KOREA'S OUTSIDE DIRECTOR SYSTEM

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Introduction of the outside director system

After the economic crisis that broke out in late 1997, the Korean government has pursued restructuring in various sectors to reform the economy. One sector of restructuring is corporate restructuring, and this includes three categories: business area restructuring, governance restructuring, and financial restructuring. One aspect of governance restructuring was the introduction of the outside director system in 1998. It was meant to place a check on large shareholders and management and to improve management transparency.

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Korea's outside director system is modeled on that of the US. However, there is a significant difference between the two systems. In the US, the selection and functions of outside directors are the result of existing corporate practices rather than government legislation. In Korea however, the system was directly introduced by the government.

The system's operation and government policy

In 1998, the government revised the listing standards and procedures of the Korea Stock Exchange and stipulated that listed firms must occupy one-fourth of their directorships with outside directors. In 2000, the outside director requirements were made into law with the passing of the new Securities and Exchange Law. The

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<Current Outside Director Regulations in the Securities and Exchange Law>

Definition of Outside Director: A director who is not employed by the company.
Applies to: All listed companies.
Ratio of outside directors: At least 1/4 of all directors.
Added regulation for firms with assets over 2 trillion won: At least half of the board (more than three seats) must be occupied by outside directors, the director nomination committee should consist of at least one-half outside directors, the audit committee should consist of two-thirds outside directors.
The following persons cannot become outside directors:

- The top shareholder, those related to the top shareholder, large shareholders and their family members.
- Employee of the company or of an affiliate, a former employee who quit less than two years ago.
- Family member of an employee.
- Employee of a firm with "special relations" with the company.
- An employee of a firm whose director is an employee of the company.

<Regulations on Outside Directors by the Ministry of Justice>

Higher ratio of outside directors: A higher ratio of outside directors will be on the audit committee and the outside director nomination committee, and in the long term, the audit committee will be exclusively occupied by outside directors. All committees will include at least one outside director.
Limited liability: Unless an action is intentional or for personal gain, liability is limited to a reasonable amount (about 5 times the director's salary).
Greater independence: Standards for independence will be strengthened by legal revisions.
Greater support: Outside directors can consult legal experts, financial experts, or other experts in or out of the company.
Strengthened rights: Outside directors will have veto power over internal transactions.

details of the new law are described below.

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The government plans to increase the proportion of outside directors and strengthen their rights to improve corporate governance. Recently, the Ministry of Justice announced a number of bills to strengthen the role of outside directors, many of which are expected to be adopted in policy. In addition, some of the bills go beyond "recommendations" and will have some regulatory power through revision of related laws such as commercial law, security transaction law, external audit law, or antitrust law.

Outside directors in Korean companies

After the adoption of the outside directors became mandatory in 1998, many firms have not been eager to invite outside directors.

After the adoption of the outside directors became mandatory in 1998, many firms have not been eager to invite outside directors. According to one survey in 1999, listed firms reduced their total number of directors in order to fulfill the requirement that one-fourth of directors be from outside the company. [1] Most companies are fulfilling the minimum requirement however.

Out of the 646 listed firms in April 2000, there were 1,464 outside directors. This figure marked an increase of 17% from 1,251 outside directors in June 1999. In addition, because the number of firms decreased in the period, the number of outside directors per company increased from 1.9 to 2.3.

Table 1. Outside Directors in Listed Companies

	June 1999	April 2000	Increase Rate
Companies (A)	722	646	-10.5%
Outside Directors (B)	1,251	1,464	17.0%
B/A	1.9	2.3	21.1

Source: Outside Directors in Listed Corporations, "Sangjang", Korea Listed Corporation Association, May, 2000.

1) "Survey Analysis of Shareholders' Meetings and the Outside Director System", Sangjang, Korea Listed Corporation Association, June, 1999.

Table 2. Number of Outside Directors in Listed Companies

	Companies (A)	Directors (B)	Outside Directors (C)	Outside Directors per Company (C/A %)	Proportion of Outside Directors (C/B, %)
Manufacturing	391	2,603	799	2.0	30.7
Non-manufacturing	109	840	275	2.5	32.7
Finance	17	239	163	9.6	68.2
Total	517	3,682	1,237	2.4	33.6

Source: Outside Directors in Listed Corporations, "Sangjang", Korea Listed Corporation Association, May, 2000.

Looking at the 517 firms that settled their accounts in December 1999, the number of outside directors per company was 2.4, which is similar to April's figure. The proportion of outside directors in the board was 33.6% or about one in three. One interesting point was that the financial industry had a high proportion of outside directors, because the government especially urged financial companies to adopt outside directors in order to help financial sector restructuring.

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The management participation rate of outside directors is gradually rising. The attendance of outside directors in board meetings increased from 43.9% in 1999 to 53.5% in 2000. Of course, attendance at board meetings is not a perfect indicator of participation in management. In addition, although it is an improvement over the past, a 50% rate still cannot be considered a high attendance level.

The proportion of outside directors in large corporations, which have been the main target of restructuring by the government after late 1997, is far greater than that of listed corporations in general. This is partly because large firms with assets of over 2 trillion won are required to have one-half of their board occupied by outside directors. The outside director system seems to be more active in large corporations, with an average board meeting attendance rate of 70.8% in 1999 compared to a 49.7% rate for listed corporations.

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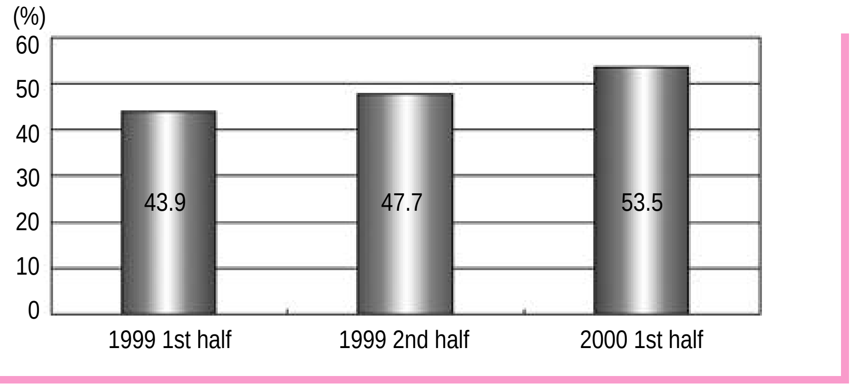
Figure 1. Participation Rate of Outside Directors at Board Meetings



Source: Analysis of Outside Directors' Management Participation, Korea Stock Exchange, June, 2000.

Table 3. Outside Directors in the Top Four Conglomerates

	Affiliates (A)	Directors (B)	Outside Directors (C)	Outside Directors per Affiliate (C/A %)	Ratio of Outside Directors (C/B, %)	Participation Rate in Board Meetings (%)*
Hyundai	17	107	53	3.1	49.5	73.5
Samsung	14	128	47	3.4	36.7	74.0
LG	12	83	32	2.7	38.6	72.8
SK	9	63	24	2.7	38.1	55.8
Total	52	381	156	3.0	40.9	70.8

*: All board meetings from the first half of 1999 to the first half of 2000
Sources: Outside Directors in Listed Corporations, "Sangjang", Korea Listed Corporation Association, May, 2000.
Analysis of Outside Directors' Management Participation, Korea Stock Exchange, June, 2000.

Opinions on government policies

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Because the outside director system has only been in place for two years in Korea, it is difficult to know the management tendencies or effects of outside directors in Korean companies. It is also difficult to know what kind of effect the system will have in the future. Even in the US, where outside directors have been regularly appointed for decades, there are a wide variety of research results on their management effects. Noting this ambiguity, some observers argue that the Korean government has been too hasty in passing the outside director regulations.

Such sceptics state that the outside director regulations pursued by the government, which were modeled on US business practices rather than laws, are too indiscriminate and rigid. They contend that the US system of outside directors evolved over a long period in a different environment from Korea's, and that there has been no definite proof of its effectiveness. Therefore, they recommend that the present system be maintained and gradually strengthened, or that it be improved after looking at its effect in the corporate world.

Another opinion is that the outside director system should be strengthened by raising the participation of outside directors in management before expanding their numbers. Currently, there is not enough information about potentially successful outside directors, and outside director participation is also relatively low. In this situation, merely raising the proportion of outside directors would only undermine a company's board and lead to increased costs.

The government should create policies that improve the effectiveness of the current system.

Overall, there is agreement at least in principle that Korea needs corporate restructuring. However, it is hard to identify what the real problem is and how to solve it. The government should create policies that improve the effectiveness of the current system, and experts including economists, managers and lawyers should continue proposing new ideas for a "Korean system of outside directors". VIP