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# CORPORATE GOVERNANCE REFORM IN TAIWAN

## *Could the Independent Director System Be an Effective Remedy?*

John S. Liu and Chyan Yang

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### Abstract

At the forefront of corporate governance reform in Taiwan is establishment of the independent director system. We report upon the reform as related to the independent director system. Listed companies have acted in response to the reform in a way that may not serve its original purpose.

Keywords: Taiwan, corporate governance, independent director system, board independence, board of directors

### Overview

Taiwan's government officials and politicians began the year 2007 facing the immediate challenges of cleaning up the aftermath of a corporate governance failure reminiscent of the Enron and WorldCom scandals. News that the Rebar group, one of the largest conglomerates in Taiwan, had fallen into deep financial trouble broke out on the second day of the New Year. A total of US\$2.21 billion was discovered to have been embezzled from the shareholders of the group's related companies by the controlling family. The failure in corporate governance is the largest ever in Taiwan, not only in terms of money defrauded but also of the people

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involved. A total of 107 people were later indicted on charges of embezzlement and multiple violations of banking, accounting, and securities laws. Economic consequences aside, the failure resulted in the resignation of the island's top financial regulation official and even snowballed into a political crisis in which the public demanded that Taiwan's premier resign.<sup>1</sup>

Corporate governance failure can have multifaceted consequences. Economically, in addition to investors' loss of wealth, such failure is known to affect a country's rates of innovation and economic growth and its ability to attract international capital.<sup>2</sup> Politically, crises similar to the Rebar scandal are not uncommon. In countries where the corporate world is largely controlled by wealthy families, and public policies are distorted by the political influence of these controlling owners, the political implications of failure can be even more extensive.

Ever since the collapse of Enron in 2001 and WorldCom in 2002, corporate governance reform has become a worldwide movement. The U.S. corrected its systemic weaknesses in the corporate governance structure with the enactment of the Sarbanes-Oxley Act. Principles promoted by the Organization for Economic Cooperation and Development (OECD) are widely referenced among countries seeking to upgrade their corporate governance systems. Taiwan was not absent from this reform wave. We report in detail Taiwan's own experience in corporate governance reform, emphasizing the establishment of the independent director system.

On January 1, 2007, a new amendment to Taiwan's Securities and Exchange Act (SEA) was enacted as law. The amendment consisted of several legal components crucial to corporate governance reform, the key element of which is the independent director system. A set of rules in the amendment provides the legal basis to regulate the appointment of independent directors to the corporate boards of public companies. The design and implementation of the independent director system was intended not only to promote better practice but to prevent further failure in governing corporations. There were no shortages of companies like Enron and WorldCom that expropriate shareholder wealth in Taiwan. A total of 4.46% of listed companies were involved in financial distress in the year 2001.<sup>3</sup> Most such companies ended up in liquidation or bankruptcy. Corporate governance

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1. See "Taiwan Premier Faces Pressure to Quit over Rebar," *Financial Times*, January 14, 2007, <<http://www.ft.com>>, accessed March 12, 2007; and "Prosecutors Indict 107 in Rebar Inquiry," *Financial Times*, March 9, 2007, <<http://www.ft.com>>, accessed March 12, 2007.

2. Randall Morck, Daniel Wolfenzon, and Bernard Yeung, "Corporate Governance, Economic Entrenchment, and Growth," *Journal of Economic Literature* 43:3 (September 2005), pp. 655–720.

3. A total of 41 companies out of the 919 listed recorded having financial troubles.

reform was urgently needed and an independent director system was believed by Taiwanese authorities to be one of the solutions to the problems.

The independent director system has long been a key to board-related corporate governance reforms in well-established economies. East Asian economies embraced the concept in recent times. Japan, South Korea, and China all established the independent director system between 1999 and 2003. Following this development, Taiwanese authorities began a series of actions to set up an independent director system; these included adding new rules and revamping existing laws and regulations.

Agency problems are well known to be inherent in modern corporations in which ownership and control are separated.<sup>4</sup> In such corporations the senior managers, and their principals, such as stockholders, may have different objectives, and agents may pursue goals that are not in the best interests of their principals. Requiring boards of directors is one mechanism to bring the agency problem under control.<sup>5</sup> A board possesses the right to “ratify and monitor major policy initiatives and to hire, fire, and set the compensation of top level decision managers.”<sup>6</sup> Endowed with such powerful authority, board composition is crucial to corporate governance of modern corporations.

A typical board is composed of inside and outside directors. Inside directors are any directors who are company employees, whereas outside directors are those who are not. Outside directors are usually separated into affiliated and independent directors. Affiliated directors are those who have family ties to top management or business relationships with the corporation. Independent directors lack such ties or relationships. They are certainly more likely to make independent judgments in the boardroom. The terms independent director, outsider, and non-executive are often used interchangeably in the literature. In this article, we use the term “independent director” to specify the board directors who are able to make independent judgments. They are the ones who have “no need or inclination to stay in the good graces of management, and who will be able to speak out,

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4. Agency problem occurs when one party (the principal) delegates work to another (the agent). In the corporate governance context, the principal is the stockholders, and the agent commonly refers to senior managers, including CEOs. See Michael Jensen and William Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure,” *Journal of Financial Economics* 3:4 (October 1976), pp. 305–60.

5. See Eugene Fama and Michael Jensen, “Separation of Ownership and Control,” *Journal of Law and Economics* 26:2 (June 1983), pp. 301–25. They pointed out, for an open corporation, the stock market, the market for takeovers, as well as expert boards are the mechanisms to control agency problems.

6. *Ibid.*, p. 313.

inside and outside the boardroom, in the face of management misdeeds in order to protect the interests of shareholders.<sup>7</sup>

This article documents the development of independent director system reform in Taiwan and provides observations on how corporate boards responded to such reform. We begin with a review of the independent director system in two well-established Western economies as well as three major East Asian economies. The state of corporate governance in Taiwan is assessed next. This includes a historical brief on the rapid growth of companies listed on the Taiwan stock markets. We then elaborate on coordinated efforts to establish the independent director system in Taiwan. This is followed by summary statistics on the responses from listed companies to the listing rules set forth in February 2002. Ideas for further improvement of the independent director system in Taiwan are also proposed.

### Independent Director Systems around the World

Conventional corporate governance theory contends that the inclusion of independent directors on boards lowers the probability of management's expropriation of shareholder wealth.<sup>8</sup> Independent directors are believed to be more effective monitors than are insiders and affiliated directors. Accordingly, firms with an independent board bring more benefits to shareholders than firms do otherwise. Increasing a firm's financial performance is the ultimate benefit. This can be achieved by making correct strategic decisions, replacing a chief executive officer (CEO) who performs poorly, determining appropriate CEO compensation, etc. However, many empirical studies of the effects of independent boards show mixed results.<sup>9</sup> No consistent evidence exists to support the benefits of board independence. Regarding long-term firm performance, a recent large scale research project claims that firms with more-independent boards do not perform better than other firms.<sup>10</sup>

Despite the lack of strong empirical evidence, corporate governance practitioners around the world are sticking to the conventional wisdom

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7. Donald Clarke, "The Independent Director in Chinese Corporate Governance," *Delaware Journal of Corporate Law* 36:1 (2006), pp. 125–28.

8. Eugene Fama, "Agency Problems and the Theory of the Firm," *Journal of Political Economy* 88:2 (April 1980), pp. 288–307.

9. For a detailed literature review of empirical works relating to director independence, see Jonathan Johnson, Catherine Daily, and Alan Ellstrand, "Board of Directors: A Review and Research Agenda," *Journal of Management* 22:3 (June 1996), pp. 409–38.

10. Sanjai Bhagat and Bernard Black, "The Non-Correlation between Board Independence and Long-Term Firm Performance," *Journal of Corporation Law* 27:2 (Winter 2002), pp. 231–73.

and continue to call for board independence. Advocates of independent boards include professional associations, institutional investors, and governments. For example, the United States's National Association of Corporate Directors (NACD) calls for a substantial majority of board directors to be independent.<sup>11</sup> The core corporate governance principles of the California Public Employees' Retirement System (CalPERS) suggest likewise.<sup>12</sup> In Taiwan, board independence was on the agenda of a governmental task force for corporate governance reform.<sup>13</sup> Perhaps the most influential promoter of the independent directors system is the OECD. The organization published the *OECD Principles of Corporate Governance* in 1999, specifically calling for a "sufficient" number of directors capable of exercising independent judgment.<sup>14</sup> The document was widely referenced by policy makers of OECD and non-OECD countries for establishing legal and regulatory frameworks for corporate governance. Since the publication of the document, principles of corporate governance have appeared in one country after another. Virtually all of them include rules on board independence.

The United Kingdom released its first corporate governance codes in 2000. In the "Board Balance" section of the codes, it specifies that "not less than one-third of the board" should be non-executive directors.<sup>15</sup> The 2003 update of the same document increases the non-executive director requirement to "at least half the board."<sup>16</sup> This in fact is more stringent than the original Cadbury Report, which does not recommend a specific number of non-executive directors on a board.<sup>17</sup>

In the U.S., beginning in the 1970s there was a trend toward greater board independence. The proportion of independent directors increased from

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11. See U.S., National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Director Professionalism* (Washington, D.C.: National Association of Corporate Directors, 2005).

12. See Section III.A.1, U.S., California Public Employees' Retirement System, *Corporate Governance Core Principles & Guidelines* (Sacramento: California Public Employees' Retirement System, September 2006).

13. See Taiwan, Taskforce for Reforming Corporate Governance, *Accountability of Companies in Taiwan: Policy Agenda and Action Plan to Strengthen Corporate Governance* [in English] (Taiwan: Executive Yuan, November 12, 2003).

14. See Article V.E.1, OECD, *OECD Principles of Corporate Governance* (Paris: OECD, 1999/2004).

15. See provision A.3.1, UK, Committee on Corporate Governance, *The Combined Code: Principles of Good Governance and Code of Best Practice* (UK: Committee on Corporate Governance, May 2000). This first "combined" code combines the Cadbury and the Greenbury Reports.

16. See provision A.3.2, UK, Financial Reporting Council, *The Combined Code on Corporate Governance* (UK: Financial Reporting Council, July 2003).

17. See provision 4.11, UK, Committee on the Financial Aspects of Corporate Governance, *The Financial Aspects of Corporate Governance* (London, UK: Gee & Co., Ltd., December 1992). This is commonly called the Cadbury Report.

20% in 1970 to 60% in 1991. That year about 70% of firms had a majority-independent board and 85% had more independent than inside directors.<sup>18</sup> A new New York Stock Exchange (NYSE) rule regarding independent directors was established in November 2003. Section 303A.01 of the *NYSE Listed Company Manual* clearly states, "Listed companies must have a majority of independent directors." In addition, the audit, nominating, and compensation committees should all be composed entirely of independent directors.<sup>19</sup>

Japan included the independent director system in its major revision of the Commercial Code, by which the U.S.-style committee system became an optional alternative to the existing corporate auditor system. The new dual system became effective in April 2003. For those companies that choose to adopt the new committee system, the majority of members of each committee should be independent directors.<sup>20</sup> Per Commercial Code requirements, the Tokyo Stock Exchange (TSE) issued a new document, *Principles of Corporate Governance for Listed Companies*, requiring each of the audit, nomination, and compensation committees to be made up of three or more directors. More than half the members of each committee must be independent directors. However, in auditor systems, appointment of independent directors is not required.<sup>21</sup>

South Korea drastically overhauled its corporate governance system after the 1997 Asian financial crisis.<sup>22</sup> One major effort was introduction of the *Code of Best Practice for Corporate Governance*, released in September 1999. This code requires that the "number of outside directors shall be such that the board is able to maintain practical independence."<sup>23</sup> The February 2003 revision of the same document changed the required minimum number of independent directors to two.<sup>24</sup> Korea's Securities and Exchange Act, on the other hand, sets the requirement to "not less than one-fourth of [the] total number of its directors."<sup>25</sup> Despite the inconsistencies

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18. Sanjai Bhagat and Bernard Black, "The Non-Correlation between Board Independence and Long-Term Firm Performance," *Journal of Corporation Law* 27:2 (Winter 2002), pp. 231–73.

19. See Articles 303A.01, 303A.04.a, 303A.05.a, and 303A.07.b of NYSE, *Listed Company Manual* (New York: NYSE, 2003).

20. Hiroyuki Itami, "Revision of the Commercial Code and Reform of the Japanese Corporate Governance," *Japan Labor Review* 2:1 (Winter 2005), pp. 4–25.

21. See TSE, *Principles of Corporate Governance for Listed Companies* (Tokyo: Tokyo Stock Exchange, March 2004), pp. 14–15.

22. Joongi Kim, "The Next Stage of Reforms: Korean Corporate Governance in the Post-Asian Financial Crisis," *Asian Journal of Comparative Law* 1:1 (May 2006), Article 15.

23. See Article II.2.2, Korea, Committee on Corporate Governance, *Code of Best Practice for Corporate Governance* (Korea: Committee on Corporate Governance, September 1999).

24. See *ibid.*, February 2003.

25. See Article 191–16, Korea, Financial Supervisory Commission, *Securities and Exchange Act* (Korea: Financial Supervisory Commission, July 2005).



in these documents, the regulations on appointments are becoming more specific and stringent in Korea.

The China Securities Regulatory Commission initiated its independent director system in August 2001 by issuing the *Guidance Opinion on the Establishment of an Independent Director System in the Listed Companies*, whereby listed companies in China were required to have at least two independent directors by June 30, 2002. Such directors were to constitute at least one-third of each board by June 30, 2003. In addition, the document requires that independent directors constitute more than half the members of the board's audit, nomination, and compensation committees.<sup>26</sup> Chinese listed companies comply with the rule at an incredibly efficient rate. As of 2004, practically all companies listed on the Shanghai Stock Exchange and Shenzhen Stock Exchange have independent directors sitting on their boards.<sup>27</sup>

Table 1 summarizes the requirements for the number of independent directors on boards and committees for each country discussed above. The requirements of the Taiwan SEA are listed in the last row for comparison purposes. The U.S. has the most stringent rules, which require that all three committees be composed entirely of independent directors. Two independent directors on the board is the minimum requirement for all countries except Japan. This is consistent with the widely held view that corporate governance practices worldwide evolve gradually toward a similar pattern.<sup>28</sup>

### In Need of Corporate Governance Reform

What has been the state of corporate governance in Taiwan for the past several years? Judging from the number of companies that have faced financial distress, corporate governance there deserves a rating no better than "fair." From 1992 to 2005, a total of 211 listed companies were in financial distress, in contrast to the eight total from 1980 to 1991. Table 2

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26. See Articles 1.3 and 5.4, China, Securities Regulatory Commission, *Guidance Opinion on the Establishment of an Independent Director System in the Listed Companies* (China: Securities Regulatory Commission, August 2001).

27. We have obtained the statistics by examining the type of each board of directors of the companies listed in the Shanghai and Shenzhen Securities Exchange. The data are from the Taiwan Economical Journal (TEJ) database. The proportions of companies that include independent directors were 99.9% and 99.8%, respectively, for Shanghai and Shenzhen in 2004, whereas there were none in 2002.

28. Stilpon Nestor and John Thompson, "Corporate Governance Patterns in OECD Economies: Is Convergence Under Way?" OECD, 2000, <<http://www.oecd.org/dataoecd/7/10/1931460.pdf>>, accessed January 18, 2007.



TABLE 1 *Independent Director Requirements in Various Countries*

<i>Countries</i>	<i>Laws/Codes/Principles</i>	<i>Requirements on the Board</i>	<i>Requirements in the Committees</i>
UK	“The Combined Code on Corporate Governance” (Financial Reporting Council, Jun. 2006) <sup>1</sup>	At least half, or two for smaller companies	Audit: entirety Nomination: majority Remuneration: at least three, or two for smaller companies
U.S.	“Listed Company Manual” (New York Stock Exchange, Nov. 2006) <sup>2</sup>	Majority	Audit: entirety Nomination: entirety Compensation: entirety
Japan	“Principles of Corporate Governance for Listed Companies” (Tokyo Stock Exchange, Mar. 2004) <sup>3</sup>	Not required	Audit: at least half Nomination: at least half Compensation: at least half
South Korea	“Securities and Exchange Act” (Financial Supervisory Commission, Jul. 2005) <sup>4</sup>	Not less than one-fourth, or not less than three and not less than half for securities companies	Inspection: not less than two-thirds for securities companies
China	“Code of Best Practice for Corporate Governance” (Committee on Corporate Governance, Feb. 2003) <sup>5</sup>	Minimum two and one-half for large companies	Audit: two-thirds Nomination: majority Compensation: entirety
Taiwan	“Guidance Opinion on the Establishment of an Independent Director System in the Listed Companies” (China Securities Regulatory Commission, Aug. 2001) <sup>6</sup>	Two by Jun. 2002, and one-third by Jun. 2003	Audit: at least half Nomination: majority Compensation: entirety
	“Securities and Exchange Act” (Financial Supervisory Commission, Executive Yuan, 2006) <sup>7</sup>	Not less than two and not less than one-fifth for companies designated by the competent authority	Audit: entirety

SOURCES: Requirements for each country are extracted from the documents specified in the *Laws/Codes/Principles* column.

<sup>1</sup> See Articles A.3.2, A.4.1, B.2.1, and C.3.1.

<sup>2</sup> See Articles 303A.01, 303A.04-a, 303A.05-a, and 303A.07.b.

<sup>3</sup> See pp. 14–15.

<sup>4</sup> See Articles 191–16, 54–5, and 54–6.

<sup>5</sup> See Articles II.2.2, II.6.3, and III.1.2.

<sup>6</sup> See Articles 1.3 and 5.4.

<sup>7</sup> See Articles 14–2 and 14–4.

TABLE 2 *Number of Listed Companies Involved in Financial Distress*

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Financial distress companies	2	2	1	3	4	0	15	31	33	41	10	17	22	30
Total listed companies	235	266	298	375	451	509	603	716	830	919	1,026	1,097	1,167	1,194
Percentage	0.85	0.75	0.34	0.80	0.89	0.00	2.49	4.33	3.98	4.46	0.97	1.55	1.89	2.51

SOURCE: The data are calculated by the authors based on information collected from the TEJ database.

NOTE: All information is reported as at the end of each year. The total number of listed companies involved in financial distress in the period 1992 through 2005 is 211. This sharply contrasts the total number in the period 1980 through 1991, which was only 8.

summarizes the trend of listed companies in financial distress.<sup>29</sup> The number of companies with financial troubles increased gradually from 15 in 1998 to 41 in 2001. By the year 2002, this dropped sharply to 10 companies but increased again gradually to 30 companies in 2005. Most of these companies in financial distress ended up in liquidation or bankruptcy, if they were not already in those straits when their financial problems first erupted. Several firms incurred heavy societal costs, as thousands of stockholders saw their investment money evaporate without knowing what had happened.

One government document summarizes well the problems of corporate governance in Taiwan.<sup>30</sup> First, there is narrow control of decision-making in companies. Controlling shareholders dominate the board in family-run companies, and directors and supervisors may fail to play their monitoring role honestly. Second, there is a lack of transparency in the financial status of many companies. The creative extension of common accounting practices blurs a company's real financial status, and three-way financial transactions among related parties, as well as false or ambiguous financial statements, are common. Third, there is excessive financial leveraging. Many companies give inflated valuations of stock and real estate as pledged collateral. In addition to these three main problems, there are other issues such as excessive bonuses offered to management and board members and hidden in the form of stock shares, etc.

Major corporate governance reform does seem necessary to prevent further financial disasters from happening. What makes the reform more imminent is the fast expansion of the Taiwan stock market. The numbers of listed companies, directors, supervisors, and shareholders as well as the size of capital involved have all increased drastically within the past 15 years or so. A brief story about the rapid growth of listed companies helps us grasp the context.

The 1980s were wonder years in Taiwan. During the decade, the island's economy enjoyed continuous strong growth. The country's average gross domestic product (GDP) growth rate was over 8%. A feeling of an exuberance of wealth permeated all who participated in the booming economy. Much of the spare money flooded into the stock market, which was immersed in a casino-like atmosphere. The Taiwan Stock Exchange Capital-

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29. Companies involved in financial distress are handpicked from a company's basic information in the TEJ database. The database contains information on when and what trouble the company has encountered. Financial distress includes situations where a company has defaulted on a loan principal or interest payments, renegotiated loan terms that extend the cash payment schedule, renegotiated for reduced principal and interest payments, traded at 100% margin, went bankrupt, or was liquidated, etc.

30. See Section IV.1, *Accountability of Companies in Taiwan* (Taiwan: Executive Yuan).

ization Weighted Stock Index (TAIEX) soared 20 times from 636 on July 30, 1985, to its all time high of 12,495 on February 10, 1990. Nevertheless, the prosperity came to a halt the same year. The TAIEX tumbled down to 2,560 in just eight months and since then has never returned to its previous peak.

One major reason for the frenzy before the stock market crash was attributed to too much money chasing too few stock shares. There were only 141 companies listed on the TSE in 1987. The limited supply of shares could not meet the overwhelming demand. It was apparent that there was a need to increase the number of listed companies in order to boost the supply of stock shares. Deregulation of the stock market was inevitable, and stock-listing rules have since been gradually relaxed.

Several deregulation policies were executed in the early 1990s, among them the establishment of an over-the-counter (OTC) market. Formal operation of the market started on November 1, 1994, under the name of the GreTai Securities Market (GTSM). The number of listed stocks on the GTSM increased from virtually none to 499 by the end of 2005. In the same period, the number of stocks listed on the TSE also increased, although not as drastically as on the GTSM. Altogether, the number of listed companies in the two markets grew almost fivefold from 235 in 1992 to 1,194 in 2005. Table 2 contains the data on the increasing trend for the total number of listed companies on these two stock markets.

Stock market deregulation brought stocks of many companies to the open market, and as a result, the prestigious board director seats among listed companies were also augmented. The total number of directors increased from 2,275 in 1992 to 9,511 in 2005. Directors of companies are the elites in the corporate world and in effect control the business environment. Without suitable rules for these newcomers to follow, corporate governance problems could burst out anytime a downturn in an economy occurs.

Another driving force for corporate governance reform is the increasing globalization of financial markets. Many Taiwanese companies are seeking the inclusion of international investors to broaden their investor base. Other firms seek to be listed in overseas markets. To attract funds from international capital markets, an internationally accepted corporate governance practice is required. Overall, better corporate governance should increase the competitiveness of Taiwanese corporations. One government document noted specifically that strong corporate governance is important for "the long-term development of Taiwan's economy."<sup>31</sup>

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31. See Section V, *ibid.*

## Reform toward an Independent Director System

The Taiwanese authority has put in effect a series of efforts to reform corporate governance systems.<sup>32</sup> In this section, we focus on the systematic and coordinated efforts involved in implementing the independent director system.

The efforts began with the elimination of the shareholder requirement for board directors and supervisors. In Taiwan, board directors are traditionally associated with ownership. Only shareholders are eligible to be elected as board directors. Shareholders certainly are proper candidates for directors because they have a stake in the company. Yet, one condition for director independence is that directors have no economic ties of any form with the company. To clear the way for non-shareholding professionals to become independent directors, the shareholder constraint in the Company Act was lifted in November 2001.<sup>33</sup>

The subsequent effort was revision of the listing rules. In February 2002, both the TSE and GTSM added a set of new requirements to their listing review rules (hereafter Listing Rules). Companies are required to host at least two independent directors and one independent supervisor on their board in order to qualify for listing on the TSE and GTSM.<sup>34</sup> Those that do not seat independent directors and supervisors would not be cleared for listing. This was a major and effective move toward implementation of the independent director system. The effort is nevertheless only partial because companies already listed on the TSE and GTSM are not required to follow suit: they are only encouraged to invite independent directors to sit on their boards.

A corporate governance document, “Corporate Governance Best-Practice Principles for TSEC/GTSM Listed Companies” (hereafter known as the

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32. According to governmental documents, the series of reforms implemented in the early millennium include: amended the Company Act to ban the cross-holding of shares, introduced the system of independent directors and supervisors, improved the quality of information disclosure by TSE/GTSM-listed companies, instituted legal proceedings against improper acts and related corruption, assisted investors to pursue claims for damages, promulgated the “[c]orporate governance best-practice principles for TSE/GTSM listed companies,” strengthened internal audit and internal control systems, established the Market Observatory Post System for the capital market, and secured the passage of many new laws. See Section IV.2, *ibid.*

33. The revision was on Company Act Article 192, regarding directors, and Article 216, regarding supervisors.

34. See Article 9–10, Taiwan, Taiwan Stock Exchange Corporation (TSEC), *Taiwan Stock Exchange Corporation Rules Governing Review of Securities Listings* (Taiwan: TSEC, amended March 2006); and Article 1–8, Taiwan, GTSM, *Directions for Determining Unsuitability for OTC Listing under Article 10, Paragraph 1 of the GreTai Securities Market Regulations Governing Review of Securities Traded on Over-the-Counter Markets* [in English] (Taiwan: GTSM, amended March 2006).

Principle and released in October 2002) comes next.<sup>35</sup> The Principle collects all the existing rules, guidelines, and consensuses on corporate governance into one document. It is structured similarly to the 1999 version of the OECD corporate governance principles. The Principle elaborates on the protection of shareholders' rights and interests, enhancing the function of the board of directors, empowering the supervisors, respecting stakeholders' rights, and improving information transparency. It is not a firm law but it does set the corporate governance standard for companies in Taiwan to follow. A later amendment further advises listed companies to promulgate their own corporate governance principles in accordance with principles in the Principle.<sup>36</sup>

The independent director system is one of the main subjects in the Principle, which requests listed companies to place an appropriate number of independent directors on their boards.<sup>37</sup> It also offers provisions to support independent directors in executing their jobs and allows for the separation of independent directors' compensation plans from those of other directors.<sup>38</sup> The principles regarding supervisors are similar.<sup>39</sup>

Neither the Listing Rule nor the Principle has the status of law, and efforts were made to upgrade the independent director system to the legal level. The endeavor was finally completed in December 2005. An amendment of the SEA was passed by Taiwan's legislature, stating that the competent authority shall require publicly listed companies to appoint two or more independent directors. The rule is nevertheless soft and leaves room for flexible execution.<sup>40</sup> In addition to independent directors, another major reform to the existing board structure was introduced. Companies can either establish an audit committee or keep supervisors within the board. If

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35. TSEC and GTSM jointly endorsed this document.

36. This amendment was released in December 2003.

37. See Article 24 of the Principle.

38. See Article 25 of the Principle.

39. Regarding supervisors, Articles 43 and 44 of the Principle include statements similar to that of Articles 24 and 25.

40. Regarding independent directors, the amendment (SEA Article 14–2) states, "A company that has issued stock in accordance with this Act may appoint independent directors in accordance with its articles of incorporation. The Competent Authority, however, shall as necessary in view of the company's scale, shareholder structure, type of operations, and other essential factors, require it to appoint independent directors, not less than two in number and not less than one-fifth of the total number of directors." These rules are flexible in that they also allow voluntary appointment of independent directors and thus leave room for gradual enforcement of the system. The actual execution beginning in January 2007 only requires that financial institutions such as financial holding companies, banks, bills finance companies, insurance companies, etc., and listed companies in the non-financial sector with paid-in capital exceeding US\$1.6 billion to compulsorily appoint independent directors.

a company adopts an audit committee, it must be composed of only independent directors, no less than three of them.<sup>41</sup>

To formally differentiate the independent directors from other outside directors, the SEA amendments bind independent directors with certain legal responsibilities. They are treated differently. Their qualifications, restrictions on shareholding, and methods of nomination should be specifically defined.<sup>42</sup> Independent directors therefore become a position on the board rather than a category of directors. The other difference is that dissenting and qualified opinions from independent directors—for certain issues—must be noted in the minutes of the directors' meeting.<sup>43</sup> All active opinions of an independent director are to be legally recorded. The purpose of these legal bindings is to increase the level of responsibility of an independent director.

The implementation details for the rules set forth in the SEA amendment were presented in a new document, "Regulation Governing the Establishment of Independent Directors of a Public Company." It was put into effect in January 2007. Table 3 summarizes the contents and purposes of these laws, principles, and rules.

The Listing Rules, the Principle, and the SEA amendment were aligned in sequence; they form the core of Taiwan's independent system reform. Many supportive actions were planned and executed around the same time to facilitate execution of these core rules. Among them was an amendment to a bylaw of the SEA. It relaxes the requirement on share ownership by the board that appoints independent directors.<sup>44</sup> This provided some incentive for companies to appoint independent directors. Another supportive action is to open the market for independent directors. The Securities and Futures Institute, a semi-governmental organization, established a talent database designed as a platform to match qualified independent director candidates and companies seeking them. As of August 18, 2008, there were 2,457 potential independent directors in the database.<sup>45</sup>

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41. See Article 14-4 of the SEA.

42. See Article 14-2, *ibid.*

43. See Article 14-3, *ibid.*

44. See TSEC, *Rules and Review Procedures for Director and Supervisor Share Ownership Ratios at Public Companies* [in English] (Taiwan: SEC, amended November 2002). The revision was released in November 2002, one month after the issuance of the Principle. Article 2.4 specifies that if a company simultaneously elects two or more independent directors and one or more independent supervisor, the requirement on share ownership by the board shall be decreased by 20%. And, Articles 2, 4, and 5 include statements that exclude independent directors and supervisors from the responsibilities regarding regulations on the total stock shares owned by all board directors and supervisors.

45. See "Independent Directors/Independent Supervisors Registry," <<http://www.sfi.org.tw/ewatch/main.asp>>, accessed August 18, 2008.



TABLE 3 *Summary of Reforms Regarding the Independent Director System in Taiwan*

<i>Reforms and Effective Dates</i>	<i>Major Contents</i>	<i>Purposes</i>
The Company Act, revision, Nov. 2001	Elimination of the requirement for board directors and supervisors to be shareholders (Article 192, Article 216).	Clear the way for non-shareholding professionals to become independent directors.
The Listing Rules, revision, Feb. 2002	<ol style="list-style-type: none"> <li>1. Number of independent directors and supervisors (TSE<sup>1</sup>—Article 9–10; GTSM<sup>2</sup>—Article 1–8): there is no listing if the company has less than five members on its board of directors or less than two independent directors, three supervisors, or one independent supervisor.</li> <li>2. Limiting of family seats on a board (TSE<sup>3</sup>—Article 17–4; GTSM<sup>4</sup>—Article 1–8): there is no listing if more than two-thirds of the total number of directors of the company are mutually closely related, all of the supervisors of the company are mutually closely related or share with any one director such a close relationship.</li> </ol>	Enforce newly listed companies to place independent directors and supervisors.
The “Corporate Governance Best-Practice Principles for TSEC/GTSM Listed Companies,” new document, Oct. 2002; revised again Dec. 2003	<ol style="list-style-type: none"> <li>1. Stipulation of independent directors and independent supervisors (Article 24, Article 43): A TSE/GTSM listed company shall stipulate an appropriate number of independent directors and independent supervisor. If the company has managing directors, it is advisable that there shall be one or more independent directors among them.</li> <li>2. Separating the compensation of independent directors and supervisors from that of other directors and supervisors (Article 25, Article 44): different but reasonable compensation from that of other directors and supervisors may be set forth for the independent directors and independent supervisors.</li> <li>3. Calling for the setup of audit, nomination, and compensation committees (Article 27, Article 28): the audit committee is advised to be made the first priority. The audit committee shall consist of at least one independent director. Independent supervisors are advised to be invited to sit in at the committee meeting.</li> <li>4. Balancing the corporate power (Article 23): it is advisable that the number of independent directors be increased if the chairman also acts as the general manager or they are spouses or relatives within one degree of consanguinity.</li> </ol>	Provide corporate governance best-practice principles for listed companies to follow.

The "Rules and Review Procedures for Director and Supervisor Share Ownership Ratios at Public Companies," revision, Nov. 2002

1. Relaxing share ownership requirement for companies that seat independent directors and supervisors (Article 2): if a company has simultaneously elected two or more independent directors and one or more independent supervisors, the requirement of share ownership by the board shall be decreased by 20%.
2. Excluding independent directors and supervisors from responsibilities regarding the regulations of the total stock shares owned by all board directors and supervisors (Articles 2, 4, and 5).

Provide incentives for companies to seat independent directors.

The SEA, amendment, Jan. 2006<sup>4</sup>

1. Appointment of independent directors (Article 14-2): independent directors become mandatory for companies designated by the competent authority, and they should not be less than two in number and not less than one-fifth of the total number of directors.
2. Establishment of audit committee or supervisor (Article 14-4): a company will choose to establish either an audit committee or a supervisor. The audit committee shall be composed of the entire number of independent directors. It shall not be fewer than three persons in number.
3. Noting of independent director opinions (Article 14-3): when an independent director has a dissenting opinion or qualified opinion over major financially related decisions, it shall be noted in the minutes of the directors' meeting.
4. Limiting of family seats on a board (Article 26-3): the board seats should not be less than five and the spouses and the family members within the second degree of kinship may not exist among more than half of a company's directors.

Raise the independent director system to the level of a law.

The "Regulation Governing Appointment of Independent Directors and Compliance Matters for Public Companies," new document, Jan. 2007

Regulate the implementation details set forth in the SEA amendment.

1. Qualification and conditions for independent directors (Articles 2 and 3): this includes experienced professionals and rules out individuals with close association with the insiders.
2. Nomination procedure of independent directors (Article 5): this allows nomination by a group of shareholders with accumulated shares over 1%.
3. Shift between non-independent director and independent director (Article 6): this prohibits the shift of position from non-independent to independent director and vice versa.
4. Independent directors as managing directors (Article 8): there should be at least one and no less than one-fifth of the managing director seats of independent directors in the managing board.

SOURCE: By the authors.

<sup>1</sup>See *Taiwan Stock Exchange Corporation Regulations Governing Review of Securities Listings* (TSE).

<sup>2</sup>See *Directions for Determining Unsuitability for OTC Listing under Article 10, Paragraph 1, of the GreTai Securities Market Regulations Governing Review of Securities Traded on Over-the-Counter Markets* (GTSM).

<sup>3</sup>See *Supplementary Provisions to the Taiwan Stock Exchange Corporation Regulations for Review of Securities Listings* (TSE).

<sup>4</sup>The amendments to the SEA were enforced from January 2006 with some exceptions. One of the exceptions is that the articles related to the independent director system (14-2 through 14-5 and 26-3) are to be enforced beginning in January 2007.

TABLE 4 *Trend of Independent Director and Ownership Structure*

	1999	2000	2001	2002	2003	2004	2005
<b>No. of Boards with Independent Directors</b>							
All listed			1	207	377	531	601
(%)			(0.1)	(20.2)	(34.4)	(45.5)	(50.3)
Newly listed			0	73	99	95	59
(%)			(0.0)	(51.4)	(95.2)	(97.9)	(95.2)
TSE			0	106	179	252	269
(%)			(0.0)	(16.5)	(26.5)	(35.9)	(38.7)
GTSM			1	101	198	279	332
(%)			(0.3)	(26.4)	(47.0)	(59.9)	(66.5)
<b>Board Size (average)</b>							
Newly listed	8.90	8.93	9.15	9.91	9.86	9.62	10.00
All listed	10.15	9.88	9.70	9.63	9.63	9.64	9.59
<b>Outsiders (% , average)</b>							
Newly listed	66.8	66.7	70.8	73.7	73.4	74.3	76.3
All listed	71.0	71.3	71.4	72.0	71.2	72.1	72.9
<b>Institutional Representatives (% , average)</b>							
Newly listed	29.2	27.6	30.4	28.6	19.1	20.5	18.6
All listed	45.6	44.9	43.8	41.0	37.6	36.2	35.0

SOURCE: The data are calculated by authors based on information collected from the TEJ database.

NOTE: All information is reported as at the end of each year. Notice that 2002 is the dividing year whereby around half of the newly listed companies introduced independent directors. The key observation in this table is the differences on ownership structure variables before and after the introduction of the interim rules.

## The Response of the Listed Companies

We now examine the response of the listed companies since the introduction of the Listing Rules in February 2002. For newly listed companies, roughly half (51.4%) placed independent directors in 2002, and after 2003 virtually all have obeyed the Listing Rules. Existing listed companies, although not required to appoint independent directors, also heeded the call for such reform. A total of 134 such firms introduced independent directors or independent supervisors in 2002. By the end of 2005, a total of 601 out of 1,194 of all listed companies (50.3%) had placed independent directors on their boards. Among these companies, 38.7% were listed on the TSE and 66.5% on the GTSM. More GTSM companies comply with the rule because most companies enter the stock market through the GTSM and were forced to place independent directors. Table 4 shows the trend

and summarizes the change of several ownership structure variables from 1999 through 2005.

Ownership structure showed an apparent change for newly listed companies before and after the promulgation of the Listing Rules. Putting aside data for 2002, the average value of board size, the proportion of outside directors, and the proportion of institutional representatives all show a noticeable shift.<sup>46</sup> The board size and the proportion of outside directors increased, whereas the proportion of institutional representatives decreased. The Listing Rules were installed in February 2002; thus, 2002 serves as the dividing line.

To check if the changes are statistically significant, we first separated the data into two three-year observation windows, 1999 through 2001 and 2003 to 2005.<sup>47</sup> We then conducted the Mann-Whitney test on the pooled three-year data between the two observation windows for each variable. The results show that all three ownership structure variables are significantly different before and after the implementation of the Listing Rules. Table 5 summarizes the board structure variation for newly listed companies.

Because two independent directors and one independent supervisor have been fitted into the picture, it is not surprising that the board size of newly listed companies has increased. Our data show that the addition to the board size is 0.80 directors on average, well under three. This implies that most companies did not simply add two directors and one supervisor to their board. Board composition was probably adjusted by eliminating a few original directors in order not to expand the board too much. The addition of independent directors and supervisors also increased the proportion of outsiders. Table 5 shows that the proportion of outsiders for newly listed companies increased 9.3% on average after the enforcement of the Listing Rules. This increment may not make much of a difference, as there had been no shortage of outsiders on Taiwanese company boards. The proportion of outsiders is around 70% across the years.

The proportion of institutional representatives on the boards of newly listed companies dropped a noteworthy 9.6% on average after enforcement of the Listing Rules. One possible explanation is that institutional share-

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46. Board size is defined as the number of directors and supervisors in a company. We include supervisors in this definition because they usually attend board meetings and are generally treated as members of the board in Taiwan's corporate board system. Outside director is the proportion of directors and supervisors who do not hold a management position in a company. Institutional representative is the proportion of directors and supervisors who represent institutions that own board seats.

47. We took a three-year window rather than a one-year or two-year window for two reasons. One is that the board usually restructures once every three years in Taiwan. The other is that we wanted to look at the average effect across years.

TABLE 5 *Board Structure Variation of Newly Listed Companies from the Period 1999–2001 to 2003–2005*

	<i>Period 1999–2001</i>	<i>Period 2003–2005</i>	<i>Delta</i>
No. of companies	311	263	
Board Size			
Mean	9.00	9.80	.80
Min.–max.	4–26	5–19	
Standard deviation	2.74	1.65	
<i>p</i> -value			.000
Outsiders (%)			
Mean	68.1	74.4	9.3
Min.–max.	20–90	40–90	
Standard deviation	14.2	9.3	
<i>p</i> -value			.000
Institutional representatives (%)			
Mean	29.1	19.5	–9.6
Min.–max.	0–100	0–100	
Standard deviation	27.1	19.2	
<i>p</i> -value			.000

SOURCE: The data are calculated by authors based on information collected from the TEJ database.

NOTE: The Mann-Whitney U tests on all three variables between the three-year period 1999–2001 and 2003–05 are all significant at *p*-value 0.000.

holders surrender their board seats to independent directors. The reason institutional investors send representatives to company boards is to monitor whether their investments are being put to best use. If an independent director can do the same, then the institution may be willing to hand over the monitoring job. This phenomenon is present for both existing and newly listed companies. For example, as one of TSMC's biggest investors, Philips voluntarily surrendered one of its board seats on TSMC to Carleton Fiorina.<sup>48</sup>

Putting the whole picture together, we see that the addition of independent directors and supervisors has forced newly listed companies to increase their board size but these firms have kept their board size manageable because some institutional investors have surrendered their seats to independent directors. The status of these institutional investors hence changed

48. "Morris: I spend two months to earn Carly's consent," *Business Weekly*, April 17, 2006, pp. 44–46. TSMC is the largest semiconductor manufacturer in Taiwan.

from directors to block shareholders. As a result, the board size and proportion of outsiders has increased only marginally. The number of institutional representatives on company boards has thus been reduced.

It is also interesting to observe how existing listed companies have managed to “voluntarily” place independent directors and supervisors. In our research, we identify the directors and supervisors on the boards of existing listed companies who were declared “independent” at the end of 2002. We check if these directors and supervisors were new to the boards, compared to the directors and supervisors at the end of 2001. Of 303 independent directors and supervisors at the end of 2002, 177 (58.4%) sat on the board of the same company in 2001. More than half the newly appointed independent directors and supervisors in 2002 were old faces. Their status on the board was changed simply by adding “independent” to their original title.

Two possibilities may have led to this phenomenon. One is that these directors and supervisors were outsiders and supposedly independent in the first place. There were no such titles as “independent director” and “independent supervisor” before the enforcement of the Listing Rules. It is quite natural to give titles that suit their original roles to these directors and supervisors. The other explanation is that these directors and supervisors were actually friends and associates of the controlling shareholders who ran the companies. They happened to meet the independent requirements on the surface and therefore were conveniently reappointed to become independent directors and independent supervisors. The latter case would be a defeat of the purpose of the Listing Rules to enable board independency. Although we have no rigorous methodology to determine the proportion of each of these two cases, the convenient retitling of friends’ and associates’ seats seems to be the dominant situation because placing new outsiders on boards brings costs. For example, communication efficiency would decrease, as mutual trust takes some time to build up. The change in the decision model formed on the basis of social ties would also be expected to impact the decision quality.

The observation on how the newly listed and existing listed companies managed to meet the independent director requirements leads to thoughts on how companies in Taiwan would respond to the SEA amendment in the near future. We suggest that the trend on board composition adjustment will continue. The board size should increase a little, but by less than the total number of independent directors and supervisors installed. The proportion of outsiders should increase accordingly but only by a small percentage. Institutional representatives on boards will decrease. More important, those directors and supervisors with an independent status will be placed on the boards through a similarly convenient retitling for existing listed companies. Companies in Taiwan generally find ways to circumvent the rules if the latter get in the way.

## Improving the Effectiveness of the New System

Are the current and recently appointed independent directors and supervisors really independent? From what we have observed on the way they were appointed at existing companies in 2002, there are no guarantees that they will be independent. Many newly appointed independent directors and supervisors seem to be closely associated with the controlling shareholders. How they are appointed and compensated reflects the main reasons for the close association. In the current system, both independent directors and supervisors are elected in the shareholders' meeting once every three years. Controlling shareholders frequently treat the meeting as their personal chess game. Without support from the controlling shareholders or the block shareholders, no independent directors and supervisors would have the necessary votes to be elected. Controlling shareholders will certainly learn to cast their votes for someone whom they trust would support them on the company board. This system defeats the basic idea of the independent director system. It is not reasonable to expect an individual to act against someone who did him or her a favor.

Another issue that could cause the independent director function to fail is the compensation system. Currently, there are no firm regulations on how independent directors are to be compensated, except that the compensation given to independent directors and supervisors can be separated from that of other directors. In most cases, the bylaws of each company specify the guidelines on how the board as a whole is to be paid. Compensation to individual directors is settled in the boardroom and commonly determined by the controlling shareholder. Again, it would be naïve to expect a person to monitor and review the person who pays him or her.

As such, controlling shareholders may strongly influence independent directors and supervisors. Several actions could be taken by the authorities to help the latter two groups become more independent. For example, one can force independent directors and supervisors to endorse and sign more critical company documents that they are not required to endorse now. The more legal responsibilities they carry, the more independent they would presumably be in conducting their job. Another possible action is to speed up the transition from the current supervisor system to the committee system.<sup>49</sup> Independent directors may be a minority on the board, but they would be the dominant majority in committees.<sup>50</sup> A majority in a

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49. Article 11–4 of the SEA amendment allows a company to choose to establish either an audit committee or a supervisor. This article is a facilitator to the transition from the existing supervisor system to the committee system.

50. The SEA amendment requires that the audit committee shall be composed of the entire number of independent directors (Article 14–4).



group that holds legal responsibilities is more likely to think and judge independently.

Two longer-term ideas are proposed for consideration that may further improve the independent director system in Taiwan. These may require further amendments to the Company Act and the Securities and Exchange Act. One option would be to separate the election rules for independent directors and supervisors from those for the regular directors and supervisors. For example, independent directors and supervisors can be elected by counting heads rather than by counting stock shares, currently the only method. If independent directors were to be elected by counting the number of stockholders, then controlling shareholders would have less control over election of independent directors. This method would empower small shareholders. After all, one of the responsibilities of independent directors is to protect the interests of small shareholders.

The second idea is to further regulate the compensation scheme of the independent directors and supervisors so that the decision on their compensation is independent and less controlled by the controlling shareholders. Articles 25 and 44 of the Principle already recommend the separation of these types of compensation, but separation alone is not enough—automatic determination of compensation would be more effective. One possibility is that independent directors not be paid by the common share bonus scheme but by a basic compensation plan, with an amount that is proportional to their added value. The added value of the independent directors and supervisors is related to their independence. One easy measure of independence is the number of opinions these board members issue regarding corporate policies and key personnel appointments. The more opinions that are issued, the less asymmetry there will be between small and large shareholders in access to company information. The more opinions that are issued, the more compensation the independent directors will automatically get. While these two ideas may not be completely practical in the real corporate world, they nevertheless highlight the notion that loosening or even cutting the tight link between controlling shareholders and independent directors and supervisors is the key to board independence. We hope that these two ideas initiate further discussion on better policies to improve corporate governance in Taiwan.

### Conclusion

We have reported how the independent director system was established in Taiwan. The Listing Rules, the Principle, and the SEA amendment provide the foundation of the system. We also discussed how listed companies in Taiwan have acted in response to the regulations on board independence. For newly listed companies, board size has increased, although by

less than one seat; the number of outsiders has increased; and there are now fewer institutional representatives who sit on company boards. An interesting and important finding is that more than half of existing listed companies have merely reappointed their existing board outsiders as independent directors or independent supervisors. This phenomenon may possibly defeat the whole purpose of introducing an independent director system.

The method by which independent directors and supervisors are elected and compensated is the key to the effectiveness of the independent director system. It is crucial to loosen the link between controlling shareholders and independent directors and supervisors. Refining policies on the methods of electing and compensating independent directors and supervisors should be the core topic for further improvement of the independent director system in Taiwan.

Similar to enhancing the quality of life, the improvement of corporate governance in an economy is an endless effort. One has hindsight, but business and societal environments shift over time. There are always new issues and new challenges. In Taiwan, the corporate governance issues that emerged from the fast growth of newly listed companies seem to have come to an end, yet challenges in corporate governance are ongoing. The operating domain of the majority of businesses in Taiwan has extended to Mainland China in the last few years. New issues of corporate governance have gradually surfaced following this extension, especially from firms in the industries that have been banned from investing in China. The semiconductor manufacturing industry is one example.<sup>51</sup> Some of them extended their business to China by applying schemes that escaped governmental control and corporate governance mechanisms. In January 2006, the chairman and vice chairman of United Microelectronic Corporation (UMC), the second largest semiconductor manufacturer in Taiwan, were charged with breach of trust for failing to gain approval from their board before investing in a Chinese start-up company.<sup>52</sup> While the UMC case was well publicized, there are many other lesser known firms facing similar corporate governance issues. This new type of issue requires more attention to corporate governance reform in Taiwan. The reform has placed much of its emphasis on the independent director system. But will the independent director system be an effective remedy? From our observations, we have some reservations.

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51. Chyan Yang and Shiu-Wan Hung, "Taiwan's Dilemma across the Strait: Lifting the Ban on Semiconductor Investment in China," *Asian Survey* 43:4 (July/August 2003), pp. 681–96.

52. "UMC Duo Indicted for PRC Investment," *Taipei Times*, January 10, 2006, p. 1.