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Implementation and Enforcement in Corporate Governance

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Relations between Regulators and Prosecutors on Corporate Governance in Korea

I. Acts on Regulations of Corporate Governance

The acts covering corporate governance in Korea include Part III Companies of the Commercial Act, the Securities and Exchange Act, and the Monopoly Regulation and Fair Trade Act (hereinafter MRFTA).

With enhanced recognition over the importance of corporate governance especially after the financial crisis in 1997, Korea has continuously pursued the amendment work on each Act above. As a consequence, most part of the OECD Corporate Governance Principle has become legislated, which is now under enforcement or scheduled for enforcement.

In the chapter stipulating the punishment of each Act, violating behavior on corporate governance and its punishment are prescribed. The type of violating behavior will be explained later.

II. Administrative Bodies Regulating Corporate Governance and its Regulatory Action

The administrative bodies monitoring and regulating corporate governance structure in Korea are the Fair Trade Commission (hereinafter the KFTC) and the Financial Supervisory Committee (hereinafter the FSC). As the KFTC is in charge of regulating the corporate governance itself, major explanation will be about regulations on corporate governance in Korea. The regulations by the FSC will be briefly touched upon later.

1. The KFTC's Tasks

The KFTC is the competition authority working to promote fair and free competition in the market. Regulations on corporate governance of business conglomerates cannot be regarded as the tasks for competition authority in a traditional sense. However, as corporate governance of Korea's business conglomerates, or *chaebols*, is highly concerned to trigger harmful effects on market competition, the KFTC takes a lead to control them.

2. Problems of Corporate Governance Structure in Business Conglomerates

Korea's business conglomerates, often called as *chaebols,* have a structure controlling the overall group with 4% of small share ownership by controlling shareholders through cross shareholdings between affiliates and control over executives in affiliates as well. It triggers following problems.

<Internal Share Ownership Ratio of 10 Private Business Groups (as of April 2004)>

The Same Person	Specially Related Person	Affiliates	Total (Internal ownership ratio)	External Ownership Ratio
1.5%	2.5%	40.8%	44.8%	55.2%

Cross shareholdings between affiliates cause excessive gap between cash flow rights and voting rights by influencing voting rights of other shareholders while not increasing real capital. As a consequence, it can serve as i) an element for concentration of economic power by enabling dominance of large business group with small amount of capital, and ii) groundwork to pursue personal profits of owner and specially related person rather than minority shareholders by blocking effective functioning of internal and external monitoring mechanism.

On the other hand, owner driven business management based on cross shareholdings between affiliates will lead to undue supportive behavior between affiliates, thereby keeping insolvent companies in the market and excluding other potential competitors from entering the market. This will ultimately hamper fair competition and trigger a chain reaction bankruptcy by spreading core competency to other insolvent affiliates.

In addition, as minority shareholders do not have that much interest in business monitoring and external monitoring mechanism, such as replacement of executives with stock price

changes and hostile M&A, does not work well, administrative body's regulations on corporate governance of business conglomerates are highly required.

3. What to regulate?

Companies under business conglomerates whose total amount of assets of affiliates surpass 2 trillion won shall

- not own share of affiliates which hold their own shares
- not do debt-guarantee on other domestic affiliates
- disclose large scale internal trading with specially related person through voting process in shareholders' meeting

    - Specially related person means an owner who actually control the company concerned, or any relatives who have a certain relationship with an owner.
    - Undue internal trading or under supportive behavior which provide or deal capital, assets and personnel in a remarkably preferable means to specially related persons is prohibited to all companies. Such practice often occurs within large business conglomerates.
- And Financial affiliates under the condition above shall not exercise voting rights over their own shares in other domestic affiliates, though there are several exceptions.

Next, companies under business conglomerates with more than 5 trillion won of total assets of affiliates, shall not hold shares of other domestic companies surpassing 25% of their own net assets (the amount deducting the shareholdings in affiliates from the total amount of capital in the company concerned). However, equity investment necessary for business activities is acknowledged for its exception.

- The amendment draft of the MRFTA, which the regulation is not applied to business conglomerates, not having any problem in corporate governance structure and being armed with effective internal control system, such as cumulative voting system, written voting system and internal trade committee, is under deliberation in the National Assembly.

On the other hand, the KFTC annually sets the large business conglomerates under regulations above and reports the fact to the companies concerned. As for January 2004, there are 48 business conglomerates (847 affiliates in total) appointed as those under the restraint of cross shareholdings and 15 business groups (342 affiliates in total) appointed as those subject to setting the ceiling on total amount of shareholdings in other domestic companies.

4. Preventive and corrective measures, and criminal punishment

In order to prevent any violation of competition law, the KFTC lets companies report and make notification to the KFTC. In addition, it has an investigative power against violator to correct behavior and the rights to order share disposal and prohibition of exercising voting rights, and impose surcharges and administrative fines.

The KFTC's investigative power includes the rights to ask suspects to come to the KFTC office, listen to the opinion, request documents and information, and confirm the information to relevant organizations. However, the KFTC is not empowered with any coercive rights, such as search and seizure and imprisonment.

Among corrective measures, imposing huge amount of surcharges has worked as an effective regulatory measure against large companies with strong capital base. In response to undue internal trading, the KFTC can impose surcharges up to 5% of average revenues of recent three years of company concerned.

Against most violating activities explained above, criminal punishment can be imposed separate from administrative measure. However, in response to its violation, prosecutor can take a public action only when there is any complaint filed from the KFTC. As administrative measures taken by the KFTC are against companies concerned, severe punishment is required when the owner and executives of the company commit any serious violation. Therefore, the KFTC can file a complaint to the Prosecutor's Office or the Office can ask the KFTC to do so.

5. Regulations taken by the FSC

The FSC is supervising the works and activities done in the financial circle. In particular, the Securities and Future Committee under the FSC handles the tasks on unfair trade

investigation in securities and futures market, business accounting standards and accounting supervision. The means for supervision and regulation for tasks above taken by the FSC are similar to those of the KFTC. On the other hand, unfair trade practices, such as internal trading, and activities of forming false financial statement violating the accounting standards, are subject to face criminal punishment. Against criminal activities above, the FSC's complaint to the Prosecutor's Office is not the condition to institute a public action.

III. Characteristics of Korea's Prosecution System and its Relations with Administrative Bodies

1. Characteristics of Prosecution System in Korea

Korea's prosecutor has rights to investigate crime and take a public action. Even though judicial police has rights for investigating crime, there should be control from prosecutor. Only prosecutors have rights to request warrant to judge for coercive investigation, such as search and seizure and arrest. Judicial police can only apply for the request of warrant to prosecutors.

On the other hand, Korea does not have private prosecution, which exists in the U.K. and the U.S. Rather, it has public prosecution by state, which only prosecutors can have rights to take public action. In addition, Korea takes discretionary indictment, which prosecutors cannot take public action by considering the motives and situations of crime, even though the behavior concerned can be regarded as crime.

2. Relations between Prosecutors and Administrative Bodies

Administrative body and prosecutors are national body with separate goals. As administrative investigation is not the crime investigation, it does not, in principle, need to be controlled by prosecutors. (However, exceptions are allowed when the Securities and Futures Committee investigates unfair trading behavior under the Securities and Exchange Act.)

However, in effect, administrative body and prosecutors are closely working together in carrying out their tasks.

In other words, when the administrative body found any allegation of crime in its investigation process, it files a complaint, asks investigation or makes a notice to the Prosecutor's Office. (As both the KFTC and the FSC consist of experts of competition and financial sectors, they can more easily get an access and acquire relevant information. Therefore, in this sector, there are more cases which prosecutors take investigation in response to the request or complaint from the KFTC and the FSC rather than direct investigation based on their allegation.). In this case, the information and document of investigation taken by the KFTC and the FSC can be used for basic information for the prosecutor's investigation. However, Q&A on suspects done by two organizations has some limits to collect full evidence under the Criminal Procedure Act. In addition, it requires complementary investigation by prosecutors.

- The FSC investigates 214 cases of alleged unfair trade practices under the Securities and Exchange Act in 2003. Among these, 56 cases were filed a complaint and 77 cases were asked to be investigated.
- The KFTC filed a complaint of 23 cases in 2001, 11 cases in 2002 and 18 cases in 2003 to prosecutors. Among these, there are 6 cases of complaint on undue internal trading, which is a crime on corporate governance.

On the other hand, if prosecutors think that administrative measures are required for the case concerned according to the result of criminal investigation, they report the fact of violation to relevant administrative body.

In addition, if there are both investigations from prosecutors and the KFTC/FSC at the same time, the Prosecutor's Office and relevant administrative body closely work together by exchanging relevant information and informing the result of investigation each other.

However, due to the lack of legal experts in administrative bodies, it is hard for administrative bodies to effectively cooperate with prosecutors. In addition, while in the U.S., both the Department of Justice and the Prosecutors' Office are in charge of legal advice to national organizations, administrative and national suit, this is not the case in Korea. For these reasons, prosecutors are seconded to relevant administrative bodies in order to enhance efficiency in handling the tasks. In the KFTC, there is one seconded senior prosecutor, and

one seconded prosecutor while in the FSC, one prosecutor is seconded, carrying out the similar tasks. I am a seconded prosecutor to the KFTC.

3. Team Investigation in Korea's Prosecutor's Office

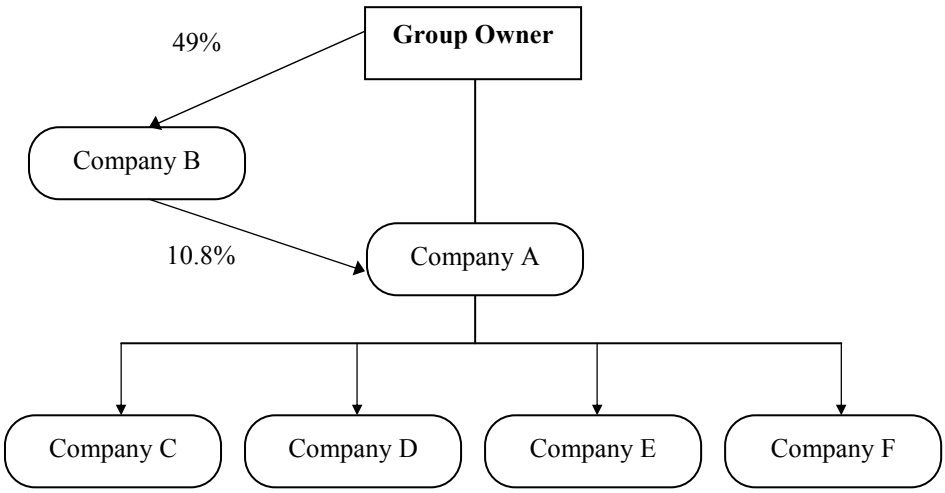
If i) there are many relevant suspects with complicated case and its investigation needs to be completed within a short period of time, or ii) concentrated and unified investigation is required based on expert investigative capability, the investigation team is formed and takes action. In case of i), the team is generally formed based on the department under the Chief Public Prosecutor in the District Public Prosecutor's Office, while in case of ii), the investigation team is generally formed with prosecutors seconded from the District Public Prosecutors' Office and prosecutors under Central Investigation Department in the Supreme Public Prosecutors' Office. If necessary, the investigation team can be formed through tax officials under the National Tax Service and accountants under the FSC. Experts in private field can involve in the team by being recruited as contract based worker. In particular, in case of corporate investigation, as it requires expertise and integrity, there are growing cases of investigation by forming the team.

On the other hand, after the Financial Crisis at the end of 1997, by issuing bonds by the Korea Deposit Insurance Corporation, the Korean government formed public fund to normalize financial institutions and protect depositors. Furthermore, in order to hold owners and senior business executives responsible for causing financial instability, the joint investigation team for public fund was formed under the Central Investigation Department in the Supreme Public Prosecutors' Office. One senior prosecutor and three prosecutors are seconded to special investigation team for insolvent companies, which is ad hoc body under Chairman and President of the Korea Deposit Insurance Corporation, overseeing investigation team consisting of judicial police, tax officials, public accountants, and staffs of the Korea Deposit Insurance Corporation. This team is working hard to identify and take harsh punishment against any illegal practices, such as embezzlement of corporate capital or defraudation of loans surpassing the credit ceiling.

IV. Real Investigation Case (Misappropriation Case of S Group)

1. Chart of Corporate Governance of S Group

Corporate Governance of S Group (As of the end of March in 2002)



2. Facts of Crime

Owner of S Group and CEO of company B, along with head of Restructuring Committee of the Group,

- signed the share swap contract between company W (unlisted company)'s shares owned by S group's owner and company A's (holding company of S group) shares owned by company B (owner of S group is controlling shareholder of this company), putting it into practice. (the contents of contract are as follows)
  - Target for exchange - shares in company W and those in company A
  - Exchange ratio – shares in company W: shares in company A = 2:1
- However, exchange contract above had problems as follows
  - Properly estimated share value – shares in company W: shares in company A = 1:2 (Even though properly estimated share value is 1:2, the actual exchange ratio was 2:1)

    - Following undue evaluation of the ratio, the owner could get three quarters of profits of share value of company A and company B had to see that amount of loss.
- Such behavior is subject to misappropriation under the Criminal Law.
- The reasons that such abnormal contract was possible are attributed to following factors.
    - There was no clear evaluation standard on non listed shares
    - As the owner of S group controlled the managerial rights as controlling shareholder of Company B, CEO of Company B could not have independent rights from the owner of the Group. As a consequence, CEO of company B signed the contract above for the profits of owner even though it is the contract giving disadvantage to its own company.

* There were other criminal cases related to S group. However, my explanation is focused on the part related to corporate governance.

3. Goal of Crime

As in the chart above, company A is serving as the holding company of S group. Although the owner of S group hardly has any shares in company A, he could control company A through owner's shares in company B. In addition, through this kind of circular shareholding, the owner has come to control the overall group. However, from April 1st 2002, pursuant to the regulation setting the ceiling on total amount of shareholdings in other domestic companies, owner can exercise his voting rights for only 2% of shares in company A held by company B, all of which amounted to 10.8%. As a result, overall controlling rights over the overall S group have come to be in shambles. Facing this situation, owner of S group has come to commit this kind of crime in order to maintain the control over the group by directly acquiring shares of company A by taking exchange contract, which does not cost that much capital.

4. Progress of Investigation and Cooperation with Administrative Bodies

Around early December in 2002, the Prosecutor's Office received the information on criminal acts. After the prosecutors form the investigation team consisting of 11 members

including prosecutors and accountants under the FSC, it confirmed the basic fact relationship for two months by confirming various documents on S group and investigation by working level officials. Through security and thorough preparation, prosecutors carried out two times of search and seizure, thereby ensuring various documents, which group owner, head of restructuring committee and CEOs of affiliates had planned and made for criminal activities abovementioned. As a consequence, after summoning suspects, prosecutors could get confessions from all suspects. On the other hand, the KFTC and the FSC had taken measures against administrative violation related to crime based on the documents investigated by prosecutors.

* Even though the leniency program exists under the Administration Law in Korea, there is no regulation, like arraignment, plea bargaining in the U.S. in the field of criminal law. In other words, there is no special institutional equipment to draw any statement on undue behavior of senior executives from subordinates. As Korea takes discretionary indictment, it can lead self-confession from suspects by providing incentives, such as imposing suspension of indictment against internal informant or investigative cooperator. However, the best way to lead statement on violation of senior executives from subordinate is to ensure evidence through search and seizure, thorough analysis on ensured evidence and objective and reasonable persuasion.

5. Significance of investigation above

By taking advantage of the fact that there is no clear evaluation measure for non-listed shares, owners of chaebols with small amount of share ownership could deal with the conditions more favorable to them without appropriately assessing the share value. By doing so, they have strengthened their control over the group and triggered loss to minority shareholders. This investigation is significant in that it take action by confining and prosecuting the owner of the group and the head of restructuring committee, thereby taking strong action against such behavior.