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Let Chaebol Be Chaebol: A Call for Self-Regulation

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I know this will upset all my activist comrades, but I think the time has come for the Korean government to let chaebol be chaebol, to remove the 25 percent investment limit imposed on large business groups. At the same time, the time has come to eliminate the Board approval requirement for outside shareholders who want to own between 15 percent and 50 percent of a company. Both these rules are outdated in Korea today.

Ten years ago, chaebol were on a drunken deworsefication binge. Dishwasher companies were starting semiconductor companies. Semiconductor companies were starting motorcar companies. And motorcar companies were buying up entire nations in Central Asia. When 1,000 percent debt-to-equity ratios collided with the Asian currency crisis, Korea itself nearly went into default. The Korean government had no choice but to rein in its out-of-control corporate dinosaurs, by prohibiting affiliates in

business groups over 6 trillion won in size from investing more than 25 percent of their assets.

Over time, this and other new regulations turned out to be quite effective. Today, the landscape has changed dramatically. Korea Inc. has gotten the religion of core competence. In stark contrast with the past, value creators now overwhelmingly dominate Korea's stock markets.

The 25 percent rule is certainly not the only cause for the improvements in Korea's industrial focus. Another key factor is fear. In March 2003, with its Board Chairman sentenced to three years in prison, SK Corp was trading at a PE ratio of 0.75x. Suddenly, Sovereign Asset Management swooped down to buy a 15 percent stake for peanuts, and started pressing for ___ surprise! ___ a new Board Chairman. The Sovereign assault on SK Corp. has been succeeded in recent weeks by notorious corporate raider Carl Icahn's assault on Korea Tobacco & Ginseng. All this has been a real wake-up-and-smell-the-coffee moment for executives of thinly-controlled Korean companies, as they realized when these unhappy shareholders eventually add up to 51 percent, they will simply be out of their jobs. Suddenly, dividends and buybacks are up in Korea, and deworsefication is a thing of the past.

The 25 percent rule, whilst designed to open corporate Korea up to the world, ironically leads to protectionism. The government may encourage foreign investment in Korea, but its largest business groups are right to complain of unequal treatment, and push for protectionist legislation. It's easier for a Japanese company to make a friendly strategic investment in a Korean company than it is for a Korean chaebol affiliate. Why?

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Nothing kills economic growth more effectively than protectionism. At this stage of Korea's corporate maturation, the answer is not to add further harm in a capitulation to the populist appeal of protectionism, by mirroring the restraint placed on the chaebol with new restraints placed on foreign investors. Korea's stock market is 40 percent owned by foreigners, one of the highest levels in the world. Such a capitulation could be disastrous.



Instead, why not remove this paternalistic shackle on Korean big business, the 25 percent rule? Korea has the world's #1 memory chip company, the world's #1 shipbuilder, and countless other world-class powerhouse companies. Why not give these companies and their business groups the same advantages as other companies from around the world?

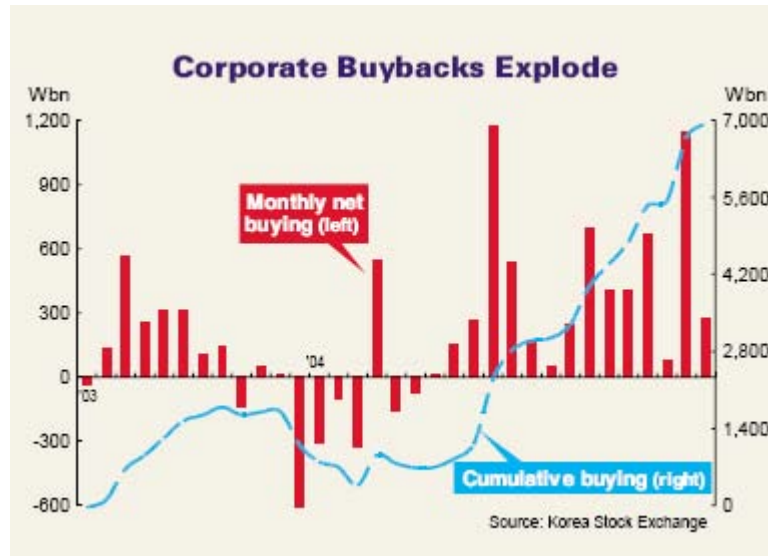
Removing the 25 percent rule can only work in conjunction with removing the 15 percent-50 percent rule, which prohibits anyone from buying between 15 percent and 50 percent of a company's stock without Board approval. This regulation is antithetical to market principles and hobbles any real voting power of stock ownership in Korea, as it interrupts the democratic flow of ownership as outsiders advance towards control positions. It is as blatantly unfair to outside shareholders as the 25 percent rule is to the chaebol.

Real criminals who embezzle, collude, manipulate, evade taxes, and commit fraud should be prosecuted. But isn't it time for chaebol investment activity to be self-regulated? Why not let shareholders and Boards regulate these matters? A key element for credible free-market principles is the class-action lawsuit. Korea wisely implemented a system for class-action lawsuits last year, and these will have a positive impact on the stock market.

Countries like Germany, France and Japan which shield dishonest Directors from class-action lawsuits have a significantly lower market cap-to-GDP ratio than those that permit class-action lawsuits, such as the U.S., U.K., Canada and Australia. Class-action lawsuits create the correct recourse in a truly democratic shareholder culture. Companies are owned by their shareholders, and the Directors have a duty to represent the shareholders. When Directors fail to do so, shareholders who have sustained financial losses as a result should be entitled to ask the courts to compel those Directors to make them whole, personally. An aggressive, fully functioning class action lawsuit system -- with large awards actually collected from dishonest Directors and paid to plaintiffs -- is an absolute prerequisite prior to relaxing the 25 percent rule. There must be real payback time for dishonest Directors, not lip service. For example, if Hyundai Motors damages its shareholders by allowing Glovis to skim \$2 billion of its revenues, the shareholders should sue the Directors and the courts should award personal judgments, collected from Directors and paid to the shareholders.

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Corporate self-regulation will not be enough to eliminate the chaebol slush fund problem in Korea. There is also a pressing need for campaign-finance reform. Today, everywhere in the world, political campaigns are expensive, and if you get no help from big business, you simply lose. Instead of arresting chaebol executives on a weekly basis for ten year-old crimes, why not legislate campaign finance reform which allows big business to support political candidates transparently, within certain agreed-to limits, using PACs



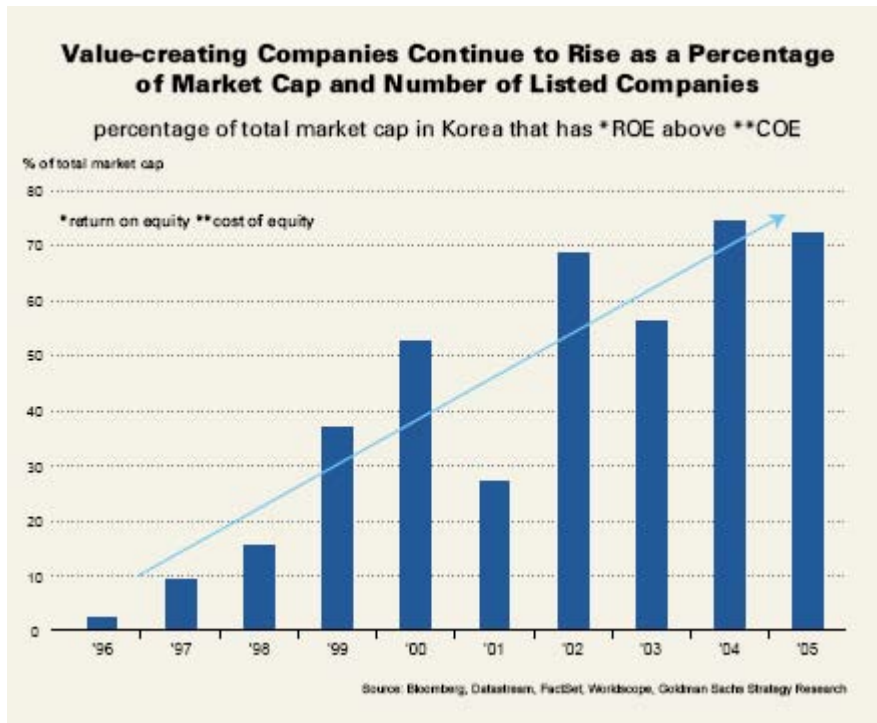
and other indirect methods? Such a reasonable and well-monitored system could put an end to years of time-and-money-wasting slush fund prosecutions. Most importantly, it would cut way down on the number of politicians who seek bribe money, as there would be a legitimate channel for business campaign contributions.

Self-regulation must also extend to financial intermediaries, who should have the same absolute fiduciary obligation to represent their clients as Directors have to represent their shareholders. Fund managers at pension, trust and insurance companies are there for one purpose only: to protect and grow the assets of the pensioners, policy holders and mutual fund investors they represent. They cannot be relied on to always buy stocks that go up and never buy stocks that go down. However, they can and should be relied on to vote their positions in ways where there is empirical evidence that appreciation, and not depreciation, will result. One of these managers recently voted a sizable position to keep a convicted felon as Board Chairman at one of his holdings, saying this vote "would support stock value." Of course, the stock fell 25 percent after he voted that way!

These managers will only discontinue their rubber-stamping of management if they, too, are threatened with losing their jobs. So, if you contribute to a pension plan, have an insurance policy, or have invested in a mutual fund, call your representative today, and ask him, "For those companies in my portfolio which pay low dividends, did you vote to raise dividends at the AGM? As you speak for more than 1 percent of the company, did you add boosting dividends as an agenda item?" If he says no, then just fire him and shift your money to a manager who is actually interested in protecting and growing YOUR money. Tell him his job is to protect your money, not his corporate cronies.

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At the end of the day, this is not about foreign investors vs. domestic investors. These is just about all the real owners of the company, the shareholders, requiring that management increase the value of their shares, and give them a fair share of the profits through dividends.



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