companies, NYSE rule Section 303A(4) also requires that companies *must* have compensation committees composed entirely of independent directors directly in charge determining compensation of the CEO, making recommendations to the board with respect to non-CEO compensation, incentive-compensation plans and equity-based plans, and reviewing as well as approving corporate goals and objectives. Like the nominating/corporate governance committee, it also requires the compensation committee to have a written charter that addresses the committee's purpose and responsibilities and an annual performance evaluation of the compensation committee.⁵⁵ Besides, the compensation committee

⁵⁴ See commentary to NYSE rule Section 303A(4).

⁵⁵ See NYSE 303A(5)(b).

would also be required to produce a compensation committee report on executive compensation and disclose it in the company's annual proxy statement or annual report filed with the SEC.⁵⁶

However, the compensation committee does not have the sole authority to determine the compensation of a CEO under the NYSE rule. Either as a compensation committee or together with other independent directors (as directed by the boards), the committee would determine and approve the CEO's compensation level based on the committee's evaluation of the CEO's performance.⁵⁷ Besides, the compensation committee may retain an outside consulting firm to assist in the evaluation of director, CEO or senior executive compensation. Whereas the compensation committee should have sole authority to retain, approve of fees and other retention terms, and terminate the consulting firm.⁵⁸

Unlike the NYSE rule, the NASD Rule 4350(c)(3) does not compulsorily require a compensation committee of the boards. However, if set up, the compensation committee must be comprised solely of independent directors. And as for the decision of compensation of the CEO, it requires that companies have CEO compensation determined by either a compensation committee or by a majority of independent directors.

5. Responsibilities of Executives Officers and Directors

a. CEO and CFO Certifications

The new legislation focuses heavily on the responsibility of officers, especially the CEO and CFO to take full responsibility for their companies' compliance with disclosure requirements and

⁵⁶ See NYSE rule Section 303A(5)(b).

⁵⁷ See NYSE rule Section 303A(5)(b)(i)(A).

⁵⁸ See commentary to NYSE rule Section 303A(5).

the truth and integrity of financial statements. The requirement of CEO/CFO certification may enhance companies to engage in better due diligence about their financial statements. The certification requirements of CEO and CFO under the S-O Act and the NYSE rule are as follows.

i. S-O Act Certification

There are two separate CEO/CFO certification requirements under the S-O Act, which are Section 906 and Section 302. To distinguish certification under Section 906 and Section 302, first, it is important to address that certification under Section 906 would be deemed to be “furnished” rather than “filed” to the SEC, while certification under Section 302 would be deemed to be “filed” to the SEC.⁵⁹ This distinction matters mainly because it would direct whether the certification would be subject to civil liability under Section 18 of the Securities Exchange Act of 1934 as a misleading statement, or it would be automatically incorporated by reference into an issuer’s registration statements, which is subject to civil liability under Section 11 of the Securities Act of 1933.

The certification under Section 906 requires that the CEO and CFO certify, as to each periodic report containing financial statements, such as annual and quarterly reports that the reports fully comply with securities regulations and the information contained fairly presents in all material respects, the financial conditions and results of operations of the company. Failure to furnish the Section 906 certification would make the periodic reports incomplete in violation of Section 13(a) of the Securities Exchange Act of 1934. Besides, false certifications may also result in significant criminal penalties.

⁵⁹ SEC Release Nos. 33-8124, 34-46427, IC-25722.

The certification under Section 302 is more extensive than the certification under Section 906. Following this Section 302 certification requirement, the SEC adopted Rule 13a-14 and Rule 15d-14 of the Securities Exchange Act of 1934, developing the term "disclosure controls and procedures"⁶⁰ to make it explicit that the "internal controls"⁶¹ contemplated by Section 302(a)(4) of the S-O Act are intended to embody controls and procedures addressing the quality and timeliness of disclosure. The SEC also included this definition to differentiate the concept of "disclosure controls and procedures" from the pre-existing concept of "internal controls" that pertains to an issuer's financial reporting and control of its assets, as currently embodied in Section 13(b) of the Exchange Act and as addressed in Sections 302(a)(5) and (a)(6) and Section 404 of the S-O Act.

With respect to the establishment and maintenance of internal controls under Section 302(a)(4) and (5) of the S-O Act, the CEO and the CFO must certify that they have designed the internal controls to ensure that material information is made known to them, have evaluated the effectiveness of the internal controls as of a date within 90 days prior to the report, and have presented in the periodic report their conclusions about the effectiveness of the internal controls. They also have to certify that they have disclosed to the auditors and audit committees all

⁶⁰ "Disclosure controls and procedures" is a newly-defined term under newly adopted Rule 13a-14 and Rule 15d-14 of the Securities Exchange Act of 1934, reflecting the concept of controls and procedures related to disclosure embodied in Section 302(a)(4) of the S-O Act. For the purpose of the new rules, "disclosure controls and procedures" is defined as controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports filed or submitted by it under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. "Disclosure controls and procedures" include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in its Exchange Act reports is accumulated and communicated to the issuer's management, including its CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

⁶¹ "Internal controls" is a pre-existing term relating to internal controls regarding financial reporting. See American Institute of Certified Public Accountants ("AICPA") Codification of Statements on Auditing Standards, AU §319.

significant deficiencies and material weakness in internal controls and any fraud whether or not material that involves management or other employees who have a significant role in the internal controls, and have indicated in the periodic reports whether or not there were significant changes in internal controls, including any corrective action with regard to significant deficiencies and material weaknesses.

Besides, under Section 302(a)(1), (2), and (3), each CEO and CFO must certify in each annual or quarterly report filed or submitted to the SEC that they have reviewed the report, that to their knowledge the report does not contain any untrue statement of a material fact, and that the financial information in the report fairly presents in all materials respect the financial conditions and results of operations of the company.

False certifications under Section 302 not only might give rise to liability under Section 11 and Section 12(a)(2) of the Securities Act of 1933, if the periodic report is incorporated by reference into a registration statement on Form S-3 or Form F-3 or into a prospectus filed pursuant to Rule 424(b), false certifications might also be subject to SEC action for violation of Section 13(a) or (15)(d) of the Securities Exchange Act of 1934 and both the SEC and private action for violating Section 10(b) and Rule 10(b)(5) of the Securities Exchange Act of 1934. According to the S-O Act, false certifications might also result in significant criminal penalties.

ii. NYSE Certification and Notification

According to NYSE rule Section 303A(12)(a), each listed company CEO must certify to the NYSE annually that he or she is not aware of any violation by the company of NYSE corporate

governance listing standards. This certification would be required to be disclosed in the listed company's annual report to the shareholders or filed with the SEC. In addition, NYSE rule Section 303A(12)(b) also requires that the CEO promptly notify the NYSE in writing after any executive officer of the listed company becomes aware of any material non-compliance with any applicable provisions of this Section 303A.

The effect of the CEO and the CFO certifications under the S-O Act and the NYSE rules is that the due diligence burden would be shared by key executives who report to the certifying officers and, in large companies, to even lower levels of executives. In fact, the SEC strongly recommended that, corporations each create a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. Such a committee would report to senior management, including the CEO and the CFO, who bear express responsibility for designing, establishing, maintaining, reviewing and evaluating the issuer's disclosure controls and procedures.⁶² Officers and employees of corporations who have an interest in, and the expertise to serve on, the committee could include the principal accounting officer (or the controller), the general counsel or other senior legal official with responsibility for disclosure matters who reports to the general counsel, the principal risk management officer, the chief investor relations officer (or an officer with equivalent responsibilities) and such other officers or employees, including individuals associated with the corporation's business units, as the corporation deems appropriate. The setup and operation of this committee might increase the effectiveness of internal controls.

b. Forfeiture of CEO/CFO Bonuses and Profits

⁶² See SEC Release NOS. 33-8124, 34-46427, IC-25722.

Under Section 304(a) of the S-O Act, if the company is required to restate its financial statements due to material noncompliance with the securities laws as a result of misconduct, the CEO and the CFO must reimburse the company for any bonus or incentive or equity-based compensation received during the 12 months following the first public issuance or the filing with the SEC of the flawed report, as well as any profits on sales of company securities during that period. However, the SEC may exempt any person from application of the section as it deems necessary and appropriate under Section 304(b) of the S-O Act.

Though it provides for the forfeiture of CEO and the CFO bonuses and profits, there is no requirement under the S-O Act that the misconduct in question be that of the CEO or the CFO. Hence, on the one hand, this provision may reinforce the oversight responsibilities of the CEO and the CFO to the subordinate officers in the company. On the other hand, this provision seems too burdensome for the CEO and the CFO given the near impossibility of monitoring the conduct of each employee to ensure the truthfulness and completeness of the financial statement despite the applicable exemptions by the SEC.

c. Loan Prohibition

One of the important provisions in the S-O Act about directors and officers is the prohibition of corporate loans to directors and officers. It is a provision that was for many years part of state corporate law, but which has been entirely deleted by the Model Business Corporation Act in the 1988 revision. But the S-O Act has now brought it back.⁶³

⁶³ See *supra* note 5, §402; 1 Model Bus. Corp. Act Ann. § 47, at 950-53 (2d ed. 1971) (describing the 1969 Model Act and earlier state law); 2 Model Bus. Corp. Act Ann., §8.60, at 8-396 (3d ed. Supp. 2002) (describing thirty-four jurisdictions that continue to prohibit loans to directors and/or officers or allow them in limited circumstances).

According to Section 402 of the S-O Act, companies are prohibited from directly or indirectly, including through any subsidiary, extending or maintaining credit, arranging for the extension of credit, or renewing the extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of the corporation. This requirement essentially eliminates all personal loans to directors and officers. Numerous questions arise accompanying the application to this provision, since this prohibition of personal loans might include various transactions which are now going on, such as the cashless exercise of stock options, split dollar life insurance, advances of director and officer indemnification expenses pursuant to charter, bylaw or contractual provisions, travel advances, personal use of company credit cards, relocation payments, deferred compensation, leveraged co-investments, loans from 401(k) plans, and forgiveness of grandfathered loans.⁶⁴

However, under Section 402(a) of the S-O Act, there are some exceptions to such prohibition of personal loans. For example, Section 402(a) does not exclude any home improvement and manufactured home loans, consumer credit under an open end credit plan, or a charge card or any extension of credit by a broker or dealer registered under Section 15 of the Securities Exchange Act of 1934 to an employee of that broker to buy, trade, or carry securities that is permitted under the rules or regulations of the Board of Governors of Federal Reserve System pursuant to Section 7 of the Securities Exchange Act of 1934 that is: (i) made or provided in the ordinary course of the consumer credit business of such issuer; (ii) of a type that is generally made available by such issuer to the public; (iii) made by such issuer by market terms, or terms

⁶⁴ Robert C. Schwenkel, *The Post-Enron Corporate Governance Environment: Where Are We Now*, 1377 *PLI/ Corp* 11, 116 (2003).

that are no more favorable than those offered by the issuer to the general public for such extension of credit.

d. Temporarily Freeze Authority

Section 1103 of the S-O Act gives the SEC the authority to petition a federal district court for a temporary order to freeze payments (whether compensation or otherwise) to directors, officers, partners, controlling persons, agents or employees of a company that appear to be “extraordinary” if there is an ongoing lawful investigation involving possible violation of the federal securities laws by the company or those persons. The temporary order will require the company to escrow, subject to court supervision, those payments in an interest-bearing account for 45 days.

6. Financial Disclosure

a. Financial Reports

Section 401(a) of the S-O Act requires each financial report, which contains financial statements and that is required to be prepared in accordance with (or reconciled to) GAAP and filed with the SEC reflect all material correcting adjustments identified by outside independent auditors.

b. Off-Balance Sheet Transactions

Section 401(a) of the S-O Act requires companies to disclose in their annual and quarterly reports all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the companies with unconsolidated entities or other persons that may have a material current or future effect on the financial condition, changes

in the financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenue or expenses.

And the SEC, pursuant to Section 401, adopted amendments to the rules⁶⁵ with respect to disclosure of off-balance sheet arrangements in a separately cautioned subsection of the Management's Discussion and Analysis ("MD&A") section of SEC filings.⁶⁶ In sum, companies must include in the MD&A a discussion of off-balance sheet arrangements⁶⁷ that have or are reasonably likely to have a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

In addition, the SEC rule also requires disclosure of contractual obligations in tabular format in the MD&A to disclose (i) long-term obligations, (ii) capital leased obligations, (iii) operating

⁶⁵ The SEC adopted amendments to Item 303 of Regulation S-K, Item 303 of Regulation S-B, Item 5 of Form 20-F and General Instruction B of Form 40-F under the Securities Exchange Act of 1934.

⁶⁶ See SEC Release Nos. 33-8182; 34-47264; FR-67 International Series Release No. 1266 File No. S7-42-02.

⁶⁷ The definition of "off-balance sheet arrangement" primarily targets the means through which companies typically structure off-balance sheet transactions or otherwise incur risks of loss that are not fully transparent to investors. For example, in many cases, in order to facilitate a transfer of assets or otherwise finance the activities of an unconsolidated entity, a company must provide financial support designed to reduce risks to the entity or other third parties. That financial support may assume many different forms, such as financial guarantees, subordinated retained interests, keepwell agreements, derivative instruments or other contingent arrangements that expose the registrant to continuing risks or material contingent liabilities. To appropriately capture these transactions, the definition of "off-balance sheet arrangement" includes any contractual arrangement to which an unconsolidated entity is a party, under which the registrant has: (i) any obligation under certain guarantee contracts; (ii) a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets; (iii) any obligation under certain derivative instruments; and (iv) any obligation under a material variable interest held by the registrant in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the registrant, or engages in leasing, hedging or research and development services with the registrant. See SEC Rule Release Nos. 33-8182; 34-47264; FR-67; International Series Release No. 1266.

lease obligations, (iv) purchase obligations, and (v) other long-term debt liabilities reflected on the company's balance sheet under GAAP. Such table of contractual obligations must be included in registration statements, annual reports, and proxy or information statements that are required to include financial statements.

c. Pro Forma Financial Information

Section 401(b) of the S-O Act requires that pro forma financial information included in the reports filed with the SEC or in any public disclosure or press or other release be presented so as not to contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the pro forma financial information not misleading. In addition, pro form financial information must be reconciled with the financial condition and results of operations of the company under GAAP.

d. Non-GAAP Financial Measure Disclosure

Pursuant to Section 401 (b) of the S-O Act, the SEC adopted new disclosure regulation "Regulation G" amendments to Item 10 of Regulation S-K and Item 10 of Regulation S-B, and Forms 8-K and 20-F of the Securities Exchange Act of 1934 to regulate the use of "non-GAAP financial measures," "adjusted" data, or earnings before "non-recurring charges."⁶⁸

Regulation G requires the company to disclose together with any non-GAAP financial measure, (i) a presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP and (ii) a reconciliation (by schedule or other clearly understandable method), which must be quantitative for historic non-GAAP measures and quantitative, to the

⁶⁸ See SEC Release No. 33-8176; 34-47226; FR-65; FILE NO. S7-43-02.

extent available without unreasonable efforts for the forward-looking information, of the difference between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP. If the reconciliation to the most directly comparable financial measure calculated and presented according to GAAP is not available for the forward-looking non-GAAP financial measure, the company must disclose that fact, explain why it is not available on a forward-looking basis, and provide any reconciling information that is available without an unreasonable effort. The company must identify any information that is unavailable and disclose its probable significance.

Regulation G also provides that a non-GAAP financial measure, taken together with the accompanying information, may not contain an untrue statement of a material fact or omit to state a material fact necessary to make the presentation of the non-GAAP financial measure not misleading, in light of the circumstances under which it is presented.

In addition, the SEC adopted amendments to Item 10 of Regulation S-K and Item 10 of Regulation S-B to provide additional guidance to those registrants that include non-GAAP financial measures in their SEC filings. The SEC also adopted amendments to Form 20-F to incorporate into that form the amendments to Item 10 of Regulation S-K. It adopted amendments to Form 8-K that require registrants to furnish earnings releases or similar announcements to the SEC.

7. Insider Trading

a. Accelerated Disclosure of Insider Trades

Section 403(a) of the S-O Act amended Section 16 of the Securities Exchange Act of 1934 providing that insider⁶⁹ trades, including any change in the ownership of securities or purchase or sale of a security-based swap agreement involving such equity security must be filed with the SEC and Securities Exchanges (if it is a listed company) within two business days. Such statements filed with the SEC must also be made electronically and disclosed on both the SEC website and the company website by the end of business day following the disclosure filing.

Pursuant to Section 403(a) of the S-O Act, the SEC adopted amendments to Rules 16a-3, 16a-6, and 16a-8, and Forms 3, 4 and 5 under the Securities Exchange Act of 1934 to implement the accelerated filing deadline applicable to the change of beneficial ownership reports required to be filed by insiders under the new legislation.

b. Prohibition of Insider Trading During Blackout Period

Section 306 of the S-O Act and new Regulation BTU (Blackout Trading Restriction) under the Securities Exchange Act of 1934 adopted by the SEC⁷⁰, ban any director or executive officer from directly or indirectly purchasing or selling or otherwise acquiring or transferring any equity security during a “blackout period” that temporarily prevents plan participants or beneficiaries from engaging in equity securities transactions through their plan accounts with respect to such security, if such director or officer acquire such equity security in connection with his or her service or employment as a director or executive officer.

⁶⁹ Insiders refer to directors, officers, and shareholders who are directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security (other than an exempted security), which is registered pursuant to Section 12 of the Securities Exchange Act of 1934.

⁷⁰ See SEC Release NO. 34-47225; IC-25909; File No. S7-44-02.

The trading prohibition only applies during a “blackout period,” which is defined for U.S. companies as any period exceeding three consecutive business days during which transactions in equity securities of such companies are temporarily suspended. Under Regulation BTU, the prohibition on insider trading during blackout periods would not apply to a blackout period that affects a plan maintained outside the U.S. primarily for the benefit of persons located outside the U.S., as such plans are not considered “individual account plans.” In addition, Regulation BTU does not apply to employee benefit plans that have been approved by a foreign taxing authority or are eligible for preferential treatment under foreign tax laws.

8. Internal Control Report

Section 404 of the S-O Act requires the SEC to adopt rules requiring each annual report to contain an internal control report, which states the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and contains an assessment of the effectiveness of the internal control structure and procedures for financial reporting. Accordingly to the SEC revised rules,⁷¹ each annual report must include a report from management on the company’s internal control over financial reporting. The internal control report must contain (i) a statement of management’s responsibilities for establishing and maintaining adequate internal controls over financial reporting for the company, (ii) management’s assessment of the effectiveness of these internal controls over financial reporting as of the end of the most recent fiscal year, (iii) a statement identifying the framework used by management to evaluate the effectiveness of the company’s internal control, and (iv) a statement that the company’s outside auditors who issued the audit report have attested to, and reported on, management’s internal controls evaluation. Such attestation report by the outside auditors

⁷¹ See SEC Release Nos. 33-8238; 34-47986; IC-26068

should be filed as part of the annual report. Furthermore, it is required that management evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

9. Corporate Governance Guideline

Under NYSE rule Section 303A(9), each listed company must adopt and disclose corporate governance guidelines. Each listed company's website would be required to include its corporate governance guidelines and the charters of its most important committees. Each company's annual report on Form 10-K filed with the SEC would be required to state that the foregoing information is available on its website.

The following topics would be required to be addressed in corporate governance guidelines: director qualification standards; director responsibilities; director access to management and, as necessary and appropriate, independent advisors; director compensation; director orientation and continuing education; management succession; and an annual performance evaluation of the board.

10. Code of Ethics and Compliance

Section 406 of the S-O Act requires companies to disclose in their periodic reports whether they have adopted a written code of ethics applicable to their senior financial officers, their CFO and comptroller or principal accounting officer, or people performing similar functions (and if not, state the reason).

In addition to requiring the disclosure mandated in Section 406, the SEC amended the rules to require disclosure as to whether the company has a code of ethics that applies to its CEO.⁷² Under the SEC rules amendments, a company has to disclose whether it has adopted a code of ethics that applies to the company's CEO, CFO, principal accounting officer or controller, or persons performing similar functions in its annual report. A company disclosing that it has not adopted such a code must disclose this fact and explain why it has not done so. The SEC rules specifically indicate that companies may have separate codes of ethics for different types of officers, directors, and employees.

The code of ethics must include standards reasonably designed to deter wrongdoing and necessary to promote: (i) honest and ethical conduct, including the handling of actual or apparent conflicts of interest between personal and professional relationships, (ii) full, fair, accurate, timely and understandable disclosure in reports and documents that the company files with, or submits to, the SEC and in other public communications made by the company, (iii) compliance with applicable governmental laws, rules, and regulations. (iv) prompt internal reporting of code violation to “an appropriate person or persons” identified in the code, and (v) accountability of adherence to the code.

Under the SEC rules, companies can choose between three alternative methods of making their ethics codes publicly available. First, a company may file a copy of its code of ethics as an exhibit to its annual report. Alternatively, it may post the text of its code of ethics, or relevant portion thereof, on its Internet website, provided however, that a company choosing this option also must disclose its Internet address and intention to provide disclosure in its annual report. As

⁷² See SEC Release NOS. 33-8177; 34-47235.

another alternative, it may provide an undertaking in its annual report on one of these forms to provide a copy of its code of ethics to any person without charge upon request.

In addition, the company is required to make “immediate disclosure” on Form 8-K or via Internet dissemination (only if it previously disclosed its website address and its intention in its most recently filed annual report) of any change to, or waiver from, the company's code of ethics for its senior financial officers within five business days after it amends its ethics code or grants a waiver.

In addition, this code of ethics can form part of a broader code of ethics that complies with the NYSE rule of “code of business conduct and ethics” and the Nasdaq rule of “code of conduct.” NYSE rule Section 303A(10) requires each listed company to adopt and disclose a code of business conduct and ethics for directors, officers and employees and promptly disclose any waivers of the code for directors or executive officers. It is important to notice that the waivers of the code for executive officers or directors could only be made by the board or a board committee.⁷³ The code of business conduct and ethics would need to be available on the company's website and the availability of the code on the website would be required to be referenced in the company's annual report filed with the SEC.

NASD Rule 4350(n) requires each listed company to adopt a code of conduct applicable to all directors, officers, and employees. The code of conduct must be publicly available and comply with the definition of “code of ethics” set forth in Section 406(c) of the S-O Act and the SEC

⁷³ See Commentary to NYSE rule Section 303A(10)

rule. Any waiver of the code for directors or executive officers must be approved by the board and disclosed in a Form 8-K within five days.

11. Approval of Related Party Transactions

To protect the interests of shareholders, NASD Rule 4350(h) requires that each Nasdaq listed company conduct an appropriate review of all related party transactions⁷⁴ for potential conflict of interest situations on an ongoing basis. All such transactions would have to be approved by the listed company's audit committee or another independent body of the board.

12. Shareholder Approval of Equity Compensation Plan

NASD Rule 4350(i) requires shareholder approval of most equity compensation plans, which now currently do not require shareholder approval. It requires shareholder approval when a stock option or purchase plan is to be established or materially amended or other arrangement made pursuant to which options or stock may be acquired by officers, directors, employees or consultants, other than warrants or rights issued generally to all security holders of the company or stock purchase plans available on equal terms to all security holders as well as shareholder approval for tax qualified, non-discriminatory employee benefits plans or parallel nonqualified plans and plans or arrangements relating to an acquisition or merger, or inducement grant. It is important to notice that parallel nonqualified plans and inducement grants still have to be approved either by the compensation committee or by a majority of the company's independent directors. Though this requirement of approval of compensation plan by shareholders could

⁷⁴ For the purpose of this rule, "related party transaction" would refer to transactions required to be disclosed pursuant to the SEC Regulation S-K, Item 404.

prevent detriment to shareholders, it would result in an increase in companies' proxy solicitation costs.

Chapter IV

The Convergence and the Transition of Corporate Governance Structure in Taiwan

A. Convergence of Corporate Governance Systems

As stated, there is not just one globally suitable corporate governance model. Adversely, every jurisdiction would develop its own structure based on its country's cultural, social, economic, and legal environment. Corporate governance systems of the U.S. and some other countries with Anglo-American legal systems, namely common law systems, are built on the foundation of a stock market-centered capital market, focusing shareholders' rights and based on dispersed ownership. This dispersion of ownership mitigates direct shareholder involvement in corporate governance and leads to the separation of ownership and management. Corporate governance systems of Germany and some other countries with Continental European legal systems, namely civil law systems, rest on a bank-centered capital market, focusing stakeholders' rights and based on concentrated ownership.⁷⁵

There is a "global convergence of corporate governance" theory, simply put, that globalization will create competition between companies governed by various corporate governance regimes.⁷⁶ Globalization will create competition between the dispersed-ownership model and the concentrated-ownership model in the corporate governance domain. The dispersed-ownership model, at the end, will emerge victorious because of the reduction of capital costs. Large

⁷⁵ See Ronald J. Gilson, Globalization Corporate Governance: Convergence of Form or Function, 49 Am. J. Comp. L. 329, 329 (2001); John C. Coffee, Jr., The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implication, 93 Nw. U. L. Rev. 641, 642-43(1999).

⁷⁶ Coffee, *supra* note 75, at 642.

corporations always need more capital to grow and compete in their product markets, and strong securities markets give these companies more efficient access to capital and support innovations through direct financing.⁷⁷

Of course there is no exception for global convergence theory of corporate governance as a theory facing contrary views. Some criticize that the dispersed-ownership model is not the most efficient model of corporate governance. They point out some shortcomings, such as the model encouraging management to place too much emphasis on short-term gains.⁷⁸ In addition, the monitoring function of management and gaining information about the company is not superior to the concentrated-ownership model.⁷⁹

The most important fact is that “one size does not fit all.” Legal systems, business cultures, and corporate structures are just too different to have a universal code of best practice applying to every company. And directly adopting legal structures from abroad is to some extent dangerous because of potential compatibility risks.⁸⁰

The OECD reflects this view in the preamble to its “Principles of Corporate Governance”, where it states, “There is no single model of good corporate governance.”⁸¹ And the Global Corporate

⁷⁷ See Ronald J. Gilson & Bernard S. Black, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 *J. Fin. Econ.* 47, 47 (1998).

⁷⁸ See Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 *J. Pol. Econ.* 61, 62 (1988) (discussing the theory of managerial myopia, which argues that the takeover market puts pressure on management and leads them to focus more on short-term profits).

⁷⁹ See Coffee, *Supra* note 75, at 661 (discussing the argument that blockholders are superior monitors); see also Jeremy Edwards & Klaus Fischer, *Banks, Finance, and Investment in Germany* (1994).

⁸⁰ See Lutz-Christian Wolff & Bing Ling, *The Risk of Mixed Laws: The Example of Indirect Agency Under Chinese Contract Law*, 15 *Col. J. Asian L* 173, 174-75 (2002).

⁸¹ See “OECD Principles of Corporate Governance”, Preamble, p. 2. (available at <http://www.oecd.org/daf/governance/principles.html>).

Governance Forum, formed by the World Bank and OECD, has been debating whether it should promote developed country governance standards or allow emerging markets to “be scored against guidelines crafted by them and shaped for their conditions, rather than against standards they had no role in writing.”

As a result, nevertheless, we cannot ignore the power of globalization and the growth of international capital markets towards the shareholder-oriented model. It is also important to recognize the differences between countries with dispersed and concentrated ownership structures.

B. Some Major Differences between the Dispersed and Concentrated Ownership Model

Though it is hard to simply sum up every corporate governance system in different jurisdictions under a “common law system” or “civil law system,” there are still some intrinsic characteristics and differences between these two legal systems.

1. Board Structure

Firstly, corporation structures in civil law countries are different from the structures set out in common law countries. Generally, there is a statutory two-tier board structure in civil law countries. A “Management Board” is solely responsible for the management of the corporation and a “Supervisory Board” supervises the activities of the Management Board. The Supervisory Board is a separate monitoring body apart from the Management Board, with members also being elected in the shareholder meeting. In some countries like Germany, a Supervisory Board

even takes charge of appointment of members of the Management Board.⁸² Since a Supervisory Board's task is not to manage, but to monitor the management and operations by the Management Board and officers, members of the Supervisory Board usually can not concurrently serve on the Management Board, nor serve as officers or employees of the corporation.

In contrast, common law countries use a monistic system in which the board of directors serves both a management and oversight function. However, for large public companies, the board's oversight function is addressed more than its management function, mainly because of the practical impossibility for such directors to exercise day-to-day operation of the company. To serve the oversight function, it is necessary to have an independent and objective board. Hence, the corporation would set up several committees, such as audit, nominating/corporate governance, or compensation committees comprised entirely of independent directors to fulfill these responsibilities.

2. Shareholder Structure

Shareholder structure might be the most fundamental difference in corporate governance structure between civil law and common law countries. Most capital obtained by companies in civil law countries traditionally is not from direct securities markets, but from intermediary financial institutes. It achieves the existence of controlling shareholder structure, no matter it is dominated by family groups or banks. While companies in common law countries are more like

⁸² See Lutz-Christian Wolff, Law as a Marketing Gimmick-the Case of the German Corporate Governance Code 3 Wash. U. Global Stud. L. Rev. 115, 117 (2004).

the shareholder-oriented structure, relying on capital from securities market. This brings about the dispersed ownership structure and mitigates direct shareholder involvement.

The concentrated ownership structure in civil law countries suggests that minority shareholders will hardly be able to out-vote controlling shareholders who have a sufficient majority of the votes, and the ownership and management of such companies would not be separate either. Besides, the concentrated ownership structure would probably lead to undisclosed related-party transactions, self-dealing, and insider trading, which are all seriously detrimental to the interests of minority shareholders.

3. Relationship between Shareholders and Board

The other important difference between civil law and common law systems is that civil law countries have mandatory corporate governance statutes with a clearly defined division of power between shareholders and directors. The corporate laws of these countries enumerate exclusive rights of the shareholder meeting, which cannot be delegated to or appropriated by the board. Powers not included in this list are assumed to be within the realm of the board's power. Shareholders in the common law countries have much more extensive rights to opt out of the statutory legal rules.

C. Reasons for Convergence

With the needs for more efficient access to foreign capital markets and protection of the interests of shareholders, there is a strong demand for changes in corporate governance systems around the world. And, naturally, a corporate governance structure in the U.S., which has strong

securities markets, has become the object of emulation. Moreover, U.S. institutional investors hold more than 50% of all listed corporate stocks (about 60% in the largest 1,000 corporations). The largest 25 pension funds accounted for 42% of the foreign equity held by all U.S. investors.⁸³ Thus, U.S. institutional investors have further urged foreign countries without sound and transparent corporate governance systems to make significant changes in their formal governance institutions to more closely resemble the U.S. corporate governance system, since the quality of the corporate governance system of a country is a significant determinant for capital market development.⁸⁴

In addition, with more and more non-U.S. corporations listing their securities on U.S. securities exchanges to directly raise foreign investment, such foreign private issuers not only voluntarily comply with the listing agreement with the securities exchange, they are also obliged to register under Section 12(b) of the Securities Exchange Act of 1934. This registration subjects them to a host of U.S. securities regulations, though there is some exemptive relief for foreign private issuer.

It is also worth addressing that companies with access to strong securities markets will have a significant competitive advantage over companies that do not. Thus, countries would like to enable their companies to take advantage of the global securities markets by providing them a legal regime that could adequately protect the interests of shareholders and meet the latest trends of corporate governance reforms.

⁸³ See James McRitchie, *Enhancing the Return on Capital Through Increased Accountability* (2003), available at <http://www.corpgov.net>.

⁸⁴ CalPERS has announced a set of general principles-its six General Principles including director accountability to shareholders' rights.

D. Transition of Legal Regulatory scheme of Corporate Governance in Taiwan

1. Overview

It is very late for Taiwan to assume modern notions of corporate governance in comparison to other Asian countries. For example, Singapore in 1989 had required audit committees. In 1998, Japan launched its first code of best practice of the Corporate Governance, and Korea had adopted new listing rules about corporate governance by the Korea Stock Exchange.⁸⁵ This reluctance to assume modern notion may be because Taiwan suffered much less during the Asian financial crisis in 1997 or because of the Taiwanese government's strongly interventional economic policies.

Generally, a Taiwanese company raises capital through both direct financing in capital markets and indirect financing, such as bank loans. But capital markets have become an increasingly important source for obtaining capital lately.⁸⁶ Between 1999 and January 2004, the number of companies listed on the Taiwan Stock Exchange increased from 462 to 670, and the market capitalization increased from NTD 11,803,524 millions (around USD 347,162 millions) to NTD 13,910,346 million (around USD 409,128 millions).⁸⁷ These figures not only show that the reliance on the capital market to raise funds for Taiwanese companies is stronger than ever, it also shows the need for the transformation of the corporate governance system to meet the latest corporate governance developments.

⁸⁵ See Jamie Allen, Code Convergence in Asia: Smoke or Fire, CGI, 23, 32-35 (2000), available at <http://www.gcgf.org/library/speeches/AllenAsiaCnvrq.doc>

⁸⁶ See Rafael La Port et al., Corporate Ownership Around the World, 54 J. Fin. 471, 491-500 (1999).

⁸⁷ See Statistics of Securities Market, TSE, available at <http://www.tse.com.tw/docs/statistics/statisticalF.htm>

The Securities and Futures Commission (“SFC”), which is Taiwan’s securities regulator has emphasized the importance of good corporate governance structure to public companies and added more disclosure requirements in SFC rules. But it was not until November 2001 when Taiwan’s congress passed the amendment of corporate law, when formally established a legal foundation for a corporate governance system in Taiwan. Based on the revision of corporate law, the SFC adopted several rules about corporate governance, such as rules adding more disclosure requirements in public companies’ periodic reports and real time disclosure, as well as rules setting up the qualification of independent directors and their duties for listed companies. In addition, Taiwan Stock Exchange (“TSE”) and Taiwan’s computerized over-the-counter market, also known as GreTai Securities Market, (“GTSM”), adopted best practices of corporate governance for listed companies. In addition to listed companies, there are also some similar best practice principles of corporate governance adopted by SROs in Taiwan regulating some financial institutes, such as securities firms, futures commission merchants, securities investment trust enterprises, and securities investment consulting enterprises.

2. Corporate Governance Structure in Taiwan

This section includes a brief introduction of securities markets and some issues of corporate governance structure in Taiwan.

a. Composition of Investors in Taiwan Securities Market

Before introducing the corporate governance structure in Taiwan, it is important to note that the securities markets in Taiwan are not like those in the U.S. or other countries where large

institutional investors play important roles, by forming a strong lobby for reform.⁸⁸ Conversely, according to the statistics made by TSE in December 2003, only 5.09% of trading volume is contributed by the foreign institutional investors, 12.75% is from domestic institutional investors, while 81.55% of trading volume is contributed by the domestic individual investors.⁸⁹

With the largest percentage of trading in Taiwan's securities market contributed by individual investors, Taiwan's securities market is a shallow plate market. It is easily affected by market sentiments and fluctuation, resulting in a high turnover rate of trading. Individual investors usually lack professional knowledge and have less extensive access to information than institutional investors. Plus, they are usually minority shareholders of companies, and are more passive than institutional shareholders in actively overseeing the operation of companies. Consequently, the transition of corporate governance structure in Taiwan is not based on institutional investors' advocacy and pressure as influential shareholders on companies, but on government's strategy making.

b. Interior Corporate Structure

The original corporate law in Taiwan is transplanted from Germany. There is a mandatory requirement of a two-tier board structure, boards of directors and supervisors in Taiwan.⁹⁰ Under corporate law, Boards are in charge of management of corporations and operation of business, whereas supervisors are in charge of monitoring the execution of business operations of the

⁸⁸ Supra note 18,195 (By 1998, institutional investors held about 60% of the shares in companies traded on the New York Securities Exchange).

⁸⁹ Securities Transaction categorized by the type of investors, TSE, available at <http://www.tse.com.tw>

⁹⁰ See Taiwan's corporate law, Art. 192 (providing for the board of directors); Art. 216 (providing for the supervisors).

corporations. They have the duty to audit the statements and records prepared for submission to the shareholders' meeting by the board of directors, and to make a report of their findings and opinions at the meeting of shareholders.⁹¹

c. Family Group Concentrated Structure of Ownership

Looking at the corporate governance structure in Taiwan, it is important to realize that most Taiwanese companies are small and medium-sized enterprises, and are usually dominated by family groups. In fact, one of the prominent features of Asian business landscape is the predominance of family-run companies. About two-thirds of listed companies and substantially all of private companies are family-owned.⁹²

This strong family control over companies usually encompasses overwhelming control over both boards and supervisors, including decision-making and operation of the business, oversight of management, and also the agendas of shareholder meetings.⁹³ Though there are some advantages of a family-controlled business, such as having a strong leadership and cohesive management team formed by the family members, there is no denying that there are some serious downsides that this absolute concentrated power might lead to potential abuses of power, sacrificing the interests of minority shareholders. And one of the most serious drawbacks is the lack of effective oversight function to the board and management.

In order to de-centralize this family-dominated, concentrated ownership structure, there is a mandatory requirement for public companies to disperse of securities in the Securities Exchange

⁹¹ Id. Art. 219, Paragraph 1.

⁹² See OECD Asian Roundtable on corporate Governance , White Paper on Corporate Governance in Asia (2003).

⁹³ Supra note 86, at 502 (stating that family-controlled companies are very common).

Law and SFC rules in Taiwan. However, in reality, it is still hard to break up the existing family-dominated type of ownership structure or to prevent these family groups from utilizing other nominal shareholders to conceal the holding of concentrated ownership structure.

d. Cross Shareholding

In addition to the family-controlled ownership structure, there is another issue of cross shareholding by parent and subsidiary companies in the corporate governance structure. Before the revision of corporate law in 2001, there was no provision prohibiting cross-holding shares between parent companies and their subsidiaries. Therefore, there was a loophole in the legal framework, allowing some subsidiary companies to be set up as investment companies with their main corporate purpose to buy a great deal of their parent companies' shares from stock markets. There are two major purposes behind this purchase scenario: one is to manipulate the stock market by driving up their parent companies' stock price and the other is to being elected as director or supervisor of their parent companies, allowing parent companies to gain more control power over boards and supervisors. However, both of the purposes are detrimental to the interests of minority shareholders.

Thus, the revision of corporate law expressly prohibits the cross shareholding between parent companies and their subsidiaries. It provides that subordinate companies shall not redeem or buy back any controlling companies' shares, nor accept any of them as collateral. In this way, the revision of corporate law may bring an end to the existing cross shareholding structure between parent and subsidiary companies in Taiwan.

e. Legal Person Shareholder

Under corporate law in Taiwan, it is permissible for a legal person (or government) shareholder “itself” to be elected as director or supervisor, or for the person to designate several representatives to run for election. The legal person (or government) must appoint a natural person to act on its behalf, carrying out the director or supervisor’s duties. If the legal person (or government) designates several representatives to run for election of directors and supervisors, they can all be elected concurrently. This difference creates a critical unfairness as the natural person cannot be elected for several posts of directors and supervisors at the same time. Moreover, no matter what model the legal person (or government) adopts, once the legal person (or government) or the appointed representatives have been elected, the legal person has the right to remove its appointed directors and supervisors and replace them with other appointees at will. In this way, if the legal person (or government) designates representatives to be elected as directors or supervisors, the “actual” director or supervisor would not be that natural person but the legal person (or government). It is also hard to determine and distinguish the attribution of legal responsibilities of the legal person and its appointees.

Moreover, though there is a prohibition under corporate law that supervisors cannot concurrently be directors, officers or employees of the corporation, there is no restriction prohibiting a legal person from appointing several representatives to be elected concurrently as directors and supervisors. These appointees can be irrespectively elected as directors and supervisors even though they are from the same legal person (or government) shareholder, because they are deemed different “persons.”

Hence, with respect to the election of directors and supervisors in Taiwan, one of the serious downsides, which has not been solved yet by the revision of corporate law in 2001, is that there is no restriction for several representatives of the same legal person (or government) shareholder from being elected and serving concurrently as directors and supervisors. Since supervisors in the corporate governance structure in Taiwan are responsible for the oversight of boards and management, several representatives beholden to one legal person would lead to an inadequate check-and-balance mechanism in the corporate governance.

3. Transition of Corporate Governance Structure

As stated, there was an overall revision of corporate law in 2001. This has brought in a major transition from a concentrated-ownership model towards a U.S. shareholder-oriented and dispersed-ownership model in the corporate governance system in Taiwan. corporate law in Taiwan establishes the fundamental regulatory basis for the corporate governance system and applies to every corporation whether public or private. With respect to public companies, they must also adhere to Taiwan's Securities Exchange Law, which focuses on the function of securities markets, like disclosure and transparency of corporation information and prevention of securities frauds. Several important aspects included in the revision of corporate law in 2001 are discussed in the following subsections.

a. The Independence of the Board of Directors and Supervisors

The original corporate law requires that all directors and supervisors must be shareholders of the company. This election requirement maintains existing major shareholders' control over the company, and hinders the independence of the board of the company. Since companies in

Taiwan are mostly owned by family groups, if independent directors and independent supervisors can only be elected from shareholders, it is hard to expect majority shareholders not to expropriate interests of minority shareholders.

Thus, the revised corporate law allows non shareholders to be elected as directors or supervisors. Though this single revision of the revised article cannot show much of the advocacy of independence of boards, the importance behind this revision is that it supplies a legal basis for the SFC or other competent authorities to promulgate rules concerning independent directors and independent supervisors in public corporations.

And after revision of the corporate law, the SFC soon adopted rules and releases to provide responsibilities and qualifications of independent directors and independent supervisors in public companies. TSE and GTSM also amended their listing rules, requiring new listed companies to have at least two independent directors and one independent supervisor on the boards. However, without a mandatory requirement of independent directors and independent supervisors by law levels, the SFC or other authorities cannot require every public company to set up and maintain independent directors and independent supervisors on the board by rules. Hence, the SFC rules only suggest public companies voluntarily setting up independent directors and independent supervisors. As for TSE and GTSM listing rules, firstly, they are only applied to companies which are new applicants of listing. And there is no requirement for already listed companies to have independent directors and independent supervisors on the board. Secondly, they don't expressly require new applying companies to maintain independent directors or independent

supervisors after their securities are listed. Hence, there is room for improvement to have a good effect of independence of board directors and supervisors.

Moreover, without major shareholders' support, like allocating their votes for the "independent" directors or "independent" supervisors candidates, it is almost impossible for a independent director candidate to be elected. Accordingly, it is also hard to expect these directors or supervisors to exert their oversight duties to the best of their abilities and prevent major shareholders from eradicating the interests of minority shareholders, especially when they are actually nominated and elected by these major shareholders.

However, there are some imperfections of the requirements of independence of boards and supervisors in new corporate governance regulations. It might somehow serve to help undermine the current domination of controlling shareholders over the board and supervisors.

b. The Duty of Loyalty

One of the most notable recent changes of the corporate governance structure in corporate law was the addition of an express duty of loyalty of directors, supervisors, and officers. Before revision, the corporate law and civil law had expressly imposed a duty of care on directors, supervisors, and officers, but there was no express duty of loyalty under corporate law. Even though the duty of loyalty of directors has been developed by case law in Taiwan, it is still debated whether the duty of loyalty is nonetheless owed by directors and other fiduciaries. Thus, the new express duty of loyalty of directors provided in corporate law is an important step towards increasing the responsibilities of directors and other fiduciaries. But the ultimate

effectiveness of the duty of loyalty still largely depends on how Taiwan courts and scholars develop and interpret the specific nature and scope of the duty.

c. The Role of Manager

The basis of modern corporate governance structure, the separation of ownership and management, gives rise to powerful managers since corporations rely on professional managers more and more. The greater role and increased responsibilities of managers provided in the revision of corporate law shows that it is placing greater importance on professional managers in corporations.

First, the new provision provides a company with more flexibility to create whatever management position, structure, and hierarchy it may require, allowing companies to establish their own management systems in their charters. Second, the new provision clarifies the authority of managers to administer the affairs of the company and sign documents on behalf of the company if provided in the charter of the company or by contract. By expressly allowing managers to act as the legal representative of the company, the new law indicates the shift towards increased authority and power for managers. And third, along with the greater power imposed on managers provided in the revised corporate law, it also comes with the duty of loyalty in the revised corporate law on managers to prevent abuses and misconduct.

d. Convergence of Corporate Governance Structure

The recent revisions of the corporate law indicate that Taiwan is making a gradual transition toward a shareholder-oriented model of corporate governance structure. And the revisions of the

corporate law also show that Taiwan is now struggling with the family group ownership structure by bringing in independence of directors and supervisors, the duty of loyalty, and imposing increased power on managers.

From the revision of Taiwan's corporate law, we know that several points of the U.S. corporate governance system have been converged. These include enhancing shareholder values and upholding shareholder rights by transforming the ownership structure of the company and by imposing more responsibilities on directors and supervisors; introducing independent directors and independent supervisors to provide an outside view in overseeing the operation of business; and imposing increased responsibilities on professional managers to enhance the separation of ownership and management.

Besides, under the Corporate Governance Best-Practice Principles adopted by TSE and GTSM for their listed companies, it is advisable to make it a first priority to set up the audit committees to be in charge of reviewing the accounting system, the financial condition, and major financial or business transactions, examining internal control system, and assessing and nominating outside auditors. It is also advisable for listed companies to set up other special committees. However, these are only optional not compulsory requirements. Thus, it may also reduce the accomplishment that would have been expected.

Chapter V

Impact of Changes of the U.S. Corporate Governance on Foreign Private

Issuers Listed on the NYSE and Nasdaq

A. Foreign Private Issuers Listed on the NYSE and Nasdaq

By January 15, 2004, there were 467 foreign private issuers⁹⁴ from 50 countries listed on the NYSE,⁹⁵ and the number is growing, not decreasing. There are several reasons for foreign companies seeking to list their securities on national securities markets like the NYSE or Nasdaq. One is to obtain more efficient sources of capital from one of the biggest capital markets in the world, and the other is more important, by listing securities on the U.S. securities market to increase the credibility and confidence of investors to increase their stock value.

We can see this benefit from companies like China Life Insurance Company Limited, which holds 45% of the life insurance market in China. It listed its securities on NYSE on December 17, 2003 and on its trading debut the stock price rose 27% in a single day.⁹⁶ This benefit is also shown by Infosys Technologies Limited, an Indian developer of customized software company, which listed its securities on Nasdaq since March 1999. Since its listing, Infosy's share price has risen more than 500 percent.⁹⁷ Thus, being listed on the U.S. securities markets voluntarily subjects the company to more stringent restrictions of corporate governance but also benefits the foreign private issuers in obtaining more capital.

⁹⁴ Foreign private issuers, as such term is defined in Rule 3b-4 of the Securities Exchange Act of 1934 means any foreign issuer other than a foreign government excluding companies with most of their shareholders, officers, assets, or business closely related to the U.S.

⁹⁵ See NYSE Complete list of Non-U.S. Listed Companies, available at <http://www.nyse.com/pdfs/forlist040115.pdf>

⁹⁶ Karen Talley, Bear Stearns, E*Trade Gain on Earnings News, December 18, 2003, Wall St. J., at C3.

⁹⁷ Supra note 85.

As stated, the S-O Act has been probably the most sweeping piece of reform legislation covering corporate governance of public companies in the U.S. since the 1930's, and a number of new reporting and corporate governance requirements are imposed on public companies, which generally comprises both U.S. companies and foreign private issuers. Although there are some different treatments and exemptions for foreign private issuers under the SEC and SROs rules, the S-O Act in the end doesn't expressly exclude its application on foreign private issuers or make any distinction between the U.S. and foreign private issuers.

Thus, to follow the requirements provided in the S-O Act, such as the certification requirement of the CEO and the CFO, the loan prohibition, the audit committee, and auditor independence regulations and so on will do more than just increase the costs of foreign private issuers to access to the US securities markets. It will also raise sovereignty concerns or might conflict or duplicate with the regulations of foreign issuers in their mother countries.

Accordingly, on December 17, 2002, the SEC held two roundtable discussions on the international implications of proposed rules on auditor independence and attorney conduct.⁹⁸ It also proposed and adopted releases, providing narrow exceptions or exemptions for foreign companies. However, because Congress did not specifically provide exceptions for foreign private issuers in the S-O Act, the SEC has stated that it does not believe it has authority to draft broad exceptions for foreign issuers from provisions of the S-O Act.⁹⁹ Thus, for an existing

⁹⁸ See Auditor Independence Roundtable and Attorney Conduct Roundtable, available at <http://www.sec.gov/news/audindtrans121702.htm>

⁹⁹ For a discussion of the application of the Sarbanes-Oxley Act and the SEC's related rulemaking to foreign private issuers, see <http://www.ffhsj.com/firmpubs.htm>

foreign private issuer or for one who has not yet been but is considering listing its securities on the U.S. securities markets, the issuer must make a careful evaluation of and advance planning for the potential impact of the new corporate governance regulations in the U.S.

B. Impact of New Legislation on Foreign Private Issuer

1. Federal Regulation

As stated, since the S-O Act doesn't expressly exclude the application on foreign countries, it doesn't apply only to the U.S. public companies but also to foreign private issuers.¹⁰⁰ To resolve such problems arising from the lack of express exemptions or different treatments under the S-O Act, the SEC made Rule 10A-3 under the Securities Exchange Act of 1934, and in some releases, expressly provides different treatments for foreign private issuers from the application of the S-O Act. But unless the SEC provides rules or releases to the contrary, the foreign private issuer would have to comply with the S-O Act as other U.S. domestic companies. In complying with the new legislation, the following provisions may require foreign private issuers to pay more attention to and make some changes in the procedures or internal settings concerning the corporate governance structure.

a. CEO/CFO Certifications

Section 302 and Section 906 of the S-O Act each require certifications by the CEO and the CFO of all public companies, including foreign private issuers. The SEC has adopted rules¹⁰¹ requiring that the CEO and the CFO certify financial and other information contained in periodic

¹⁰⁰ See Gerald S. Backman, Compliance with the New Corporate Governance Requirements, 1363 PLI/Corp 581, 585 (2003).

¹⁰¹ See SEC Release NOS. 33-8124, 34-46427, IC-25722.

reports filed with the SEC. For foreign private issuers filing annual reports on Form 20-F or 40-F,¹⁰² the certifications must be included in those annual reports.

Because of the requirement of certifications by the CEO and the CFO, it will necessitate the establishment, maintenance and regular evaluation of the effectiveness of internal and disclosure controls and procedures to enable the CEO and the CFO to provide their certifications. Some companies also have set up committees in charge of the internal and disclosure control systems or developed sub-certification procedures whereby subordinate officers and employees certify required information within their areas of responsibility in order to assist the CEO and the CFO in meeting their certification responsibilities.

Thus, foreign private issuers in complying with the requirement of certifications by the CEO and the CFO accordingly must start implementing the internal and disclosure controls and procedures and begin conducting evaluations of such controls, so that the company will have all required controls and procedures in place and will be fully prepared for the required disclosures and certifications by the CEO and the CFO at the time of the filing their annual reports on Form 20-F or 40-F with the SEC.

b. Loan Prohibition

One of the most controversial parts of applying the S-O Act to foreign private issuers is the requirement of loan prohibition to directors and officers. Under Section 402 of the S-O Act, it is

¹⁰² Form 20-F is used by foreign private issuers to either register a class of securities under the Securities Exchange Act of 1934 or provide an annual report required under the Act. Form 40-F is used by foreign private issuers to file reports under the Act after having registered securities under the Securities Act of 1933 and by certain Canadian registrants.

unlawful for companies to directly or indirectly extend or maintain credit, to arrange for the extension of credit, or to renew any extension of credit in the form of a personal loan to or for any director or executive officer of the company.

As stated in Part III, Section 402 does not expressly define what is a "personal loan" or an "extension of credit," so the prohibition of loans to directors and officers may also apply to some non-conventional arrangements. Thus, in complying with this requirement, foreign private issuers should conduct a detailed review of all kinds of option exercise programs, employee benefit plans, and other related arrangements to determine if they involve loans or extensions of credit.

c. Audit committee and Rule 10A-3

Section 301 of the S-O Act requires all listed companies listed on the national securities exchanges to have audit committees comprised solely of independent directors, which has been extremely controversial in some foreign jurisdictions. Not every foreign jurisdiction requires companies to have a designated audit committee, though they might have alternative governance structures that serve similar functions, such as supervisory boards or statutory auditors, which are as independent from management boards as independent directors. Besides, the requirement that the audit committee consist only of independent directors might also incur some problems in some countries like Germany, where the supervisory board must include employees who are by definition not independent.¹⁰³ In addition, the requirement that the audit committee be responsible for the appointment, compensation, and oversight of the outside auditors might also

¹⁰³ See Robert C. Schwenkel, *The Post-Enron Corporate Governance Environment: Where Are We Now*, 1377 *PLI/Corp* 11, 66 (2003).

incur problems in some jurisdictions like Japan, where the outside auditor would be retained only by the shareholders.¹⁰⁴

Facing such basic legal-structured contradictions among jurisdictions, the SEC proposed Rule 10A-3 to provide a general exemption for foreign private issuers with securities listed on the national securities market from audit committee requirements of the S-O Act if the foreign private issuer meets the following requirements: (i) The foreign private issuer has a board of auditors (or similar body), or has statutory auditors, established and selected pursuant to home country legal or listing provisions expressly requiring or permitting such a board or similar body; (ii) The board or body, or statutory auditors are required under home country legal or listing requirements to be either separate from the board of directors, or composed of one or more members of the board of directors and one or more members that are not also members of the board of directors; (iii) The board or body, or statutory auditors, are not elected by management of such issuer and no executive officer of the foreign private issuer is a member of such board or body, or statutory auditors; (iv) Home country legal or listing provisions set forth or provide for standards for the independence of such board or body, or statutory auditors, from the foreign private issuer or the management of such issuer; (v) Such board or body, or statutory auditors, in accordance with any applicable home country legal or listing requirements or the issuer's governing documents, are responsible, to the extent permitted by law, for the appointment, retention and oversight of the work of any registered public accounting firm engaged (including, to the extent permitted by law, the resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer; and (vi) The audit committee

¹⁰⁴ Id. at 66.

requirements of paragraphs (b)(3), (b)(4) and (b)(5) of Rule 10A-3 apply to such board or body, or statutory auditors to the extent permitted by law.

However, if the foreign private issuer cannot meet these general exemption requirements, there are still some individual exemptions provisions which may apply. With respect to the requirement of independence of the audit committee for foreign private issuer, first, the SEC rule would permit non-management employees to sit on the audit committee if the employee is elected or named to the board of directors or the audit committee of the foreign private issuer pursuant to home country legal or listing requirements. Secondly, it would permit one member of the audit committee of a foreign private issuer, if he is an affiliate of the foreign private issuer or a representative of such an affiliate, who has only observer status on, and is not a voting member or the chair of the audit committee, and neither the member nor the affiliate is an executive officer of the foreign private issuer. Thirdly, it would permit one member of the audit committee of a foreign private issuer to be a representative or designee of a foreign government or foreign governmental entity that is an affiliate of the foreign private issuer, who is not an executive officer of the foreign private issuer.

Besides, the SEC clarified in Rule 10A-3 that in the case where a foreign private issuer has a two-tier board of directors, the term “board of directors” means the supervisory or non-management board. Accordingly, that board could either form a separate audit committee or, if the entire supervisory or non-management board was independent within the provisions and exceptions of the rule, the entire board could be designated as the audit committee.

If foreign private issuers avail themselves of the exemptions under Rule 10A-3, they have to disclose their reliance on the exemptions and their assessment of whether, and if so how, such reliance would materially and adversely affect the ability of their audit committee to act independently and to satisfy the other requirements of the SEC rule. Such disclosure must appear in, or be incorporated by reference into, the annual reports on Forms 20-F and 40-F as well as proxy statements or information statements for shareholders' meetings at which elections for directors are held.

d. Financial Experts on the Audit Committee

The S-O Act and the SEC rules require disclosure of whether there is any financial expert on the audit committee in the annual reports, and there is no exception for foreign private issuers. However, since requiring an audit committee financial expert to possess expertise relating to U.S. GAAP could further burden foreign private issuers who use home country accounting principles or international accounting standards to prepare their primary financial statements, the SEC rule added an instruction to clarify that the audit committee financial expert's understanding must be of the GAAP used by the foreign private issuer in preparing its primary financial statements filed with the SEC.¹⁰⁵ It is also required that foreign private issuers that do not prepare their primary financial statements in accordance with U.S. GAAP most include a reconciliation to those principles in the financial statements that they file with the SEC. Moreover, in conjunction with Rule 10a-3, it is not required under the SEC rules that a foreign private issuer disclose whether its audit committee financial expert is independent.

e. Non-Audit Services of Accounting Firm

¹⁰⁵ See SEC Release NOS. 33-8177; 34-47235.

Under Section 201 of the S-O Act, it is unlawful for a public accounting firm to contemporaneously provide its clients with audit and a variety of non-audit services. As for permitted non-audit services, including tax services, they may be provided by an accounting firm if they are approved in advance by the audit committee of the company. The SEC rule also requires that engagements be subject to detailed pre-approval policies and procedures established by the audit committee, provided that the audit committee is informed of each service and the policies and procedures do not constitute delegation of the audit committee's responsibilities to management.¹⁰⁶

Thus, foreign private issuers should conduct a review of all services provided by outside auditors to make sure that prohibited non-audit services have totally ceased by the end of the grandfathered period. In addition, in light of the requirement for pre-approval of all auditor services by the audit committee, it should specifically pre-approve both audit and permitted non-audit services provided by the outside auditors.

f. Disclosure Controls

As with the certification requirement stated above, the disclosure controls requirement has focused on companies' internal disclosure processes. Amongst which, the CEO and the CFO are required to assess their companies' disclosure controls prior to the filing of periodic reports and publicly disclose the results of the evaluations. This requires the CEO and the CFO to take responsibilities for disclosure and makes it more difficult for them to disclaim knowledge of their company's disclosure.

¹⁰⁶ See SEC Release NO. 33-8183; 34-47265; 35-27642; IC-25915; IA-2103, FR-68.

Under the S-O Act, the SEC has adopted new rules which require all public companies including foreign private issuers to maintain “disclosure controls and procedures,” which are designed to ensure that all material information about the business will be known by those individuals responsible for preparing the company’s public disclosure.¹⁰⁷ Even though the SEC has not mandated or identified any specific set of disclosure controls, it has recommended, not mandated, in various releases that the company set up a committee, which could be responsible for establishing and supervising the company’s entire disclosure process, developing procedures for funneling information to the committee, and considering the materiality of information and determining disclosure obligation on a timely basis.

g. Off-Balance Sheet Transaction Disclosures

Foreign private issuers would also have to comply with the disclosure requirements of the off-balance sheet transaction in the annual and quarterly reports provided in Section 401 of the S-O Act and by the SEC rules¹⁰⁸ about off-balance sheet arrangement disclosed in the MD&A. Several items in the definition of “off-balance sheet” arrangement refer to U.S. GAPP. In general, foreign private issuer’s MD&A disclosure should just focus on its primary financial statements and include a discussion of the reconciliation to U.S. GAPP, if it is necessary for an understanding of the financial statements as a whole. However, to identify the types of arrangements which are subject to disclosure under the SEC rule above, a foreign private issuer must assess its guarantee contracts and variable interests pursuant to U.S. GAPP.

h. Non-GAAP Financial Measure Disclosure

¹⁰⁷ See SEC Release NOS. 33-8238; 34-47986; IC-26068.

¹⁰⁸ See SEC Release Nos. 33-8182; 34-47264; FR-67; International Series Release No. 1266.

As stated in Part III, the SEC adopted a new disclosure regulation, Regulation G, requiring public companies to disclose or release such non-GAAP financial measures, including in that disclosure or release a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure. However, the SEC made a significant distinction that will permit many foreign private issuers to use press releases and other information without being subject to Regulation G.¹⁰⁹ A foreign private issuer is exempted from Regulation G if (i) the securities of the company are listed or quoted on a securities exchange or inter-dealer quotation system outside the U.S., (ii) the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with GAAP, and (iii) the disclosure is made by or on behalf of the company outside the U.S. The exceptions above focus on whether the financial measure relates to U.S. GAAP and whether the disclosure is made by or on behalf of the foreign private issuer outside of the United States. This is a balance of the interests of U.S. investors and the interests of foreign private issuers in communicating globally, including in their home markets.

In addition to Regulation G, the SEC also amended Form 20-F of the Securities Exchange Act of 1934 to incorporate Item 10 of Regulation S-K, which is similar to but tougher than Regulation G, to impose requirements concerning the use of non-GAAP financial measures in an SEC filing. Accordingly, foreign private issuers will be subject to the same requirements as domestic issuers with respect to the use of non-GAAP financial measures in filings with the SEC on Form 20-F. However, filing Form 40-F is not subject to those requirements.

¹⁰⁹ See SEC Release No. 33-8176; 34-47226; FR-65.

i. Code of Ethics

Pursuant to the S-O Act, the SEC adopted rules¹¹⁰ providing that foreign private issuers are required to disclose in their annual reports on Form 20-F and 40-F whether they have adopted a written code of ethics that applies to the company's CEO, CFO, principal accounting officer or controller, or people performing similar functions, and the changes or waivers of the code of ethics. However, in contrast to U.S. domestic companies, foreign private issuers don't have to provide in a current report "immediate disclosure" of any change to, or waiver from, the company's code of ethics for its senior financial officers and CEO. Nevertheless, the SEC strongly encourages prompt disclosure by foreign private issuers under cover of Form 6-K or on the foreign private issuers' websites.¹¹¹

2. SRO Listing requirement

a. NYSE Rule

Generally, the NYSE rules do not apply to foreign private issuers. Under NYSE rule Section 303A(11), foreign private issuers are allowed to follow home country practice in lieu of the new requirements, except that such companies would be required to: (1) have an audit committee that satisfies the requirements of Rule 10A-3; (2) notify the NYSE in writing after any executive officer becomes aware of any non-compliance with any applicable provision; and (3) provide a brief, general summary of the significant ways in which its governance differs from those followed by domestic companies under NYSE listing standards.

¹¹⁰ See SEC Release NOS. 33-8177; 34-47235.

¹¹¹ See SEC Release NOS. 33-8177; 34-47235.

Section 303A(11) also demands listed foreign private issuers to disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under the NYSE listing standards. The disclosure may be provided either on the issuer's website (provided in English) and/or in their annual report distributed to U.S. shareholders. If it is only provided on the website, the annual report must state and provide the website address.

b. Nasdaq Rule

NASD Rule 4350 currently provides that foreign issuers are not required to do any act that is contrary to a law, rule or regulation of any public authority exercising jurisdiction over such issuer or that is contrary to generally accepted business practices in the issuer's country of domicile. Nasdaq rules also provide exemptions from the requirements of NASD Rule 4350 as may be necessary or appropriate to carry out this intent. Nasdaq also proposes to provide that a foreign issuer that receives an exemption from NASD Rule 4350 would be required to disclose in its annual reports filed with the SEC each requirement from which it is exempted and describe the home country practice, if any, followed by the foreign private issuer in lieu of these requirements. In addition, a foreign issuer making its initial public offering or first U.S. listing on Nasdaq would be required to disclose any such exemptions in their registration statement.

Chapter VI

Conclusion

The importance of good corporate governance structure is the more efficient access to capital for companies. Since better corporate governance would lead to higher returns on equity and greater efficiency, it has been addressed around the world. However, it is important to realize that there is no one perfect model of corporate governance suitable to every country. It would be different and changed by time, history, and existing legal grounds. But due to the globalization and integration of financial and capital markets, it seems inevitable for companies to adjust themselves to the most influential corporate governance model nowadays. And it also encourages governments to establish or revise their regulatory schemes for better corporate governance structures to maintain investors' confidence in securities markets.

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