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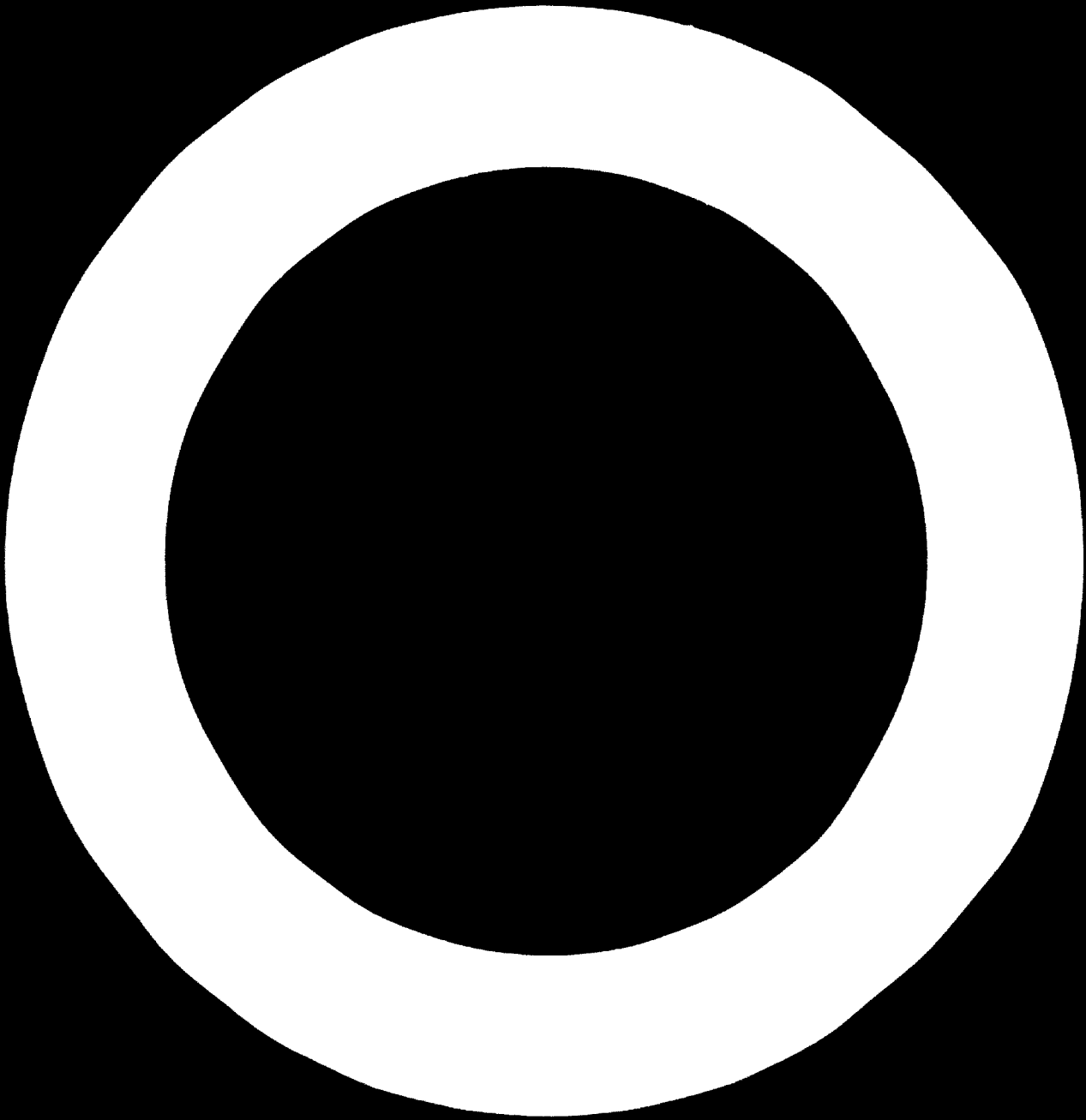
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TAIWAN: A CASE STUDY OF CAPITAL MARKETS

By

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SUMMARY

1. The initial step toward the development of a capital market in Taiwan was taken by the Government in the 1950's, with the distribution to large landowners, as part of the Government's land reform programme, of shares of four of the larger Government-owned enterprises in exchange for their land. The Taiwan Stock Exchange was not organized until 1962, following which event there have occurred several underwritings of new issues of securities. In the early part of 1966, China Securities Investment Corporation was formed for the purpose of engaging in a general securities business. As yet, it must be conceded that the capital market in Taiwan is far from being either broad or active.
2. It was only about seven years ago that the currency was firmly stabilized and the foundations were laid for the development of healthy industrial economy. Since that time, the total share of industry in the burgeoning national income has grown to well over one-third. Accompanying this growth, there has arisen a considerable middle class, with savings available for investment, thus providing a sound basis for the development of a capital market.
3. It is to these savings of the middle class that the capital market in Taiwan must look primarily for its funds, since the banks and other financial institutions are not in a position to provide them in sufficient amount. A large part of the savings of the middle class has been invested in real estate, but a surprisingly large volume has been accumulated in the banks. The biggest job that has to be faced in the development of the capital market is to entice a goodly share of these savings into investment in securities. This will necessitate a re-building of confidence, which was badly shattered three years ago by events that took place on the stock market.

4. Following the organization of the Taiwan Stock Exchange, there occurred a boom in stock prices. The bubble burst in 1964, at which time the Government attempted without success to stabilize the market. Stock prices fell off about 60%, and the total value of transactions on the Exchange fell off about 90%.

5. There are some 34 non-Government corporations of which the stocks are listed on the Taiwan Stock Exchange. The assets of these corporations represent only a tiny fraction of the value of privately owned business enterprises in Taiwan. The reason that many qualified corporations have not taken steps to list their shares is that they are family-controlled, and the principal stockholders are loath to take in new stockholders.

6. About 90% of the total business in listed stocks is carried on by non-bank brokers ("Class A security traders"). Ostensibly this is for the account of the investing public, but in fact it is known that a considerable though undetermined portion of the trading is carried on by these brokers for their own account. Most of the trading is concentrated in a few speculative favorites. Taking a selected list of dividend paying issues, which excludes some of the more speculative stocks, the number of shares traded on an annual basis, averages about 40% of the total outstanding. This turnover reflects, in part, the system of trading, which permits trading in futures for settlement at fortnightly intervals. Ordinarily, a futures transaction of this type is cancelled out by a reverse transaction at or before the expiry of the fortnightly period, without any change of ownership of the shares traded. These transactions swell the turnover, but they do not contribute significantly to the spreading of share ownership, which is a primary objective to be sought in the development of the capital market.

7. Under Taiwan law, as in many other jurisdictions, the existing stockholders of a corporation are given the prior ("preemptive") right to purchase their proportionate parts of any new issue of stock. As the offering price for issues of new shares has frequently been fixed at the par value, which is apt to be well below the market quotation, most of the offerings have been successfully completed without recourse to the services of an underwriter. However, there has recently been introduced, by Governmental action, as a condition precedent to the listing of an issue of new shares, a requirement for the underwriting of a portion of the issue, so as to achieve a wider distribution of the stock. This is accomplished by obtaining a waiver from some or all of the existing stockholders, in favor of an underwriter, of their rights with respect to a portion of the new shares being offered to them.

8. In the interest of promoting private enterprise and, at the same time, the spread of share ownership through underwritings, the Government has recently enunciated the policy of transferring state enterprises to private investors through public offerings of their stocks. As regards foreign-owned corporations, the Government has obtained from some of the foreign owners the assurance that a portion of the shares of the local company will be made available to investors in Taiwan.

9. During 1966, the Government took further action toward encouragement of the development of the capital market by introducing in the legislature a new securities law. If enacted, this will relax certain legal restrictions which now impede the operation of a general securities business. The proposed legislation would do away with the mandatory segregation of the businesses of brokers and dealers in

securities, and would allow direct transactions between dealers and their customers ("over-the-counter" transactions). This is necessary to enable firms like China Securities Investment Corporation to conduct, under one roof, the various activities embraced in a general securities business.

10. A service to the capital market, to the general securities business and to the corporations seeking capital would be the introduction in Taiwan of a wider variety of classes of securities available for purchase by investors. Such securities as convertible preferred stocks and debentures, participating preferred stocks and debentures, subordinated debentures, or transferable rights to subscribe to new shares are presently unknown in Taiwan. As a new corporation law, which has just been enacted and promulgated by the Government, authorizes the issuance of these various types of securities, it is expected that they will gradually come into use.

11. Regulation of the securities business in Taiwan is provided by the Securities and Exchange Commission, which came into being with the inauguration of the Taiwan Stock Exchange. The young Commission could not escape the blame for the stock market debacle of 1964, which was accompanied by disclosures of manipulation and malpractices that the Commission was supposed to suppress. Unfortunately, the Commission was permeated at that time with the philosophy that high stock prices were good for the country, and that it was proper for the Commission to do what it could to stabilize the market at a level which, as events proved, could not be economically justified. The philosophy of the present Commission is more nearly attuned to the sounder view that the aims of the Commission should center upon two principal objectives, namely: the prevention of manipulation, and the inclusion

of adequate disclosures in the financial statements and related data that are made available to investors.

12. Too often, the emphasis of the work of the certified public accountants, who are responsible for certifying the financial statements, is upon tax savings for the corporations concerned, and scant heed is paid to the requirements of the shareholders for informative reports. Measures have been taken by the Securities and Exchange Commission which are tending to ameliorate the situation. As a result of the Commission's probing into the work of the certified public accountants, five of them were temporarily barred about a year ago from practicing before the Commission.

13. The Commission is now beginning to enforce a requirement for certificates of public accountants which state that generally accepted auditing standards and accounting principles have been followed, with only such exceptions as are specifically pointed out in the certificate. It has been considering the promulgation of a rule that the certified public accountant shall receive his appointment early in the year covered by the financial statements with respect to which he will be called upon to furnish a certificate. Under the present custom of appointing the certified public accountant after the close of the year, it is next to impossible for him to furnish a proper certificate.

14. The tax structure in Taiwan, although calculated to encourage private investments in productive enterprises, is slanted in favor of direct investments by entrepreneurs and fails to give corresponding consideration to the needs of the capital market. Likewise, the Government's regulations with respect to the repatriation abroad of foreign capital which is invested in Taiwan overlook the special needs of the capital market. Unfortunately, the new corporation law, mentioned above, purports to substitute certain rigid and arbitrary rules in the place of managerial discretion in matters of corporation finance, and it gives to a small minority of stockholders the opportunity to create a nuisance value for themselves. The effect of these provisions has been to cause the deferment of some proposed issues of new shares

in which the investing public of Taiwan would have been invited to participate.

15. These legal problems, it is believed, have arisen inadvertently, as there can be no doubt regarding the Government's sincerity in seeking the development of the capital market. Therefore, it may be expected that remedial action will be taken by administrative action, where possible, or by legislative amendment.

BRIEF REVIEW OF CAPITAL MARKET IN TAIWAN

A. Moderate Successes Achieved

16. The present status of the capital market in Taiwan has been described by a recent observer as "embryonic." That is hardly a fair statement, as concrete steps, which have achieved moderate results, have been taken by the Government of the Republic of China and by leaders in banking and industry to establish a capital market and to promote its development.

17. These steps have borne fruit in the organization and operation of a stock exchange, which has moderate claims to sophistication, and in the establishment of an underwriting business, which has played a moderate part in the flotation of new issues of securities. Both of these have achieved some degree of success in broadening the ownership of industrial securities by the public, which is one of the primary objectives to be accomplished in the development of a capital market.

18. Industrially, Taiwan is after all quite a new country. It was only about seven years ago that the currency was firmly stabilized and the foundations were laid for the development of a healthy industrial economy. Since that time, a great number and diversity of new manufacturing plants have been erected, and the total share of industry in the burgeoning national income has grown to well over one-third. Accompanying this growth there has arisen within Taiwan's population of 13,000,000 a considerable middle class of small businessmen, merchants, artisans and professional people with savings available for investment, thus providing a sound basis for the development of capital market.

B. Definition of "Capital Market"

19. The term "capital market" is used herein to denote the mechanism for bringing together those in need of capital funds and those that can supply these funds. Those in need include business enterprises and shareholders seeking to realize upon their

investments. Those that can supply the funds consist of investors, both individuals and institutions. The mechanism of the capital market brings about transactions between these two groups through an intermediary acting as the link between them.

20. This intermediary may be a stock exchange, where brokers and dealers in securities carry on transactions for their customers, or it may be an underwriting firm, which assists in placing a new issue of securities with the public. Broadly speaking, these operations comprise the general securities business, which is commonly referred to as investment banking. It embraces the conduct of transactions from time to time in all three capacities of broker, dealer and underwriter.

21. In a strict sense, the capital market is not concerned with loans to or investments in a corporation which result from a direct transaction between the seeker and the supplier of capital funds, without the services of an intermediary. Such loans and investments are customarily made by banks, by development finance companies and frequently by insurance companies and by Governments. Important though these loans and investments are in the promotion of the economy, when they are made without an intermediary they by-pass the market, which is one of the ingredients postulated in the term "capital market."

22. Where a capital market is lacking, the general public has no means of participating in industrial investments. With a broad and active capital market, operating under the private enterprise system, the savings of the people can be mobilized and channelled into productive use, thereby significantly fostering growth.

C. Concrete Steps Taken

23. The initial step looking forward to the development of a capital market in Taiwan was taken by the Government in the 1950's, with the distribution to large landowners of shares of four of the larger Government-owned enterprises in exchange for their land, which was then distributed to the farmers. This was the famous and highly successful "land-to-the-tiller" programme. The shares of the

corporations of which the Government thus divested itself are among those that are now traded on the stock exchange.

24. The Taiwan Stock Exchange was organized in 1962 under the sponsorship of the Government and of business leaders, and in line with the recommendations of United States and other foreign advisors. In the early part of 1966, there was organized under the sponsorship of the Government and of business leaders a new company, China Securities Investment Corporation, to engage in a general securities business. It has a capital of \$1.5 millions, all privately owned, and has recourse to low-interest Government loans of \$1.25 millions, which latter amount is expected to be doubled when the company's business grows. The organization of this company was spearheaded by China Development Corporation, which is a highly successful privately owned development finance company that has been operating in Taiwan for eight years.
25. The existence of a capital market in Taiwan may be said to date from the opening of the Taiwan Stock Exchange, which affords facilities for transactions among investors through member firms of the Exchange. Following this event and prior to the organization of China Securities Investment Corporation, several underwritings of new security issues were handled by the banks and by China Development Corporation, whose charter permits it to engage in this type of business in addition to development finance. The organization of China Securities Investment Corporation marked an important step forward, because this is the only firm that has been set up thus far to conduct a general securities business in Taiwan.
26. However, it must be conceded that the capital market in Taiwan is far from being either broad or active. Except for purely speculative trading, the volume of transactions would be considered small by most standards, and underwritings are sporadic.

D. Sources of Capital Funds

27. Sources of funds which are available for employment in the capital market in Taiwan include the 11 local banks, to a limited extent the 16 insurance companies, China Development Corporation, China Securities Investment Corporation and, to a large extent, the untapped savings of the wealthy and more especially the middle class.
28. The banks, with combined deposits of close to \$1,000 millions, are engaged to some extent in brokerage and underwriting activities, but they concentrate their own purchases of securities in Government bonds. It is, of course, a question whether the banks, having a preponderance of demand and other short-term liabilities, would be wise to expose themselves heavily to the risks of stock investments. The insurance companies, with combined assets of only \$25 millions, provide a moderate reservoir of funds that could be channelled in part to the capital market, were it not for the fact that they tend to concentrate their investments in corporations which they either control or dominate, and in which the investing public does not get the chance to participate. China Development Corporation and China Securities Investment Corporation, in addition to underwritings, make portfolio investments in equity securities, but their resources for this purpose are not significant in relation to the needs of the capital market.
29. It is to the untapped savings of the middle class to which the capital market must look primarily. A large part of these savings has been invested in real estate, with a resultant inflation in land values which has contributed nothing to the economy. Nevertheless a surprisingly large volume of savings has been accumulated in the banks. The aggregate of savings and time deposits in the banks has multiplied nearly five times in the past five years, reaching about \$500 millions at the present time, or about one-half of the total bank deposits.

30. The biggest job that has to be faced in the development of the capital market is to entice a goodly share of these savings into investment in securities.

E. Re-building of Confidence Needed

31. This job will necessitate a re-building of confidence, which was badly shattered three years ago by developments in the stock market as outlined hereinafter. Given a revival of confidence, the basis exists for accomplishing the task. Yields on stocks in Taiwan are attractive by reasonable yardsticks, being better than those obtainable on time deposits and close to those obtainable on long-term savings deposits. The average yield on stocks is around 9.5%, which compares with 6% to 8.4% on time deposits and with about 10% on savings deposits of over one years.

32. As is well known, in most developed countries the yields on good stocks have almost consistently remained far below those obtainable on other savings media. This reflects faith in the growth opportunities afforded by these stocks. That the better Taiwan stocks also have growth possibilities has been demonstrated by the history of many of its better managed corporations, although admittedly the record is not uniformly good.

STOCK MARKET

A. History of Taiwan Stock Exchange

33. The Taiwan Stock Exchange, which is the only stock exchange in Taiwan, has experienced a checkered career during its brief history. Following its organization in 1962, there developed a boom in stock prices, touched off in part by enthusiasm for the new institution and what it might accomplish for investors, and in part by the action of prices on the Exchange for shares of the Government-owned sugar monopoly (not to be confused with the corporations whose shares were distributed under the land reform programme.) A portion of the shares of the sugar company had been released by the Government for public distribution and, as there occurred a rapid advance in the price of sugar, the shares of this company soared on the Exchange, carrying upward the prices for the rest of the list.

34. The bubble burst in 1964. Both the prices and the volume of trading slumped drastically. The Government--mistakenly, it must be concluded--attempted to stabilize the market by large purchases of shares, particularly of the sugar company. It was, however, unable to stem the tide, and it lost large sums in the endeavor. Numerous small shopkeepers, businessmen and others of the white collar group lost their life savings. Public outcries and demonstrations against the Government took place, and there was general disenchantment with the idea of stock investments.

35. It might be argued that the Taiwan Stock Exchange was started before the country was ready for it. That argument would overlook the fact that the risks attendant upon such an event would be present whenever the step was taken, and perhaps it was better to go through the unhappy experience earlier rather than later.

36. More of a point could be made of the argument that it is dangerous for a Government to invite public participation in enterprises which continue to be heavily dominated by the Government, as was the case in Taiwan with the sugar company. In

such a case, when things go wrong the Government is sure to get the blame, and public confidence is damaged to a greater degree than it would be if the Government had not been a participant.

37. In consequence of the debacle, the annual trading volume on the Taiwan Stock Exchange fell from about \$900 millions in 1964 to about \$100 millions in 1966, a shrinkage of close to 90%. This was accounted for in part, but by no means entirely, by the decrease in share values. The stock price index compiled by the Taiwan Stock Exchange fell off about 60% from its 1964 peak to its low in mid-1966. Subsequently, share prices recovered moderately.

B. Operations of Stock Exchange

38. The Taiwan Stock Exchange is operated by a limited liability company which is owned by a highly responsible group of business interests. Its operations follow the system of continuous trading on the floor during business hours. There are about 50 issues of shares listed on the Exchange and available for trading. These include 12 issues of preference shares and four issues of shares of Government-owned companies, in which the public holds an insignificant minority interest. Thus there are some 34 non-Government corporations with common stocks listed on the Exchange. The aggregate market value of the shares of these corporations stands at about \$150 millions. In contrast, the aggregate amount of bonds of non-Government corporations listed on the Exchange is only \$2.2 millions, issued by three companies. Practically no trading goes on in the bonds.

39. The membership of the Taiwan Stock Exchange consists of 18 "Class A" security traders, including five banks, and six "Class B" security traders, consisting of five other banks and China Securities Investment Corporation. A Class A security trader is authorized by law to deal only as a broker for the account of customers,

and may not legally trade for his own account. A Class B security trader is authorized by law to deal only for the account of himself, and is not allowed to act as a broker for the account of others. About 90% of the total business on the Exchange is carried on by the 13 non-bank Class A security traders. Ostensibly, this is for the account of the investing public, but in fact it is known that a considerable though undetermined proportion of the trading is carried on by these security traders for their own account, in the names of family members or friends.

40. The original purpose of permitting banks to participate in the brokerage business was to add to the respectability of the business and to extend brokerage services to the less accessible parts of the country, where the banks have branches and where the non-bank firms cannot afford to provide service. Despite the precedent established in some of the developed countries of excluding banks from the brokerage business, there appears to be merit in the concept that banks in the developing countries are in a position to make a contribution in this field. Unfortunately, the objective of steering the banks actively into this business, in order to promote public confidence and to augment the volume of investment, has not been fulfilled in Taiwan.

41. Visits to the offices of some of the larger Class A security traders, doing the bulk of the brokerage business, disclosed that the number of customers in these offices averaged between 15 and 20, with a considerable sprinkling of women. This is more than might have been expected, since the volume of trading was then at a low ebb.

42. All of the non-bank Class A security traders have their offices in the business section of Taipei, the capital city, which is located in the northern part of the country. None of them maintains a branch office. It was concluded that there should

be established one or more offices of non-bank Class A security traders in Kaohsiung, in the southern part of the country. This is the second largest city, with a population of about one-half that of the capital city, from which it is removed by some 200 miles. It is, moreover, an important and growing industrial hub, with considerable funds which could be channelled to the capital market via the Exchange if provided with suitable facilities. Since there is quick and ready communication between the two centres, no practical obstacle would be presented.

C. Increased Listings Required

43. Although exact figures are lacking, the assets of corporations listed on the Taiwan Stock Exchange certainly represent a tiny fraction of the value of business enterprises in Taiwan. In addition to the 34 non-Government corporations whose shares are listed, there must be many times that number, including numerous corporations of relatively large size, which could qualify for listing. Evidently a broadening of the roster of listed corporations would contribute importantly to the development of the capital market.

44. The reason that so many qualified non-listed corporations have not taken action to list their shares is that most of the corporations doing business in Taiwan are family-controlled. The principal stockholders of such corporations are proverbially loath to take in new stockholders. Indeed, this has often been found to be the case in developed as well as in developing countries. The feeling is particularly prevalent in Taiwan, where family ties are strong. So long as the enterprise is family-controlled, the head of the family can manage the business with a relatively free hand. When new stockholders are taken in, the enterprise becomes accountable to strangers, and the fear arises of having to deal with dissident or disgruntled stockholders.

45. A similar problem, it may be reported, would confront China Development Corporation if it were to dispose of its equity investments wherein the development company and a limited number of partners hold all of the shares. While China Development Corporation is technically free to distribute its own holdings of such an enterprise, it concedes that as a matter of good relations it would be reluctant to do so without at least the tacit consent of its fellow shareholders.

46. As has been illustrated in the developed countries, force of circumstances tends in time to overcome the reluctance to take in new stockholders. The original family holdings became more widely spread among the descendants, at which point the enterprise becomes more willing to take on the added responsibilities attendant upon the further expansion of the list of stockholders. Further, as the enterprise grows, it becomes necessary to raise additional capital, which the family may not be in a position to provide, thus forcing the business to invite the participation of new shareholders. In so doing, the company frequently learns that its fears have been exaggerated.

47. There is reason to believe that similar forces are already at work in Taiwan, and that in consequence thereof a substantial number of companies, now closely held, will in due course list their shares on the Taiwan Stock Exchange and invite the public to participate in their ownership.

D. Volume of Transactions

48. The current volume of business on the Taiwan Stock Exchange seems small enough, and certainly it is small in relation to the potentialities for the development of the capital market in Taiwan. It is not so small, however, in relation to the limited volume of shares which are listed and available for trading. Most of the trading on the Taiwan Stock Exchange is concentrated in a few speculative favorites. Taking a selected list of dividend paying issues, which includes

some of the more speculative stocks, the number of shares traded, on an annual basis, averages about 40% of the total outstanding. This can be compared with a total turnover of 16% on the New York Stock Exchange during 1965, a year of active trading.

49. The turnover on the Taiwan Stock Exchange reflects, in part, the system of trading that is in vogue. Under this system, transactions may be either "cash", in which event they are settled on the following business day, or "regular way", which is a form of trading in futures for settlement at fortnightly intervals. While the volume of these future transactions is erratic, it appears on the average to run at about one-half of the volume of cash transactions.

50. Ordinarily a futures transaction is cancelled out by a reverse transaction, at or before the expiry of the fortnightly period, without any change of ownership of the shares traded. Such a transaction consists, in effect, of a wager placed upon the course of prices for the particular stock during the next 14 days. These transactions swell the turnover on the Taiwan Stock Exchange, but they do not contribute significantly to the spread of share ownership, which is a primary objective to be sought in the development of the capital market.

51. The foregoing discussion of the share turnover on the Taiwan Stock Exchange is particularly pertinent because of a widespread belief in financial circles in that country that the volume of trading is not high enough and should be stimulated. The argument is truthfully made that the non-bank Class A security traders find it difficult to make a living on the current volume of trading, and that a healthy brokerage community is needed for the development of the capital market. The difficulty, however, can be ascribed to the low commission rates which the Class A security traders are permitted to charge. These commissions have been fixed at

0.15 of 1% of the value of the transactions, which is far too low. This rate may be compared with an average commission of about 1% which prevails on the New York Stock Exchange and which, experience shows, is not so high as to discourage trading.

52. The adverse effects upon the earnings of the brokerage community of a curtailment of futures transactions, if that were undertaken, would be more than offset by the establishment of an appropriate commission rate. It is no secret that the present low scale of commissions tempts the Class A security traders to resort to transactions made surreptitiously for their own account in the hope of making a profit aside from their brokerage commissions. This is an invitation to price manipulation in a market where regulation is at best imperfect.

E. Possible Improvements

53. Apart from the revision of commission rates, there are some other steps which the Taiwan Stock Exchange could take to improve the character of trading on the Exchange. In the first place, the size of the trading unit could be reduced with advantage to the security traders and the investing public. It averages about \$300 in value, which may not seem high in a developed country but is quite high for Taiwan and tends to discourage the smaller investors. An appropriate revision could reduce the average size of the trading unit to say \$100. This would largely eliminate the need that has been asserted for the creation of a market to deal in odd lots, which consist of less than a full trading unit.

54. Also, the Taiwan Stock Exchange could advantageously increase the price differential, which represents the minimum permitted variation in the per-share price of a stock between one transaction and the next. The differential now averages about 0.25 of 1% of the price, and on some stocks goes as low as 0.1 of 1%. This is almost infinitesimal when translated into monetary amounts, considering the normally low

scale of share prices in Taiwan. In consequence, wholly insignificant fluctuations in prices can lead to the false impression that there is a bullish or bearish trend in the market, when in fact there is no real trend.

UNDERWRITING

A. Operations of Underwriting Firms

55. The underwriting of securities is as yet a young art in Taiwan. The importance of an expansion of this business is that underwritings are geared to the double purpose of tapping sources of savings for investment in productive enterprises and of spreading the ownership of shares, which can be accomplished more rapidly and effectively through an underwriting than through piece-meal sales on a stock exchange. The listing on the stock exchange of additional issues of securities that have been distributed through an underwriter will help to bring about a healthy growth of stock exchange business.

56. In the strict sense, in which the underwriter takes a financial commitment for that portion of an issue of securities which is not taken by the shareholders or the public, there have been almost no underwritings in Taiwan. Operations have been considered as underwritings when they partake of some but not all of the characteristics of a true underwriting. Specifically, such operations have usually made use of an underwriter to assist in the distribution of an issue of securities by taking orders therefor on behalf of the issuer, but without putting the underwriter's own money at risk. There is no assurance under this arrangement that the issuing corporation will raise all of the capital that is needed.

57. The organizations that engage in underwriting securities in Taiwan consist, as has been stated, of the banks plus China Development Corporation and China Securities Investment Corporation. It was part of the concept of China Development Cor-

poration at the time of its formation in 1959 that, in addition to engaging directly in the underwriting business, it would acquire equity investments in new enterprises for subsequent sale to the public through underwritings. This concept of turning over the equity investments of a development finance company by sale to the public has wide acceptance, and in theory it could also be applied to some of the loans made by a development finance company.

58. Under this concept, the business of development finance goes hand in hand with the development of the capital market through underwritings. The idea has worked in some developing countries, but it has not attained fulfillment in Taiwan. Among 11 equity investments into which China Development Corporation has put about \$2 millions, none has been sold, and the likelihood of an early disposal of any appreciable part of the portfolio of equity investments appears remote. This is not the fault of the company, but is a reflection of the fact that it takes time to nurse a new enterprise to the point where it has established an earnings and dividend record such as to warrant a public distribution.

59. Additionally, there exists the problem, which has already been touched upon, of persuading China Development Corporation's fellow shareholders in the enterprises in which it has equity investments that it would not be prejudicial to them to take in outside stockholders. So far as concerns the prospect for disposing to the public of some of the loans held by China Development Corporation, the absence of any substantial bond market in Taiwan would presently preclude such an operation.

60. The establishment of China Securities Investment Corporation in 1966 to engage, among other things, in the underwriting of securities was in recognition of the fact that the best interests of the capital market are served by a separation of the functions of development finance from those of underwriting. While the two businesses

have an inter-relationship, the point of view and the objectives are different. The development finance company, as such, is primarily concerned with the broad economic implications of its operations, and it must take a long view of its loans and investments. The underwriting firm, on the other hand, is interested in a quick turnover of its capital and its stock in trade is its judgment as to pricing and prompt marketability. For a development finance company to engage actively and successfully in the underwriting of securities would require it to train a separate staff for that purpose, and would create distractions from its regular business.

B. Preemptive Rights

61. Under Taiwan law, when an offering of new shares is made by a corporation, each existing stockholder is entitled to purchase his proportionate interest. This is known as the preemptive right of stockholders, and under this system only those shares which are not taken up pro rata by the existing stockholders become available for purchase by others. The same rule holds true in many other jurisdictions, as for example in many States of the United States. It precludes an outright sale of the entire issue of new shares to an underwriter for public distribution, unless all of the existing stockholders should agree to this.

62. When an offering is made which is subject to preemptive rights, it may be desirable for the corporation to arrange for a stand-by underwriting, under which the underwriting firm is obligated to take up and pay for any shares not taken by the existing stockholders. This type of underwriting fully accomplishes the purpose to the issuing corporation that it will successfully raise the required capital. While rarely used as yet in Taiwan, this type of underwriting is being advocated in governmental and business circles and is expected to become a more widespread practice.

63. Of course, if the price at which the issue of new shares is offered is well below the current market quotation, the chances are that the entire issue will be taken up by the exercise of stockholders' preemptive rights, and in such a situation an underwriting may not be needed. But if market circumstances change adversely within the period of a month or so during which the rights can be exercised, the offering may fail, unless the issuing corporation has executed a stand-by agreement with an underwriter. If the price at which the new shares are being offered is close to the current market quotation, the risk of failure is enhanced.

64. In Taiwan the offering price for an issue of new shares has frequently been fixed at the par value, which in the case of successful corporations is apt to be well below the current market quotation. This has restrained the demand for underwriting services. In these circumstances, the existing stockholders are likely to think that they are getting their additional shares at a bargain price. They often fail to recognize that the offer to them of new shares at a substantial discount from the current market quotation is no bargain at all, since the value of their outstanding shares is diluted by an amount which compensates for the discount.

65. It may be better for the corporation to offer the new shares at close to the market quotation, thereby minimizing the dilution and at the same time raising a greater amount of capital from the sale of each new share. In that case, a stand-by underwriting becomes essential, the cost thereof to the corporation being a small price to pay for the assurance of a successful financing.

C. Forced Underwritings

66. A special form of stand-by underwriting has recently been introduced in Taiwan by governmental action, as a condition precedent to the listing of an issue of new shares on the Taiwan Stock Exchange. In this form of underwriting, the existing

stockholders are required to waive their preemptive rights in favour of an underwriter, with respect to a portion of the new shares being offered to them. For example, they may waive their rights with respect to 20% of the issue, under an arrangement for the sale of this block of shares directly to an underwriter for distribution to the public. If it is not possible to persuade all of the existing stockholders to waive 20% of their rights, the same purpose can be served by securing the agreement of some of the larger stockholders to waive enough of their rights to make up the 20% block for public distribution. The objective being sought is, of course, a wider distribution of share ownership. In turn, the corporation is benefited by having a broader market for its shares, which tends to support the price and creates a more solid base for future issues.

67. This forced underwriting of a portion of an issue of new shares in Taiwan is designed to accomplish directly what stock exchanges elsewhere accomplish indirectly, by insisting that before an issue of new shares can be listed there must be evidence of a sufficiently broad interest in the shares to assure marketability. Such stock exchanges elsewhere do not normally insist upon an underwriting, but this is frequently found to be the expedient route to satisfying the listing requirements for marketability.

68. It will be interesting to watch the results of this experiment in Taiwan. When the greater part of a corporation's stock is quite closely held, the requirement has obvious merit, even though it runs counter to the general principle of letting corporations make their own business decisions. On the other hand, when there are already many stockholders (as in the case of one of the industrial giants in Taiwan, which has about 32,000 stockholders), a forced underwriting would appear to be unnecessary. A more constructive step might be to abrogate the mandatory

requirement for preemptive rights, provided that the issue of new shares is sold directly to underwriters at substantially the current market price. Under these conditions, the existing stockholders stand to lose nothing, the issuing corporation obtains the maximum price, and the widest possible distribution of the new shares is accomplished.

D. Other Steps to Promote Underwriting

69. The Government has taken a number of other steps to broaden the distribution of share ownership in Taiwan, and at the same time to promote the underwriting business. A recent amendment to the Statute for Encouragement of Investment enunciates the policy of transferring state enterprises to private ownership through the public offering of their stocks; and, in 1966, the legislature authorized the sale to the public of four subsidiaries of the sugar monopoly, which are engaged in unrelated manufacturing activities. A difficulty which is encountered in carrying out these proposals is that, unless the Government is able to divest itself of at least a substantial majority of the shares, it remains in an equivocal position vis-a-vis the investors. This was illustrated in the events that followed the distribution to the public of shares of the sugar company itself, as has been mentioned earlier. Another difficulty is that the Government encounters resistance within itself toward parting with profitable enterprises, though quite willing to part with unprofitable ones that cannot be disposed of at a satisfactory price.

70. As regards foreign-owned corporations, the Government has obtained from some of the foreign owners the assurance that a portion of the shares of the local company will be made available to investors in Taiwan. This would normally be a minority interest, since most foreign owners would be unwilling to give up control. As a recent example, the National Distillers and Chemical Corporation of the United States

announced the intent, as part consideration for the privilege granted to it of building a chemical plant in Taiwan, of inviting local participation in this project to the extent of 30% after the project demonstrates its profitability. Naturally such action would not be appropriate for a foreign-owned company that is dependant upon its parent for a captive market, or that sells its product at prices artificially set by its parent, in which circumstances the profitability of the local enterprise is restricted.

E. Underwriting Commissions

71. A sine qua non for the further development of the underwriting business in Taiwan is the liberalization of the commissions that are allowed to the underwriters. At present the underwriting commissions are limited to a maximum of 1 1/2%. This is no doubt adequate in many instances where the underwriter takes no financial commitment, but it is clearly not enough to compensate for the risks and costs incurred where a financial commitment is taken and a merchandising job is assumed by the underwriter. Depending upon the size and quality of the issue, upon the extent of the risk and upon the degree of work involved for the underwriter, a commission of 5% or more might sometimes be appropriate.

72. Any fixed rate, however, would fail to take into account the varying needs of particular issues of securities, or the consequences of changes in general market or economic conditions. Therefore, it is concluded that no fixed rate should be established, but that the determination of the rate for each issue should be, by negotiation between the parties, subject to regulatory approval.

GENERAL SECURITIES BUSINESS

A. Range of Activities

73. As has been indicated, a general securities business consists broadly not only

of the underwriting of issues of securities but also of the handling of transactions for customers either as a broker or as a dealer. While there are both underwriters and brokers in Taiwan, these functions are divorced. Those banks which do an underwriting business, and which at the same time are authorized to conduct a brokerage business as Class A security traders, do not even carry on these operations under the same roof. Further, there are as yet no security dealers authorized to deal directly with customers.

74. Only China Securities Investment Corporation has been set up to carry on the full range of a general securities business. For the time being, its hands have been tied by the segregation of brokerage and dealership and by its lack of authority as a Class B security trader, to deal directly with customers in either capacity.

75. During 1966, a move was made by the Government toward relaxing the legal restrictions which impede the development of a general securities business. The present securities law in Taiwan dates back, in part, to pre-World War II days, when the economy was almost entirely agricultural. Recognizing that under present conditions the law is deficient in many respects, the Government introduced in the legislature an amendment which, among other things, would do away with the mandatory segregation of the businesses of brokers and dealers, and would also allow direct transactions between dealers and their customers. If this amendment is adopted, it will permit firms such as China Securities Investment Corporation to engage in a general securities business and thus to take a more active part in the development of the capital market.

76. To engage actively and successfully in the underwriting business, it is essential that the underwriter develop a retail business in securities. That is true, at least, under the conditions prevailing in a small country like Taiwan, where over-specialization in the security business does not pay. The underwriter needs to have a steady clientele of retail customers with whom he can place the securities

underwritten. There are simply not enough underwritings in Taiwan to afford the opportunity for regular business dealings with a retail clientele, on the basis of underwritings alone, or to occupy continuously the members of the staff of the underwriter who are employed in distributing the securities underwritten.

77. In order to cultivate and keep an active clientele of retail customers, and at the same time to keep his salesmen busy, the underwriter should be prepared to serve his customers in all capacities relating to their investment needs. That is to say, the underwriting firm should be able to serve its customers not only in brokerage transactions but also in direct sales of securities to them from the firm's portfolio, or in direct purchases of securities from them for the firm's portfolio. Such direct sales to or purchases from customers may be a particularly valuable service when the particular security is not listed on the stock exchange or, if listed, is traded so ineffectively that the attempt to handle the transaction on the stock exchange would upset the price equilibrium.

B. Over-the-Counter Transactions

78. Direct dealings with customers are known as over-the-counter transactions. They would take place either in listed or in unlisted securities. There are many good corporations in Taiwan which are not yet logical candidates for listing on the Taiwan Stock Exchange, whether because of their limited size, the character of their business, the narrow distribution of their shares, or simply the preferences of the management; but which, nevertheless, would provide a suitable investment medium. Giving the authority to qualified dealers in securities to make a market in the stocks of such corporations, and to transact dealings therein directly with their customers, would be of advantage to the capital market. Such stocks, after a period of grooming in the over-the-counter market, would no doubt gravitate in time

to the floor of the Taiwan Stock Exchange.

79. The establishment of an over-the-counter market, whether in listed or in unlisted issues, could be particularly useful in opening up the presently limited market for dealings in securities with institutions such as insurance companies. These institutions are often reluctant to do business on a stock exchange with its attendant publicity regarding transactions.

80. Admittedly, the establishment in Taiwan of an over-the-counter market will present problems in regulation, since this kind of market is more difficult to regulate than that provided by the facilities of a stock exchange. As has been demonstrated in other countries, these problems are not insuperable. The fact that problems will arise seems insufficient reason for abandoning the project, or for leaving with the Taiwan Stock Exchange a virtual monopoly in securities transactions.

C. Miscellaneous Services

81. Supplementing the business of underwriting and conducting brokerage and over-the-counter transactions, the operation of a general securities business normally embraces portfolio management services for investors and financial advisory services for corporations. These services have been lacking in Taiwan, but China Securities Investment Corporation is equipping itself to provide them.

82. Also, that company has formulated and proposed to the Government a plan for the sponsorship and management by China Securities Investment Corporation of an investment trust in local securities, which will extend to investors the benefits of diversification and investment supervision through a single medium of investment. This should contribute to inculcating the habit of investment, as distinguished from speculation.

83. If successful, the activities of China Securities Investment Corporation may be expected to draw some funds from abroad for investment in Taiwan securities, particularly from the overseas Chinese residing in non-Chinese countries.

D. Classes of Securities Available for Investment

84. The classes of corporation securities that are available for purchase by investors in Taiwan afford to them a narrow range of selection. Except for a very limited number of bond issues with three-year maturities, which carry an interest rate of 11.25, these securities consist solely of common stock and some issues of so-called preference stock. The latter class of stock is quite unlike anything that is customarily known as a preferred stock in the developed countries. It is essentially a common stock, with a preferential right as to dividends and assets over a specified short term, characteristically three years from the date of issuance. Preferred stocks in the normal form, consisting of shares with a preferential right as to dividends and assets over the life of the issue, are unknown in Taiwan.

85. The certificates for shares of stock of a Taiwan corporation are ordinarily available either in bearer form, evidencing ownership by the bearer and transferable by delivery, or in registered form, evidencing ownership by the person whose name is written on the certificate and transferable only on the stock register maintained by the corporation. These two are freely interchangeable, but the proportion of bearer shares to the total outstanding for any corporation is limited by its articles of association -- for example, to 90%. The use of bearer shares is regarded as an inducement to corporations to list their shares on the stock exchange, since the names of large stockholders with bearer shares are not disclosed on the stock register, for ready examination by the tax authorities. It is questionable whether the device accomplishes much for these stockholders, as the collection by them of divi-

dividends on bearer shares necessitates the presentation of certificates or the surrender of dividend coupons. It would be no great problem for the tax authorities to ascertain the identity of these stockholders from the office where the dividends are paid.

46. Bearer shares do, of course, reduce the work of maintaining the stock register, but the same purpose is accomplished when shares that are actively traded are registered in "street name"--that is to say, in the name of a broker, who thereby assumes the responsibility for keeping track of the owners and crediting them with the dividends received. The system of bearer shares is peculiarly susceptible to the risks of over-issuance of shares or forgeries, as illustrated by actual occurrences of these events from time to time in Taiwan. For that reason, it would be beneficial to proscribe the issuance of bearer shares.

47. Introduction of Wider Variety of Securities

47. In service to the general securities business in Taiwan, and at the same time to the corporations seeking capital, would be the introduction of a wider variety of classes of securities. The full gamut, as it has been evolved in the developed countries, includes convertible preferred stocks and debentures, participating preferred stocks and debentures, and subordinated debentures. These are tailor-made to fit the needs of varying types of investors and, in addition, they provide desirable flexibility to corporations in carrying out their financing operations.

48. The introduction of the use of transferable certificates, which may be traded in the market, evidencing subscription rights to issues of new shares, would be a valuable adjunct to the flotation of such issues. It would permit existing stockholders, who do not care to exercise their rights, to cash in on them to the best advantage. It would, moreover, facilitate the operations of underwriters of

such issues by enabling them, prior to the expiration of the period of the offering, to pick up rights in the market and to contract with investors for the sale to them of the shares covered thereby.

89. Eminent legal counsel in Taiwan has advised that the new corporation law, which is discussed elsewhere herein, authorizes the issuance by corporations of the various classes of securities mentioned above, including transferable certificates for rights to new shares. In consequence, it may be anticipated that issuing corporations and underwriters will cooperate in the exercise of their ingenuity, so as to make use of these new classes of securities.

REGULATION

A. Securities and Exchange Commission

90. At the same time that the Taiwan Stock Exchange was organized, there was set up in Taiwan a Securities and Exchange Commission to regulate the securities business. This is essential in a country, such as Taiwan, which is new to the securities business and where confidence needs to be built up. It will be recalled that in the United States, an active capital market developed long before the advent of the Securities and Exchange Commission in that country, but few would deny that public confidence was greatly strengthened by the regulation which was introduced by the Commission, and that consequently the capital market has been expanded to a much greater degree than would otherwise have been the case.

91. It was not to be expected that the Securities and Exchange Commission in Taiwan would fully live up to the objectives set out for it. The young Commission could not escape public blame for the stock market debacle of 1964. It is now common knowledge that the preceding bull market was characterized by manipulation and malpractice

on the part of corporation executives, wealthy speculators, brokers and certified public accountants. In at least some instances, the corporations and the accountants connived to falsify the financial statements, so as to over-state the earnings and boost the stock price, whereupon large stockholders unloaded their shares upon an unsuspecting public. These are practices which the Commission was supposed to suppress.

92. Unfortunately, the Securities and Exchange Commission in Taiwan was permeated at that time with the philosophy that high stock prices were good for the country, and that it was a proper function of the Commission to do what it could to stabilize the market at a level which, as events proved, could not be economically justified. The Commission managed a large Government-provided fund in an ambitious but unsuccessful attempt at stabilization, as previously mentioned, and it exercised pressure upon corporation executives to buy up shares of their companies in support of the Government effort. This aggravated the disaster, since some of these executives were constrained to borrow from their corporations for the purpose of buying up the shares, and they subsequently found themselves unable to repay the loans.

93. The philosophy of the present Securities and Exchange Commission in Taiwan is more nearly attuned to the sounder view that the aims of the Commission should center upon two principal objectives, namely: the prevention of manipulation, and the inclusion of adequate disclosures in the financial statements and related data that are made available to investors. Nevertheless, the stabilization philosophy persists to some degree. It became known, for example, that just before the inauguration of the President for a fourth term the Commission attempted to persuade China Securities Investment Corporation to step up its purchases on the Taiwan Stock Exchange, in order to create a strong market as a testimonial to the Government. In deference to this

wish, the company made some token purchases on which, as might have been expected, it subsequently incurred a paper loss.

94. Also, it is known that for a considerable period in 1966 the Commission delayed action upon listing applications for issues of new shares, on the theory that such listing would create an over-supply of shares and would depress the market. Thus, there developed a considerable backlog of issues awaiting listing. When the Commission finally took action to grant the applications, no adverse consequences were experienced.

B. Distinction Between Stabilization and Orderly Market

95. It is suggested that the important distinction between stabilization and the maintenance of an orderly market may not yet have been fully grasped in Taiwan. This distinction is one that has been emphasized by International Finance Corporation, which is taking a leading part in the encouragement of efforts to develop capital markets in the developing countries. As set out in the brochure issued by China Securities Investment Corporation at the time of its official opening to business:

"A disservice to the economy would be created if the company were to tie up its capital in stabilizing operations, thus being forced to suspend its ordinary business operations until its capital can be freed by liquidation of the portfolio. A sound system of trading in securities depends upon the free inter-play of supply and demand and, at the same time, the maintenance of an orderly market.

"The operation of supply and demand insures that there will be fluctuations in prices, as dictated by the public's appraisal of the business outlook, changing economic and business conditions, and the varying vicissitudes of individual companies. On the other hand, the maintenance of an orderly market requires the restriction of those extreme price fluctuations which otherwise would occur due to a temporary imbalance between supply and demand.

"In this respect the new company, by purchasing shares when the price drops too far or too fast, or selling shares when the price advances too far or too fast, is equipped to make a significant contribution toward maintaining an orderly market, while achieving a profit through the exercise of its business acumen."

96. By operating in this manner, China Securities Investment Corporation has already made some contribution to the maintenance of an orderly market on the Taiwan Stock Exchange, the form of bids for shares when other buyers were holding back. Unfortunately, its operations have been principally on the buying side, and therefore its full potential for a contribution to the maintenance of an orderly market has not been realized.

97. Transactions calculated to assist in the maintenance of an orderly market may be compared with the operations of a specialist on the New York Stock Exchange. One of the specialist's functions is to purchase shares of the stock, for which he acts as a specialist, when other buyers are lacking, or to sell shares when other sellers are lacking.

C. Regulation of Manipulation

98. Regulation by the Securities and Exchange Commission of the securities market in Taiwan relies in part upon getting detailed daily reports of all transactions on the Taiwan Stock Exchange and studying these to uncover evidences of possibly suspicious activity. For example, such evidence might be afforded by a concentration of transactions in a stock over a brief period, with the effect of running the price up or down unduly, or orders executed by the same broker simultaneously on the buying and on the selling side, suggesting a "wash" transaction which gives a false impression of market activity in a stock.

99. Representatives of the Commission make frequent spot checks at the offices of the brokers. The Commission also requires all members of the Taiwan Stock Exchange to submit to the Commission periodic certified statements of condition, with details concerning their operations.

100. Margin requirements on futures transactions are established by the Securities and Exchange Commission, which varies the amount of margin required from time to time. The margin is small by usual standards, being generally in the range of 20% to 40%, and the requirement is applied with unequal force as between purchases and sales. Thus a futures transaction consisting of the sale of a stock may call for a higher margin than one consisting of the purchase of a stock, presumably on the theory that sales are more damaging to the market than purchases and therefore should be discouraged. This smacks somewhat of the stabilization philosophy. The application of a uniform margin rate for purchases and sales would seem to be the sounder procedure.

D. Regulation of Financial Statements

101. Of equal if not greater significance is the work of the Securities and Exchange Commission which is directed to the inclusion of adequate disclosures in the financial statements and related data that are made available to investors. The Commission requires that the financial statements of all corporations whose shares are listed on the Taiwan Stock Exchange shall be audited by a certified public accountant. However, the investing public has learned by sad experience that more of the certificates that accompany these statements cannot be relied upon.

102. The point is often made that most buyers of securities pay little attention to the financial statements, or are not sophisticated enough to read them intelligently, so the question is raised as to the necessity for emphasis upon properly financial statements. The reason for the importance of reliable financial statements is that the more astute investors and the banks, brokers and investment counsellors who endeavor to give conscientious investment advice do indeed pay attention to the statements, and their influence upon the course of market prices is considerable.

Further, proper financial statements make the manipulation of prices more difficult.

103. The unsatisfactory status of accounting in Taiwan goes to the heart of the problem of developing the capital market, and therefore this matter is given treatment hereinafter under a separate heading.

D. Regulation of New Issues

104. In passing upon new issues of securities, the Securities and Exchange Commission is faced with the delicate distinction between authorizing the issue and approving it. This distinction is not always a clear one in Taiwan, because the philosophy and history of the people have led them to believe that what the Government allows it considers good. The viewpoint of more sophisticated free-enterprise societies, where the Government sets the rules of the game without calling the plays, is not a familiar one in Taiwan.

105. The securities legislation that is on the books provides that the Securities and Exchange Commission shall screen applications for new issues of securities "with a view to the financial condition or the type of operation of the corporation or the conditions that have existed in the securities market." Literal adherence to this instruction would constitute a paternalistic approach, interfering with the operation of supply and demand, and would create dangers for the Commission, of which it is fully aware. Be it said in favor of the Commission that, while not always consistent in its attitude, it has declared its espousal of the principle of letting the market make its own appraisal of the quality and pricing of the securities traded therein.

106. In cases of an enforced underwriting of an issue of new shares, such as is now being required by the Securities and Exchange Commission as mentioned above, the Commission will be faced with a touchy administrative problem. It would be best

that the selection of the underwriter or underwriters, and the determination of a fair underwriting commission, be left to negotiation among the parties. However, on account of the paucity of competition that exists in the underwriting business, it is believed that the Commission should have a say as to the fairness of the arrangements that are made.

E. Business Ethics

107. By and large, business ethics are not of the highest order in Taiwan, which makes the regulation of the securities business particularly difficult. The transition, which has already commenced in Taiwan, from a society in which most business enterprises are closely held to one in which the shareholdings are spread widely, necessarily involves a reorientation of business ethics. The same was true in the past in many of the developed countries, where the transition took place more gradually.

108. As the transition progresses in Taiwan, the problems of regulation will doubtless multiply; but it may be hoped that, with an accompanying evolution of business ethics, they should become more manageable.

ACCOUNTING MATTERS

A. Accounting Profession Held in Low Esteem

109. The basic reason for the poor performance of most of the certified public accountants in Taiwan is that the accounting profession is held in low esteem. Managements of Taiwan corporations, for the most part, have not learned to use properly prepared financial reports as a tool in management. The accountant is rated, in the eyes of the corporation executive, little higher than a bookkeeper, whose job it is to carry out the instructions of the management.

110. Too often, the emphasis is upon tax savings. In consequence, most of the work of the certified public accountants is devoted to tax matters, and scant heed is paid to the requirements of the shareholders for informative reports. The accountants, like the tax people in the lower echelons, are grossly underpaid, which tempts them to eke out their meager incomes by unsavory means. The result in many cases has been detrimental to the investors, who are misled by falsified figures; to the capital market, which lacks authoritative financial statements; and to the Government, which fails to collect the taxes that are its due.

111. Measures have been taken by the Securities and Exchange Commission which are tending to ameliorate the situation, and progress is being made toward raising the standards of the accounting profession. The Commission now maintains an unofficial list of reputable and competent certified public accountants whose certificates are acceptable to it. When a corporation submits the certificate of an accountant whose name is not on this list, the Commission makes difficulties for the corporation and for the accountant, by probing deeply into the background of the work of the accountant and by withholding acceptance of the certificate until satisfied that it has been properly given. As a result of the Commission's probing, five certified public accountants were temporarily barred about a year ago from practicing before the Commission.

B. Timing of Accountant's Appointment

112. A factor which makes for inadequate accounting practices is the custom, which is almost universal in Taiwan, of appointing the certified public accountant after the close of the year with respect to which he is asked to furnish a certificate. For example, to certify the financial statements of a corporation for 1967, the chances are that the certified public accountant will not receive his appointment un-

til the early part of 1968. He will not have the opportunity of observing the year-end taking of inventory, or of making many of the other checks which are needed for a proper audit and certification of the accounts. Moreover, he is not afforded the opportunity of consulting with the corporation during the course of the year, with regard to its accounting methods and procedures, so as to conform these to the requirements of good accounting. He should receive his appointment for auditing and certifying the 1967 statements early in that year, preferably not later than the time of the annual stockholders' meeting.

113. With this problem in mind, the Securities and Exchange Commission has been considering the promulgation of a rule that the certified public accountant for each listed corporation be selected early in the year with respect to which he will be asked to furnish a certificate.

C. Inadequacy of Certificates and Reports

114. In the absence of a requirement for the timely appointment of the certified public accountant, most of the certificates rendered have merely stated that the accountant finds the figures which are being submitted to be in accordance with the books. That is far from meeting the standards for a proper certificate. Under these standards, the certificate should state that an examination has been made "in accordance with generally accepted auditing standards," and that the figures fairly present the corporation's financial condition and the results of its operations "in accordance with generally accepted accounting principles"; in each case, with only such exceptions as are specifically mentioned in the certificate. To its credit, the Securities and Exchange Commission is now beginning to enforce a requirement for certificates in this form.

115. Another detriment is the general failure to use the so-called short form of accountant's report, which has been widely adopted in the developed countries to the exclusion, in many cases, of the so-called long form of report. The short-form report consists of a concise certificate of the certified public accountant, accompanied by the financial statements, with all necessary footnotes appended thereto. It is well suited for use in annual reports and prospectuses. The long-form report, on the other hand, contains a detailed recital of what the certified public accountant did and did not do, with detailed and perhaps superfluous comments on the various accounts, and is accompanied by a certificate which is qualified in its entirety by this recital and these comments.

116. In other words, the certified public accountant in giving a long-form report typically avoids taking a position as to conformity with accepted auditing standards and accounting principles, which are matters that only he is competent to judge. Even the trained reader of such a report has difficulty in evaluating the worth of the certificate, and the report itself is too bulky for inclusion in annual reports and prospectuses.

D. Fees Paid to Accountants

117. The fee that the certified public accountant receives from the corporation, for which he audits the accounts and certifies the financial statements, treated as confidential information, but there is no reason why the Securities and Exchange Commission cannot ascertain this as background data in its regulatory work. While the fees received by certified public accountants in Taiwan are generally low in comparison with those prevailing in more sophisticated economies, some of them run absurdly low. Even for large corporations with complex activities, they sometimes run at less than \$1,000 a year. In at least one instance, where considerations of

friendship were alleged, there was no compensation to the certified public accountant.

118. It may well be asked, "What is the quality of the work that can be expected of a certified public accountant in return for a minimal fee?" The answer is clearly that the certified public accountant who undertakes to work for such a fee is forced to do a hasty and slipshod job. An examination by the Commission into the fees that are paid to the certified public accountants can at least point the finger to situations that are suspicious on their face.

119. There must be over 100 practicing certified public accountants in Taiwan, but very few of them meet the standards of good accounting practice. Most of them operate without staff assistants, or at most with one or two assistants, who are sometimes employed on a temporary basis. In the effort to strengthen the profession, the Government has recently tightened the requirements for the licensing of certified public accountants. The Government recognizes that the training which is given in this field by colleges, business schools and vocational schools in Taiwan is inadequate, and has endeavored to bring about an improvement in the teaching of accountancy.

E. Chinese United Credit Center

120. A significant step which was taken about a year ago by China Development Corporation, in order to promote the dissemination and use of reliable financial data, was the sponsorship by it of the formation of Chinese United Credit Center. This is a new and much needed credit information service which is intended to operate ultimately in the manner of Dun & Bradstreet in the United States. It receives the support of practically all of the financial institutions in Taiwan. In addition, the two United States banks which recently established branches in Taiwan have made

a fruitful beginning in the assembly by them of financial data regarding the enterprises in Taiwan with which they or their customers have occasion to deal.

121. The process is a slow one, because it is necessary to break through the traditional aura of secrecy with which the financial data are customarily surrounded.

CERTAIN LEGAL PROBLEMS

A. Barriers on Way to Removal

122. Mention has been made of certain legal problems which confront the securities business in Taiwan, especially the barriers to the co-mingling of the business of brokers and that of dealers and to the conduct of an over-the-counter business. Under present circumstances, there is reason to believe that these barriers will be removed by amendment of the existing securities law.

123. Other legal problems in the development of the capital market remain, however.

B. Tax Structure

124. One of the remaining problems is presented by the tax structure, which is slanted in favor of direct investments by entrepreneurs but fails to give corresponding consideration to the needs of the capital market. Unlike some other developing countries, Taiwan offers no tax incentive for closely held corporations to place their shares with the public.

125. With the aim of accelerating industrial output, the Government has indeed introduced some highly important tax incentives, which make an indirect contribution to the development of the capital market by fostering the establishment of new enterprises. Notably, the Government has lowered the top income tax bracket for corporations from 25% to 18%, has decreed a five-year income tax holiday for new productive

enterprises, has provided tax exemption for a portion of the earnings of a corporation which is re-invested in the business, has allowed a tax deduction for exports, and has liberalized the customs treatment of imports of capital equipment.

126. While these incentives were being enacted into law, the tax rates on the income of individuals, including their income from investments, were raised to 52% for the top bracket, which is undoubtedly a high rate for a developing country and is reached at an income level of \$50,000. The only significant inducement extended to the public to invest in securities has been the exemption from tax of capital gains on securities held for one year or longer. Capital gains of shorter term are treated like other income.

C. Foreign Investment

127. Although the Government is decidedly interested in attracting foreign capital into Taiwan, its regulations covering the repatriation of foreign capital fail to consider the special needs of the capital market. Foreign capital may not be repatriated until the expiration of two years from the date of investment, and then only at the rate of 15% per annum. This means that the foreign investor must wait for nine years if he wishes to take home his entire capital. There is, fortunately, no ban upon the repatriation of dividend or interest income.

128. The time restriction on repatriation of foreign capital is not necessarily a handicap for the foreign entrepreneur, who is making a direct long-term investment in a new plant in Taiwan. It is, however, discouraging to the foreign investor who is interested in purchasing Taiwan securities in the market. Even if this type of investor should contemplate leaving his money in Taiwan for an indefinite period, he usually wishes to reserve, at the time of making his investment, the privilege of subsequently changing his mind.

129. There is apparently no sufficient reason for retaining the restriction on the restriction of foreign capital which is invested in portfolio securities--that is to say, securities which are purchased in the market. It is not likely that the removal of this restriction would produce a flood of portfolio investments by foreigners so as to embarrass the Government or to create the potential threat of a heavy drain on the foreign exchange reserves in the event of repatriation. On the other hand, this form of encouragement to foreign investment in portfolio securities would constitute one more step in building up confidence abroad, and should therefore promote indirectly the direct investments of foreign entrepreneurs.

130. Should the Government become concerned in the matter, it could at any time restore the restriction as to new money coming in thereafter, without breaking faith with those foreign investors who had theretofore made portfolio investments in Taiwan in reliance upon the lifting of the restriction.

D. New Corporation Law

131. In the latter part of 1966 the legislature of Taiwan adopted, and the Government promulgated, the new corporation law to which reference has already been made. The new law effected many improvements from the old law in respect of the obligations of corporations and their relations with stockholders. Regrettably, a few undesirable features crept into the new law as enacted, and these have caused concern among those officials and businessmen who are interested in the development of the capital market.

132. For example, the new corporation law requires that a corporation which expands its business must finance the expansion by the issuance of additional capital stock and not by debt. An exception is made for certain Government-approved loans, but the repayment of these must also be financed by the issuance of additional capital stock. This apparently inhibits the use of profits, of working capital or of funds generated from operations to finance any expansion, or to repay Government-approved debt incur-

red for that purpose.

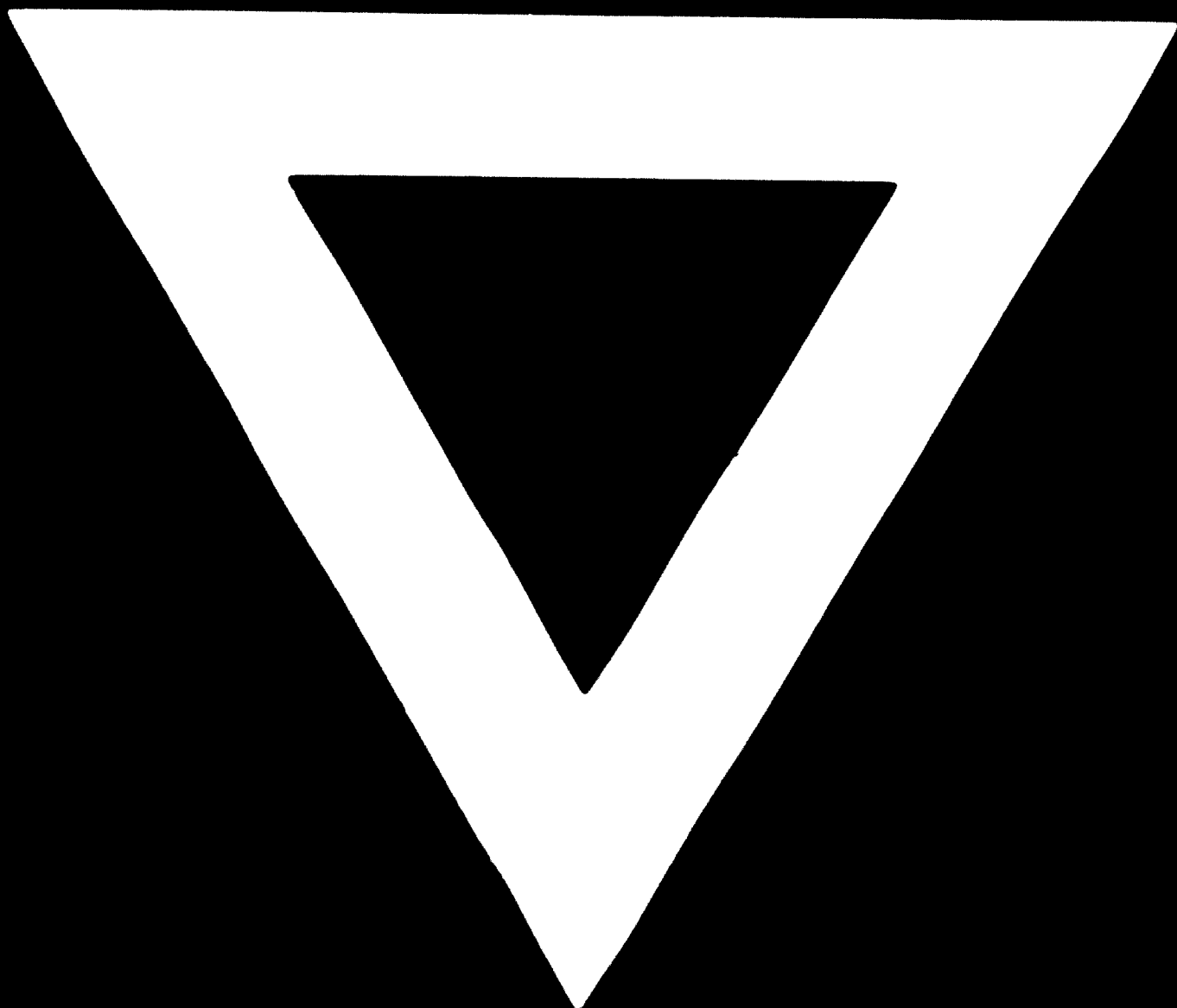
133. Further, the new law, by restricting to 25% the portion of a corporation's capital that may be invested in other corporations, appears to restrict unduly the right of a corporation to organize subsidiaries to carry on related businesses, or to participate in joint ventures with other corporations. The foregoing provisions affect the capital market adversely by substituting rigid and arbitrary rules for the discretion of management in matters of corporation finance.

134. Of course, the question as to how the expansion of a business should be financed should be keyed to such considerations as the corporation's capital structure and its ability to pay its debts. The question whether a subsidiary or a joint venture should be formed also be keyed to the circumstances of the particular case. Conceding that some governmental control in these matters is needed in Taiwan, this can be provided by the Securities and Exchange Commission, which is in a position to exercise judgment as to the appropriate course to be followed in varying situations and in the interest of the financial health of the affected corporations.

135. The new law gives to a small minority of the stockholders of a corporation the opportunity to create a nuisance value for themselves. For instance, the holders of 3% of the capital stock may at any time take legal action for the appointment by a court of an examiner into the corporation's affairs, and under certain conditions the holders of 10% of the capital stock may at any time take legal action for dissolution of the corporation. While the protection of the rights of minority stockholders is a worthy objective, over-sealousness in this regard may be productive of ill results. It is known that the effect of such provisions has been to cause the deferment of some proposed issues of new shares, in which the investing public of Taiwan would have been invited to participate.

136. The problems inadvertently posed by the new legislation have been brought to the attention of the Government in the hope that remedial steps will be taken by administrative action, where possible, or by amendment.





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