Financial Institutions in Taiwan: An Analysis of the Regulatory Scheme

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INTRODUCTION

In 1985, the disclosure of irregularities involving the Tenth Credit Cooperative and the Cathay Investment Trust Company, two leading players in Taiwan's financial sector, led to panic in the financial community. Their concomitant loss of investor confidence resulted in devastating large-scale withdrawals of funds from these two institutions as well as from a host of other financial institutions. Some equilibrium was restored only after the government appointed several government-controlled banks to assume the management of the two perpetrators of financial misconduct.[1]

The scandal involving the Tenth Credit Cooperative and the Cathay Investment Trust Company reveals some of the complicated and challenging issues present in Taiwan's financial markets, which in recent years have emerged as a vital area of growth and opportunity for both foreign and domestic investors. However, the development of financial markets has also raised many concerns regarding the soundness of Taiwan's financial institutions and the equity and efficiency of its financial systems.

The central government of the Republic of China (ROC) has played a crucial role in the development of Taiwan's economy and in the creation of its financial system. Historically, the government pursued an economic policy of strict surveillance. This initial policy contributed to the reform of Taiwan's economy and laid the foundation for its early financial expansion and economic prosperity. In its transformation from an agrarian economy to a major economic power, Taiwan has managed to achieve an economic growth rate that very few other countries have matched.[2] The country has also maintained

1. *See, e.g., Investigators into Cathay Widen Scope of Inquiries*, Fin. Times, Mar. 21, 1985, at 22; *Taiwan Minister Quits over Cathay*, Fin. Times, Mar. 12, 1985, at 15; *State Acts to Save Cathay Investment from Collapse*, Fin. Times, Mar. 5, 1985, at 23; *Taiwan Arrests Tenth Credit Chief*, Fin. Times, Mar. 2, 1985, at 23; *Financial Troubles Deepen at Tenth Credit and Cathay Plastics*, Fin. Times, Feb. 26, 1985, at 15; *Taiwan Suspends Seven Bank Officials*, Fin. Times, Feb. 15, 1985, at 18. *See generally* Tai Li-ning, *K'ai-fang Yin-hang Shih Hao-shih Hai-shih Tsai-nan*; YÜAN-CHIEN TSA-CHIH (Global Views Monthly), July 15, 1989, at 90 (all bank failures in Taiwan followed similar patterns: illegal lendings to affiliates, disclosure to public, depositors rush to withdrawals and takeovers by government).

2. For example, during the twenty-year period from 1968 to 1988, Taiwan's gross national product (GNP) grew in real terms at an average annual rate of 9.1 percent, although Taiwan's annual economic growth rate has ranged widely from a low of 1.2 percent in 1974 to

almost full employment[3] and has achieved a relatively egalitarian distribution of income.[4]

However, such regulatory conservatism has ultimately proven to be economically oppressive because of the exigencies of rapid transformations both in the internal financial system and in the global markets. The government has progressively been compelled to propose or permit various measures of deregulation.[5] Such liberalization of the financial markets has served simultaneously to revolutionize and to de-stabilize Taiwan's financial system.[6]

The current resurgence of market tension and investor insecurity in Taiwan highlights the conflict between the attraction of a liberalized, competitive free-market state and the need for preserving the soundness of the financial system through carefully drawn regulatory measures. The Tenth Credit Cooperative and the Cathay Investment Trust Company incident also demonstrates that on occasion the sole corrective for the volatility and instability of financial markets may be found in active government intervention. Therefore, regulatory measures may prove to be the most effective instruments for both maintaining the soundness of financial institutions and preserving the equity and efficiency of financial markets in Taiwan.

To determine the role of government regulation of financial institutions, it is essential to evaluate the fundamental rationales for regulating financial institutions. A multitude of rationales collectively serve to explain and justify promulgation by the government of financial regulations. Government intervention generally encompasses measures that are intended to correct instances of classic market failure while also encompassing provisions that seek to protect the health

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a high of 14 percent in 1978. *See* COUNCIL FOR ECONOMIC PLANNING AND DEVELOPMENT, INDUSTRY OF FREE CHINA, vol. LXXI, No. 2, Feb. 1989, at 52 (English part).

3. During the 1980s, Taiwan experienced relatively low unemployment, with an average unemployment rate of 2 percent during the years 1980 to 1984. Although unemployment rose to an average rate of 2.9 percent in 1985, the situation improved in 1986, 1987 and 1988, with official statistics showing unemployment standing at 1.4 percent as of the end of 1988. *See* DIRECTORATE-GENERAL OF BUDGET, ACCOUNTING AND STATISTICS, MONTHLY STATISTICS OF THE REPUBLIC OF CHINA, No. 278, 25 (Mar. 1989).

4. *See* Chien, *The Economic Development of Taiwan, Republic of China — An Economic Success Story*, INDUSTRY OF FREE CHINA, vol. LXXII, No. 1, July 1989, at 1, 2 (English part).

5. *See* Shieh, *Financial Liberalization and Internationalization in the Republic of China — Current Status and Future Policy Directions*, INDUSTRY OF FREE CHINA, vol. LXXII, No. 6, Dec. 1989, at 9-11 (English part); speech by C. Chang, The Liberalization and Internationalization of ROC's Financial Markets, at the Taiwan Financial Markets and Investment Conference 9, 9 (May 25-26, 1988) (unpublished manuscript on file with the *Journal of Chinese Law*).

6. *See* speech by S. Kuo, Liberalization of the Financial Market in Taiwan in the 1980s, at the First Annual Pacific-Basin Finance Conference in Taipei, Taiwan 1, 1 (Mar. 14, 1989) (unpublished manuscript on file with the *Journal of Chinese Law*).

of both individual financial institutions and the overall financial system. In addition to these efficiency rationales, equal importance must be given to equity considerations of the various proposed reforms.

These varying and sometimes opposing rationales for the regulation of financial institutions, upon which government policy is formed, remain fraught with controversy. The concerns of the numerous players involved, as well as their often diametrically opposed interests, needs and points of view, cause the creation and promulgation of regulations to become a series of compromises and even outright sacrifices on the part of all market participants. Furthermore, divergent considerations of economic efficiency and equity may suggest recourse to conflicting as opposed to convergent remedies.

In Taiwan, soundness regulations present a "case study" for the illustration and examination of such conflicts and concerns. This case study is of particular relevance due to the recent deregulation of Taiwan's financial markets, where competitive market forces are beginning to replace government intervention, thereby increasing the possible failure of Taiwan's financial institutions and its overall financial system. As will be argued, in the financial marketplace, fundamental rationales for regulation include concerns for the health of financial institutions, which contributes to both financial stability and economic growth. Therefore, the crux of soundness regulations is the prevention of systemic institutional failure, which menaces the equilibrium and the very existence of the financial system. In the course of this article, it will be demonstrated that financial institutions perform a multitude of essentially interconnected functions. This interdependence of financial institutions mandates the prevention of both individual and systemic failure through two methods: first, internal preventive measures within a financial institution to restrict the possible risk of that particular institution's demise; second, external systemic measures to isolate an unhealthy or failed institution and thus reduce the potential risk of bank runs or systemic collapse.

Part I of this article introduces the structure of the financial markets in Taiwan by identifying the markets' major participants, describing the government agencies responsible for the markets' regulation and discussing the regulatory activities of such agencies. Part II considers several factors that have caused or contributed to the liberalization of the financial markets in Taiwan and reviews certain amendments or modifications to principal financial laws and regulations. In light of such transformations, Part III evaluates both the immediate implications of such de-regulatory measures and, even

more importantly, the ultimate viability of certain underlying rationales for the regulation of financial institutions. Finally, through the "case study" of the soundness regulations of financial institutions, Part IV provides a forum for the analysis and discussion of such rationales. Thus, Part IV assesses the fundamental categories of regulations which are designed to reduce or eliminate potential institutional risk and proposes certain corrective measures intended further to promote the soundness of individual financial institutions and the overall financial system in Taiwan.

I. MARKET PARTICIPANTS AND REGULATORY FRAMEWORK

Financial institutions serve to facilitate the channelling of funds from capital suppliers to users, thereby effectuating an efficient allocation of scarce capital resources.[7] In performing their economic functions, financial institutions serve as intermediaries between capital suppliers and users by obtaining funds from savers and depositors and lending the proceeds to individuals or entities to undertake new productive activities.[8] Financial intermediaries include institutions such as commercial banks, insurance companies and mutual funds. In addition to the process of intermediation, financial institutions can bring together capital suppliers and users through the securities markets. Financial institutions servicing the securities markets include securities brokers and underwriters that assist corporations and governmental entities to raise capital through a direct distribution of their obligations to securities investors.[9]

Over the past thirty years, the financial sector in Taiwan has made significant contributions to the country's rapid economic development by mobilizing domestic savings and allocating investment resources. However, the growth of the financial sector surprisingly has not kept pace with the growth in other sectors of the economy.[10] This is due, in part, to restrictive government policies which have resulted in bank financing being extended on a short term basis and on conservative terms.[11] The development of longer-term financing

7. *See* G. BROKER, COMPETITION IN BANKING 110-11 (1989); T. CAMPBELL, FINANCIAL INSTITUTIONS, MARKETS, AND ECONOMIC ACTIVITY 2-5 (1982); R. LITAN, WHAT SHOULD BANKS DO? 8-10 (1987); Fischel, Rosenfield & Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 306-07 (1987).

8. For a discussion of the causes of financial intermediation and description of the various types of intermediaries, *see* Clark, *The Federal Income Taxation of Financial Intermediaries*, 84 YALE L.J. 1603, 1605-08 & nn.1-21 (1975).

9. *See infra* notes 35-55 and accompanying text.

10. *See, e.g., Grow Up, Taiwan*, ECONOMIST, Sept. 9, 1989, at 20 (Taiwan's economic success under threat because of its reluctance to bring financial system up to standards).

11. *See* Yü, Some Legal Aspects of Financial Liberalization in Taiwan, paper presented

and alternatives to bank financing has also been impeded by the lack of a developed securities market.[12] Before proceeding to an analysis of the current financial markets and the reforms undertaken by the government, it is helpful first to identify the principal types of existing financial institutions in Taiwan and the principal agencies that regulate these institutions and then to describe in general terms their regulatory activities and restraints.

A. Types of Financial Institutions

It should first be noted that certain financial services in Taiwan have been provided by institutions that have not been closely regulated. For example, in recent years a number of unregulated investment companies have been operating in Taiwan for the purpose of making various types of investments both inside and outside Taiwan.[13] There also exists a considerable amount of illegal margin lending connected with Taiwan's securities market.[14] The relative importance of the unregulated financial market in Taiwan is partially reflected by an estimation that approximately 37 percent of the funds borrowed by private companies from 1964 to 1985 were provided by unlicensed lenders.[15] Consequently, the markets for financial services in Taiwan are not identical with the total services provided by the financial institutions which are regulated.

1. Financial Intermediaries

A wide variety of financial intermediaries operate in Taiwan. This diversity results not only from the market demand for different financial services, but also from historical developments.[16] The pri-

to the National Taiwan University and University of Washington Symposium on Law and Development in Taipei, Taiwan 4 (Sept. 5-6, 1988) (unpublished manuscript on file with the *Journal of Chinese Law*).

12. Speech by C. Chang, *supra* note 5, at 20 (stating that private enterprises rely primarily on banks, rather than securities offerings, as sources of financing); speech by B. Hu, Recent Developments in Taiwan's Capital Markets: The Past as Prologue, at the 13th Joint Conference of USA-ROC and ROC-USA Economic Councils in Kona, Big Island of Hawaii 5 (Nov. 18-21, 1989) (stating that "Taiwan's bond market has historically been illiquid and very thinly traded") (unpublished manuscript on file with the *Journal of Chinese Law*); *see also* Hsu & Liu, *The Transformation of the Securities Market in Taiwan, the Republic of China*, 27 COLUM. J. TRANSNAT'L L. 169 (1988).

13. *See, e.g., A Dangerous Game in Taipei*, ECONOMIST, Sept. 9, 1989, at 97 (reporting that up to 200 finance companies operate in Taiwan and take illegal deposits totalling up to NT$ 4 billion).

14. *See, e.g., Stocks Take Taiwan on Giddy Ride*, N.Y. Times, Sept. 6, 1989, at D1, col. 3 (reporting that up to 30 percent of investments are made with illegal margin trading).

15. *See* CHANG CHING-HSI, HSÜ CHIA-TUNG, LIU YING-CH'UAN & WU TSUNG-MIN, CHING-CHI HSÜEH: LI-LUN YÜ SHIH-CHI (Economics: Theories and Practices) 516 (1987).

16. *See* LIANG KUO-SHU & HOU CHIN-YING, WO-KUO CHIN-JUNG CHIH-TU YÜ CHIN-

mary financial intermediaries currently operating in Taiwan may be grouped into four main classes based on the source of their funds and their manner of investment.

a. Depository Institutions

The first group of financial intermediaries is composed of six types of depository institutions: commercial banks, specialty banks, local branches of foreign banks, investment and trust companies, credit cooperative associations and credit departments of farmers' associations and fishermen's associations.[17] These depository institutions, which might be called "bank-type intermediaries," obtain most of their funds by accepting deposits from savers and then maintain those funds in various appropriate investments.[18] Commercial banks, the principal kind of bank-type intermediaries, receive checking deposits and supply short-term credits.[19] Specialty banks, which include agricultural banks,[20] export-import banks[21] and medium business banks,[22] have been established or designated to extend specific types of credit.[23] The government-owned Bank of Communications, specializing in the extension of industrial credits, was designated as

JUNG CHENG-TS'E (The Financial System and the Financial Policy in the Republic of China) 1 (1988).

17. Commercial banks, specialty banks, local branches of foreign banks and investment and trust companies are governed by the Banking Law and regulations promulgated thereunder. *See* Yin-hang Fa (Banking Law) (promulgated Mar. 28, 1931, last amended July 17, 1989) arts. 20, 116 [hereinafter Banking Law]. The Banking Law also governs savings banks. *See id.* Although no savings banks have been established to date, a number of commercial banks and specialty banks are permitted to engage in the business of savings banks through separate savings departments. Credit cooperative associations and credit departments of farmers' and fishermen's associations are regulated under specialized regulations. *See* LIANG & HOU, *supra* note 16, at 3-13.

18. Pursuant to the Banking Law, the business scope of banks includes, among other things, the taking of checking deposits and other types of deposits. Banking Law, *supra* note 17, art. 3.

19. *Id.* art. 70. Some of the specialty banks and other types of institutions are also allowed to conduct the business of commercial banks. *See* LIANG & HOU, *supra* note 16, at 4-5.

20. *Id.* arts. 92, 93; *see also* LIANG & HOU, *supra* note 16, at 7-8.

21. Banking Law, *supra* note 17, arts. 94, 95. The Export-Import Bank specializes in trade banking, including extending medium- and long-term credit and guarantees to certain exports, providing export finance, and conducting country risk surveys and credit investigations. *See* LIANG & HOU, *supra* note 16, at 9.

22. Banking Law, *supra* note 17, art. 96. The main functions of medium-size business banks consist of extending medium- and long-term credit to improve the operation of medium-size business enterprises. *See* LIANG & HOU, *supra* note 16, at 10-11.

23. Article 87 of the Banking Law provides that "[T]o facilitate the availability of special credit for enterprises, the central competent authority may authorize the establishment of a specialized bank or may designate an existing bank to extend such credit." Banking Law, *supra* note 17, art. 87.

Taiwan's development bank either to provide medium- and long-term credit to development projects or to take equity interest in technology-intensive industry.[24] The local branches or representative offices of foreign banks, as sanctioned by the laws of Taiwan, conduct most, but not all, banking activities engaged in by domestic banks.[25] Investment trust companies, in practice, focus on more traditional banking businesses, real estate investment and fund management, although they are authorized under the Banking Law to engage in a variety of activities, including trust fund management, direct and syndicated medium-term and long-term loans and leasing.[26] Credit cooperative associations and credit departments of farmers' and fishermen's associations accept deposits from and grant loans to their members.[27] Among these "bank-type intermediaries," commercial banks and other domestic banks are the largest and most diversified,[28] comprising nearly one half of the total assets of all financial institutions operating in Taiwan.[29]

b. Postal Institutions

The second category of financial intermediaries consists of post offices and postal agencies. These postal institutions also accept savings deposits and handle remittances locally.[30] However, unlike bank-type intermediaries, they cannot extend loans. Rather, they must redeposit accumulated funds with the Central Bank or with

24. Articles 90 and 91 of the Banking Law provide that the primary functions of an industrial bank are to extend medium- or long-term credit to industry, mining, transportation and other public utility enterprises. Banking Law, *supra* note 17, arts. 90, 91; *see also* LIANG & HOU, *supra* note 16, at 5-7.

25. Banking Law, *supra* note 17, art. 121; *see also infra* notes 128-29, 123-54 and accompanying text.

26. Banking Law, *supra* note 17, arts. 100, 101. It should be noted that the funds received by investment trust companies take the form of "trust funds" rather than "deposits." Arguably they should not be categorized as bank-type intermediaries. However, the Banking Law has defined investment and trust companies as a type of bank under the Banking Law. Moreover, the trust funds received by the investment trust companies sometimes carry "interests" and as such possess certain characteristics of deposits. *See* LIANG & HOU, *supra* note 16, at 14-15.

27. For a description of the operation of credit cooperative associations and credit departments of farmers' and fishermen's associations, *see* LIANG & HOU, *supra* note 16, at 11-13.

28. For instance, in addition to their respective permissible businesses, many commercial banks and specialty banks are allowed to engage in savings or trust business through their savings or trust departments. Banking Law, *supra* note 17, art. 28.

29. Total assets of Taiwan's 16 domestic banks at the end of January 1989 stood at NTS 3,693.7 billion, with such banks accounting for approximately 48.82 percent of total deposits. *See* ECONOMIC RESEARCH DEPARTMENT, CENTRAL BANK OF CHINA, FINANCIAL STATISTICS MONTHLY, Feb. 1989, at 21-22.

30. *See* LIANG & HOU, *supra* note 16, at 13.

banks designated by the Central Bank for reinvestment purposes.[31] With regard to the deposit-taking business, the postal savings system has become the single most important competitor to full-service domestic banks.[32]

c. Insurance Companies

The third category of financial intermediaries includes life insurance companies and fire and marine insurance companies. Unlike the depository-type intermediaries described above, insurance companies must obtain their funds in the form of premiums from those whom they insure. However, insurance companies also invest the funds they receive, thereby effectively assuming the functions of an intermediary. Consequently, insurance companies generally act like bank-type intermediaries—channelling funds from "lenders" to borrowers.[33]

d. Investment Funds

The fourth category of financial intermediaries consists of securities investment trust fund enterprises. These enterprises are authorized to establish mutual funds by pooling the funds of individuals and other investors, and by using such funds to purchase debt or equity obligations of businesses or government entities.[34]

2. Institutions Operating in the Securities Markets

Users of funds may raise them in the securities markets by offering and issuing securities to capital suppliers. Financial institutions which operate in the securities markets facilitate such matching of capital suppliers and users by providing an institutional framework for the distribution and trading of securities.

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31. *Id.* at 14.

32. The postal savings system has grown rapidly in recent years. For instance, from 1961 through January 1989, deposits in the postal savings system, in comparison to all deposits in domestic banks, grew from 3 percent to about 16.63 percent. *See* ECONOMIC RESEARCH DEPARTMENT, CENTRAL BANK OF CHINA, FINANCIAL STATISTICS MONTHLY, Mar. 1989, at 47; COUNCIL FOR ECONOMIC PLANNING AND DEVELOPMENT, TAIWAN STATISTICAL DATA BOOK 145, 165 (1988).

33. Pao-Hsien Fa (Insurance Law) (promulgated Dec. 30, 1929, last amended Nov. 30, 1974) arts. 2, 146. Article 146 of the Insurance Law provides that the funds and capital reserves of insurance companies can be deposited in banks or invested in government bonds. *Id.* art. 146(1), (2). Investments in corporate stocks and bonds as well as real estate are subject to certain limitations. *Id.* art. 146(3), (4).

34. Pursuant to such arrangements, investors could entrust their savings to others for expert management and diversification of investments which would not be available to them as individuals. *See* Cheng-chüan T'ou-tsu Hsin-t'o Chi-chin Kuan-li Pan-fa (Regulations Governing the Management of Securities Investment Trust Funds) (Ministry of Finance, Ref. No. 76-*T'ai-Ts'ai*-3-00991) (promulgated Aug. 10, 1983, last amended Oct. 6, 1987).

a. Securities Firms

Subject to certain exceptions, both equity and debt securities of "public companies" in Taiwan are distributed through underwritten offerings.[35] When engaging in a rights offering of equity securities to shareholders of companies listed on the Taiwan Stock Exchange, the issuer must, by means of an underwritten public offering, sell a specific percentage of its outstanding shares to the public.[36] In order to conduct an underwritten public offering, a financial institution must be licensed to act as an underwriter under the Securities and Exchange Law.[37]

Trading of securities in Taiwan is conducted on the Taiwan Stock Exchange or the over-the-counter market. The Taiwan Stock Exchange, presently the sole stock exchange in Taiwan, is a corporation owned by both government and privately-controlled banks and enterprises.[38] It is independent of those institutions or entities transacting business through it, all of whom pay a user's fee.[39] Only licensed brokers, dealers and integrated securities firms are allowed to trade on the Exchange.[40] Brokers act as agents, executing transactions only for their customers, not for their own accounts.[41] Traders, on the other hand, are permitted to deal in securities only for their own accounts, not for their customers.[42] Integrated securities firms are firms that combine the three activities of brokerage, trading and underwriting.[43] Subject to quite limited exceptions, all transactions in listed securities must be made through the Taiwan Stock Exchange.[44]

To complement the Taiwan Stock Exchange, an over-the-counter market was established in 1982 on the initiative of the Securities and

35. Public companies are defined as all companies limited by shares, whether or not listed on the Taiwan Stock Exchange, whose capital exceeds the minimum amount specified by government authorities. Kung-szu Fa (Company Law) (promulgated Dec. 26, 1929, last amended Dec. 7, 1983) art. 156, para. 4; Cheng-chüan Chiao-i Fa (Securities and Exchange Law) (promulgated Apr. 30, 1968, last amended Jan. 29, 1988) art. 22, para. 1, 22-1 [hereinafter SEL]. For a description of the practice with respect to the underwriting and distribution of securities by the underwriters in Taiwan, *see* YU HSUEH-MING, CHENG-CHÜAN KUAN-LI (Securities Regulation) 331-35 (1983).

36. *See* SEL, *supra* note 35, art. 28-1.

37. *Id.* arts. 44, 16(1), 15(1).

38. *See* 3 LAI YING-CHAO, CHENG-CHÜAN CHIAO-I FA CHU-T'IAO SHIH-I (Commentary on the Securities and Exchange Law) 208-11 (1986).

39. SEL, *supra* note 35, arts. 124, 125; *see also* LAI, *supra* note 38, 208-11.

40. SEL, *supra* note 35, art. 125(1); T'ai-wan Cheng-chüan Chiao-i So Ku-fen Yu-hsien Kung-szu Chang-ch'eng (Articles of Incorporation of the Taiwan Stock Exchange, Inc.) (adopted Oct. 23, 1961, last amended June 24, 1986) art. 32.

41. SEL, *supra* note 35, arts. 15(3), 16(3).

42. *Id.* arts. 15(2), 16(2).

43. *Id.* art. 45, para. 1.

44. *Id.* art. 150.

Exchange Commission in Taiwan.[45] The over-the-counter market is currently limited primarily to shares and bonds that are not listed on the Taiwan Stock Exchange.[46]

b. Other Regulated Participants

In addition to brokers, dealers, underwriters and integrated securities firms, several other regulated institutions also participate in Taiwan's securities market. For instance, securities investment consulting enterprises engage primarily in advising investors in the appraisal of and investment in domestic and certain approved foreign securities.[47]

In 1980, in an effort to increase overall market liquidity and marketability of individual securities, the government authorized the establishment of a securities finance institution to provide margin loans and stock loans for securities transactions. This institution extends credit to dealers and investors, the latter of whom open accounts through securities brokers in order to buy and sell securities.[48]

In 1976, in an effort to encourage the growth of the money market (dealing largely with instruments with maturities of less than a year),[49] the government authorized the establishment of bills finance companies.[50] As the primary intermediaries in Taiwan's money market, bills finance companies are authorized to issue, underwrite or

45. *Id.* art. 62; T'ai-pei Shih Cheng-chüan Shang-yeh T'ung-yeh Kung-k'uai Cheng-chüan-shang Ying-yeh Ch'u-so Mai-mai Yu-chia Cheng-chüan Shen-cha Chun-tse (Guidelines for the Review of Purchase and Sale of Securities at the Places of Business of Dealers Participating in Taipei Securities Dealers' Association) (Ministry of Finance, Ref. No. 76-*T'ai-Ts'ai-Chen*-8932) (promulgated Feb. 24, 1988) [hereinafter Guidelines for the Review of Purchase and Sale of Securities in Taipei Securities Dealers' Association].

46. Guidelines for the Review of Purchase and Sale of Securities in Taipei Securities Dealers' Association, *supra* note 45, arts. 3, 4, 5.

47. Such enterprise may, among other activities, provide research or advice, on commissioned basis, on matters related to securities investment, issue publications relating to securities investment activities and conduct seminars in connection with securities investment. Cheng-chüan T'ou-tsu Ku-wen Shih-yeh Kuan-li Kuei-tse (Rules Governing Administration of Securities Investment Consulting Enterprises) (Executive Yuan, Ref. No. *T'ai*-72-*Ts'ai*-17982) (promulgated Oct. 6, 1983) art. 5.

48. Cheng-chüan Chin-jung Shih-yeh Kuan-li Kuei-tse (Rules Governing Securities Finance Institutions) (Executive Yuan, *T'ai*-72-*Ts'ai*-1939) (promulgated Nov. 1, 1983) arts. 5(1), 7.

49. The money market in Taiwan may be divided into the following six sub-markets according to the particular instruments and transaction methods: (1) interbank call loan market; (2) treasury bill market; (3) bankers' acceptance market; (4) negotiable certificates of deposit market; (5) commercial paper; and (6) offshore banking market. For a description of the development and structure of Taiwan's money market, *see* K. KING, THE DEVELOPMENT AND PROSPECTS OF TAIWAN'S MONEY MARKET (1989).

50. Tuan-ch'i P'iao-chüan Chiao-i-shang Kuan-li Kuei-tse (Regulations Governing

guarantee short-term instruments,[51] thereby facilitating the flow of short-term funds.[52]

Finally, it should be noted that certain financial intermediaries are permitted to engage in certain securities-related activities. Under the Banking Law, for example, banks may be permitted to engage in brokerage and underwriting, in addition to normal banking business activities.[53] Investment trust companies are also authorized to manage trust funds, invest in securities, and trade in securities for their own account.[54] As mentioned above, securities investment trust enterprises are authorized to issue beneficiary certificates for developing mutual funds and to engage in securities investment using proceeds from such funds.[55]

B. Regulatory Framework

The government of the ROC controls financial institutions operating in Taiwan through both direct and indirect government ownership of certain financial institutions and through regulation. A majority of the domestic banks have traditionally been owned or controlled by the government, and government agencies or instrumentalities are believed to own majority equity interests in many of the banks which, in turn, control a substantial percentage of the nation's bank deposits.[56] The government also exercises indirect control over other types of financial institutions such as the Taiwan Stock Exchange.[57]

In addition to ownership, the government also controls financial institutions through a broad spectrum of regulations. Financial intermediaries are subject to the Banking Law, promulgated on March 28, 1931; financial institutions operating in the securities mar-

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Short-Term Bill Traders) (Ministry of Finance, Ref. No. 72-*T'ai-Ts'ai-Jung*-26894) (promulgated Dec. 5, 1975, last amended Nov. 11, 1983).

51. These companies are authorized to issue short-term (up to one year) negotiable instruments, deal in debt securities with remaining maturity period of no more than one year and such other certificates of short-term indebtedness as may be approved by the Ministry of Finance. *Id.* arts. 3, 4.

52. For a discussion of the function and operation of bills finance companies in facilitating fund flows, see LIANG & HOU, *supra* note 16, at 18-22.

53. Banking Law, *supra* note 17, art. 3(15).

54. *Id.* art. 101(2), (5), (6), (7).

55. *See supra* note 34 and accompanying text.

56. Agencies or instrumentalities of the ROC government are believed to own a majority of the equity interest in most of Taiwan's 24 domestic commercial banks. *See* Liang, *The Taiwan Economy and Financial Markets*, INDUSTRY OF FREE CHINA, vol. LXXI No. 4, Apr. 1989, at 8 (English part); Yü, *supra* note 11, at 4.

57. SEL, *supra* note 35, arts. 93, 95, 100, 102. For a discussion of the operation and development of the Taiwan Stock Exchange, *see* Speech by K. Yao, The Development of the Taiwan Stock Exchange, at the Taiwan Financial Markets and Investment Conference 100-06 (May 25-26, 1988) (unpublished manuscript on file with the *Journal of Chinese Law*).

ket are subject to the Securities and Exchange Law, promulgated on April 30, 1958.

Because the recent liberalization of the financial markets in Taiwan has been effected primarily through the amendment of the Banking Law and the Securities and Exchange Law, this article will limit its discussion to financial institutions governed by those laws. The Banking Law describes how the following financial intermediaries are established and operated: commercial banks, savings banks, specialty banks, investment and trust companies and foreign banks in Taiwan.[58] The Securities and Exchange Law applies to the following institutions operating in the securities market: brokers, dealers, underwriters, integrated securities firms, securities investment trust enterprises, securities financing enterprises, securities investment consulting enterprises, securities depositories and other securities-related institutions.[59]

All of the principal agencies that administer the Banking Law, the Securities and Exchange Law and related laws and regulations are part of the executive branch of Taiwan's central government.[60] The executive branch, the highest administrative organ of the state, is greatly involved in the formulation and implementation of policy in virtually every sphere. Even though the executive branch of the central government is constitutionally responsible to the legislative branch, legislation in Taiwan has generally been initiated by the executive branch.[61] The executive branch is currently composed of eight ministries, which include the Ministry of Finance, and a number of commissions and councils, including the Central Bank of China.[62] All financial institutions are primarily under the direct or indirect supervision of the Ministry of Finance. The Central Bank of China, which performs all normal central banking activities, also imposes

58. Banking Law, *supra* note 17, arts. 70-76 (commercial banks), 77-86 (savings banks), 87-99 (specialty banks), 100-115 (investment and trust company), 116-124 (foreign banks).

59. SEL, *supra* note 35, arts. 16, 18.

60. The Constitution of the Republic of China provides for a central government with five branches. In addition to the executive branch, the central government also has legislative, judicial, examination and control/investigation branches. Each of the five branches is called a "Yuan". *See* Chung-hua Min-kuo Hsien-fa (Constitution of the Republic of China) arts. 53, 62, 77, 83, 90 [hereinafter ROC CONST.]. In addition to the separation of government into five branches, the ROC government is characterized by the division into central, provincial and county levels, each with defined powers. *Id.* arts. 107, 112, 121. Supervision and regulation of financial institutions fall primarily within the exclusive jurisdiction of the central government. *Id.* arts. 53, 57.

61. *Id.* arts. 57, 58.

62. Hsing-cheng-yüan Tsu-chih Fa (Statute on the Organization of the Executive Yuan) (promulgated Mar. 31, 1947, last amended June 29, 1980) art. 3.

certain regulations affecting financial institutions.[63]

1. Banking

Financial intermediaries regulated by the Banking Law are under the primary supervision of the Ministry of Finance.[64] In addition to other activities, the Ministry passes upon applications for the establishment of new banks[65] and branches,[66] the consolidation or merger of banks,[67] alterations to the authorized business of banks[68] and the dissolution of banks.[69] The Ministry also establishes the minimum capital requirement of banks[70] and prescribes the maximum ratio between the liabilities of a bank and its net worth.[71] In addition, the Ministry may at any time require preparation and submission by a bank of certain financial statements for examination,[72] suspend a bank from operation or revoke a bank's license under certain circumstances,[73] and determine penalties for violations of the Banking Law.[74]

In addition to conducting monetary policy and fulfilling functions as the fiscal agent of the government, the Central Bank of China also regulates such matters as reserve against deposit ratios and asset and liability requirements.[75] In conjunction and cooperation with the Ministry of Finance, the Central Bank also performs certain functions related to the supervision and examination of banks.[76] Under the Banking Law, the Central Bank must approve banking transactions

63. *See, e.g.*, Chung-yang Yin-hang Fa (Regulations Governing the Operations of the Central Bank of China) (promulgated by the Nationalist Government on May 23, 1935, amended by the *President-68-Tung-1-I-5573* order on Nov. 8, 1979) arts. 19, 23, 24, 25, 26 [hereinafter Regulations Governing the Operations of the Central Bank of China].

64. Banking Law, *supra* note 17, art. 19. The Ministry of Finance is the competent authority at the Central Government. The competent authorities at the provincial or municipal levels are the local governments.

65. *Id.* arts. 22, 53, 54.

66. *Id.* arts. 27, 57.

67. *Id.* art. 58, para. 1.

68. *Id.*

69. *Id.* art. 61.

70. *Id.* art. 23.

71. However, the Ministry of Finance should consult with the Central Bank on such matter. *Id.* art. 44.

72. *Id.* art. 45.

73. *Id.* arts. 62, 64, 65, 135.

74. *Id.* art. 134.

75. *Id.* arts. 42, 43.

76. *Id.* art. 45. For a discussion of the financial monitoring and examination system, *see* Lou, *Tang-ch'ien Chin-jung Chih-tu chih Fa-chan Ch'u-hsiang yü Wen-ti* (The Present Developing Trend and Problems of the Financial System) T'AI-WAN YIN-HANG YÜEH-K'AN (The Bank of Taiwan Monthly), July 1989, at 1, 2.

and bank issues involving foreign currencies[77] and establish maximum lending rates on certain types of loans.[78] Finally, the Central Bank also provides facilities as a lender of last resort to banking institutions.[79]

Other institutions also have some regulatory functions. For example, the Central Deposit Insurance Corporation was established according to the Deposit Insurance Regulation that was promulgated under the Banking Law[80] in order to protect the interests of depositors.[81] The Bankers' Association also plays an important role in affecting policies. Prior to 1989, for instance, it was responsible for making proposals regarding the range of lending rates for approval by the Central Bank.[82]

2. Securities

The Securities and Exchange Law is the principal legislation governing Taiwan's securities markets and their participants. The Securities and Exchange Commission, which is under the jurisdiction of the Ministry of Finance, is responsible for implementing and administering this Law.[83] The Commission exerts extensive regulatory authority over the offering, issuance and trading of securities.[84] In addition, the Securities and Exchange Law specifically empowers the Commission to promulgate rules under certain circumstances. For instance, in accordance with the guidelines promulgated by the Commission, issuers of securities are generally required to obtain approval from, or register with, the Commission for all securities offerings.[85] The Commission has also promulgated regulations requiring, unless otherwise exempted, periodic reporting of financial information by all public companies[86] and their major shareholders.[87]

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77. Banking Law, *supra* note 17, art. 4.

78. *Id.* art. 37, para. 2.

79. Regulations Governing the Operations of the Central Bank of China, *supra* note 63, art. 19.

80. Banking Law, *supra* note 17, art. 46.

81. Ts'un-k'uan Pao-hsien T'iao-li (Deposit Insurance Law) (promulgated Jan. 9, 1985) art. 1 [hereinafter Deposit Insurance Law].

82. Prior to its most recent amendment, the Banking Law provided that basic lending rates in Taiwan were set by Banker's Association, subject to overall supervision by the Central Bank of China. *See* LIANG & HOU, *supra* note 16, at 64.

83. SEL, *supra* note 35, art. 3.

84. *Id.* arts. 2, 6.

85. *Id.* arts. 17, 22; *see also* Fa-hsing-jen Mu-chi yü Fa-hsing Yu-chia Cheng-chüan Ch'u-li Chun-tse (Guidelines for Issuance and Offering of Securities by Issuers) (Securities and Exchange Commission, Ref. No. 77-*T'ai-Ts'ai-Cheng*-1-08728) (promulgated July 26, 1988).

86. SEL, *supra* note 35, art. 36.

87. The Securities and Exchange Law also imposes on "public companies" certain public

In addition to providing mechanisms for the public offering and issuance of securities, the Securities and Exchange Law contains enabling provisions intended to administer the licensing of securities firms and to supervise their operations.[88] Regulations, for instance, have been promulgated to govern the establishment of securities brokers, dealers and underwriters and the administration of securities investment trust fund enterprises and securities investment consulting enterprises.[89] The amounts and rates of margin loans and securities loans are prescribed by the Commission after consultation with the Central Bank of China.[90]

The Commission is also responsible for the supervision of other specific activities in the securities market.[91] In general, the Securities and Exchange Law prohibits most kinds of market manipulation and abuses of inside information that are also prohibited in the United States.[92] For example, the Securities and Exchange Law includes sanctions against insider trading based on unannounced information that materially affects share price movement. Penalties for violation include prison terms and treble damages compensation to injured persons.[93]

The Commission has various administrative responsibilities.[94] For instance, it is directly empowered to curb abuses and violations of applicable laws and regulations through such administrative measures as the issuance of warnings and the revocation of licenses.[95] However, unlike the U.S. Securities and Exchange Commission, the Taiwan Securities and Exchange Commission has no direct authority under

disclosure and reporting requirements regarding share ownership of their directors, supervisors, managers and holders of more than 10 percent of their shares. *See id.* art. 25.

88. *See, e.g., id.* arts. 44, 45, 48.

89. Cheng-chüan-shang She-chih Piao-chun (Regulation Governing the Standards for Incorporation of Securities Firms) (Ministry of Finance, Ref. No. *T'ai-Ts'ai-Cheng*-2-2583) (promulgated May 17, 1988) [hereinafter Incorporation Regulation]; Cheng-chüan T'ou-tsu Hsin-t'o Shih-yeh Kuan-li Kuei-tse (Rules for Administration of Securities Investment Trust Fund Enterprises) (Executive Yuan, Ref. No. *T'ai-72-Ts'ai*-9651) (promulgated May 26, 1983); Rules Governing Administration of Securities Investment Consulting Enterprises, *supra* note 47.

90. SEL, *supra* note 35, art. 61.

91. For instance, in an effort to regulate mergers and acquisitions, article 43-1 of the Securities and Exchange Law provides that public tender offers may not be made off the Taiwan Stock Exchange or the over-the-counter market without approval. *Id.* art. 43-1.

92. *See, e.g., id.* arts. 155, 156, 157, 157-1.

93. *See id.* arts. 157-1, 175.

94. *Id.* art. 3. For instance, the Securities and Exchange Commission is empowered to investigate, to curb abuses and to issue administrative measures. *Id.* arts. 38, 39, 57, 64, 65, 148.

95. *See, e.g., id.* art. 66. For a comparison of the administrative powers between the U.S. and the Taiwan Securities and Exchange Commission, see YU, *supra* note 35, at 608-09.

the Securities and Exchange Law to seek either temporary or permanent injunctions in court.[96]

The Taiwan Stock Exchange has the status of a self-regulatory organization. Its primary responsibility is to review applications by issuers to list on the Exchange and, in conjunction with the Securities and Exchange Commission, to review all securities offerings by listed companies.[97] Certain activities of securities dealers are further regulated under the rules of the Securities Dealers' Association, a self-regulatory organization under the supervision of the Commission.[98]

II. LIBERALIZATION OF THE FINANCIAL MARKETS

A. Government Control of Financial Institutions

In the nineteenth century, Taiwan was a province of China. It was ceded to Japan at the end of the Sino-Japanese War of 1894-95, and for nearly half a century, its economy consisted primarily of agricultural production to serve the needs of Japan.[99] During this period, Taiwan's trade was also restricted almost exclusively to exchanges with Japan. In 1945, when the ROC government reasserted control over Taiwan upon the defeat of Japan in the Second World War, the government inherited an economy plagued by, among other problems, a scarcity of daily necessities, a shortage of trained personnel, a serious lack of savings and foreign exchange, and high unemployment and inflation. Therefore, upon its relocation to Taiwan in 1949, the ROC government launched an extensive program of economic reconstruction which included the land reform program in the 1950s,[100] the development of the export industry in the 1960s[101] and measures to

96. For a discussion of the injunction power of the U.S. Securities and Exchange Commission, see T. HAZEN, THE LAW OF SECURITIES REGULATION 13 (1985).

97. SEL, *supra* note 35, arts. 138-143.

98. *Id.* arts. 89-92. For example, issuers intending to have their securities traded on the over-the-counter market are required to obtain approvals from the Association. Guidelines for the Review of Purchase and Sale of Securities in Taipei Securities Dealers' Association, *supra* note 45, art. 2. For a discussion of the operation and development of the Association, *see* YU, *supra* note 35, at 432-34.

99. For a discussion of the Japanese occupation of Taiwan, *see* Kublin, *Taiwan's Japanese Interlude, 1895-1945*, in TAIWAN IN MODERN TIMES 317-357 (P. Sih ed. 1973).

100. For a discussion of the economic reconstruction and land reform in Taiwan, *see* Koo, *Economic Development of Taiwan*, in TAIWAN IN MODERN TIMES, *supra* note 99, at 397-429.

101. Following the successful land reform in rural areas, beginning in 1953, the ROC government began to pursue a policy of balanced growth by simultaneously modernizing and increasing agricultural productivity and stimulating industrial development. *See* Cheng, *The Doctrine of People's Welfare: The Taiwan Experiment and Its Implications for the Third World*, in SUN YAT-SEN AND THE ECONOMIC HISTORY OF TAIWAN 251 (C. Cheng ed. 1989) [hereinafter Cheng, *The Doctrine of People's Welfare*]. To protect the developing manufacturing sector, measures such as high tariffs, import controls, and multi-tiered exchange controls

restructure and modernize the economy in the 1970s.[102] At almost every critical point in the development of Taiwan's economy, the guidance provided by the government has proven to be vital to the country's development and growth.[103]

During this period of reconstruction and development before the 1980s, both banks and securities firms in Taiwan were heavily regulated, reflecting the government's active role in the operation of Taiwan's economic system as a whole.[104] Government control of financial institutions and markets encouraged public savings by mandating

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were put into place. *See* S. KUO, THE TAIWAN ECONOMY IN TRANSITION 298-300 (1983). During the early 1960s, after an industrial base had been laid down, the ROC government dismantled some of the protectionist measures adopted in the 1950s. At the same time it introduced new measures to stimulate domestic and foreign investment in industry, particularly in export-oriented enterprises. *See id.* at 300-03. The export strategy was successful, and during the period 1961 to 1972, the ROC's overall annual export growth averaged some 29 percent. *See* COUNCIL FOR ECONOMIC PLANNING AND DEVELOPMENT, TAIWAN STATISTICAL DATA BOOK 1988 210 (1989). Textiles, plastics and electrical appliances gradually replaced Taiwan's traditional agricultural exports (mainly sugar and rice) as the country's leading export products. At the same time, domestically produced durable and capital goods replaced imports as the government adopted new import substitution policies to complement its emphasis on export expansion. *See* Amsden, *Taiwan's Economic History: A Case of Etatisme and a Challenge to Dependency Theory*, in TOWARD A POLITICAL ECONOMY OF DEVELOPMENT: A RATIONAL CHOICE PERSPECTIVE 163-171 (R. Bates ed. 1988).

102. In the early 1970s, heavy industries, such as steel and petrochemicals, grew rapidly and began to sell into foreign markets. *See* Cheng, *The Doctrine of People's Welfare*, *supra* note 101, at 251. Taiwan's economy, heavily dependent on import for petroleum and certain other key raw materials, was severely affected by the oil price shocks of the 1970s. The ROC government reacted to the strains produced by the first oil price shock by lifting price controls in order to curb demand. It also launched a major infrastructure investment program consisting of ten major development projects, which provided useful pump-priming for the economy and linked Taiwan's industries into modern transportation and communications networks. *See, e.g.*, COUNCIL FOR ECONOMIC PLANNING AND DEVELOPMENT, EVALUATION OF TEN MAJOR DEVELOPMENT PROJECTS 112-13 (1979). In its ten-year development strategy for the period 1980 to 1989, the ROC government targeted the ROC economy to move up the industrial scale into more capital-intensive, technology-oriented industries. *See* COUNCIL FOR ECONOMIC PLANNING AND DEVELOPMENT, TEN YEAR PLAN FOR CONSTRUCTION OF TAIWAN 12 (1980). To accomplish this goal, the government has encouraged research and development by the introduction of advanced foreign technology.

103. For discussions of the history of Taiwan's economic development, *see* R. CLOUGH, ISLAND CHINA 69-94 (1978) (examining period from 1950s to 1970s); S. KUO, *supra* note 101 (examining period from 1951 to 1981); ECONOMIC GROWTH AND STRUCTURAL CHANGE IN TAIWAN: THE POSTWAR EXPERIENCE OF THE REPUBLIC OF CHINA (W. Galenson ed. 1979) (examining period from 1895 to 1976); Amsden, *supra* note 101, at 142 (examining period from 1895 to 1968); Koo, *supra* note 100, at 397-433 (examining period from 1945 to 1970); Tsiang, *Foreign Trade and Investment as Boosters for Take-Off: The Experience of Taiwan*, in EXPORT-ORIENTED DEVELOPMENT STRATEGIES: THE SUCCESS OF FIVE NEWLY INDUSTRIALIZED COUNTRIES 27-56 (V. Corbo, A. Krueger & F. Ossa eds. 1985) (examining period from 1950s to 1980s).

104. Governmental policy directed toward the financial sector was implemented both by means of direct and indirect government ownership of key financial institutions, such as domestic banks, as well as through regulatory control.

adequate interest rates on time and savings deposits, thereby facilitating the acceleration of Taiwan's economic growth.[105] Control of financial institutions and markets also allowed the government to influence the distribution of savings and credit to various borrowing sectors, which in turn affected the level and composition of economic activities.[106] By establishing specialty banks, for example, the government channeled savings to economic sectors that were thought to require preferential access to capital and credit.[107]

Closely linked to its central objective of mobilizing scarce capital, the government's tight control of financial institutions also reflected its recognition that the stability and soundness of both individual financial institutions and the financial system as a whole were critical to the proper operation of a financial system and to the continued development and growth of the country's entire economy.

Although soundness of the financial system is clearly an important regulatory goal, the methods for achieving such an objective are not always apparent. For example, in the course of its ambitious program for economic development, the ROC government had assumed that price competition would disrupt the stability of the economy. Because of this assumption, one regulatory response was to reduce the competitive pressures on profits and capital by restricting interest rates.[108] Another response designed to protect the financial sector

105. In addition to setting the interest rates on time and savings deposits, other methods adopted by the government of Taiwan to encourage savings include favorable tax policies (such as exempting from personal income tax certain interest income from time and savings deposits) and sound governmental fiscal policies. *See* S. KUO, *supra* note 101, at 5-21 (1983); Lundberg, *Fiscal and Monetary Policies*, in ECONOMIC GROWTH AND STRUCTURAL CHANGE IN TAIWAN: THE POSTWAR EXPERIENCE OF THE REPUBLIC OF CHINA 263, 287-94, 300-07 (W. Galenson ed. 1979); Tsiang, *supra* note 103, at 42-48; *see also* McKinnon, *Issues and Perspectives: An Overview of Banking Regulation and Monetary Control*, in PACIFIC GROWTH AND FINANCIAL INTERDEPENDENCE 319, 319-25 (A. Tan & B. Kapur eds. 1986) (examining relationship between real rates of interest and economic growth).

106. Other methods adopted by the government of Taiwan to affect the allocation of capital and credit include tax policies (such as granting high-depreciation allowances to encourage investment in particular sectors) and subsidized rates for loans to priority sectors. *See* Fry, *Financial Structure, Monetary Policy, and Economic Growth in Hong Kong, Singapore, Taiwan, and South Korea, 1960-1983*, in EXPORT-ORIENTED DEVELOPMENT STRATEGIES: THE SUCCESS OF FIVE NEWLY INDUSTRIALIZING COUNTRIES 275, 294-98 (V. Corbo, A. Krueger & F. Ossa eds. 1985); *see also* Johnson, *Political Institutions and Economic Performance: The Government-Business Relationship in Japan, South Korea, and Taiwan*, in THE POLITICAL ECONOMY OF THE NEW ASIAN INDUSTRIALISM 136, 147-49 (F. Deyo ed. 1987); Koo, *The Interplay of State, Social Class, and World System in East Asian Development: The Cases of South Korea and Taiwan*, in THE POLITICAL ECONOMY OF THE NEW ASIAN INDUSTRIALISM 165, 172-76 (F. Deyo ed. 1987); Lundberg, *supra* note 105, at 300-07.

107. *See supra* notes 20-24 and accompanying text.

108. *See, e.g.*, S. KUO, *supra* note 101, at 285-93 (stating that price stability, including interest rate stability, was the primary concern during the post-war reconstruction period).

against the dangers of instability and failure was the limitation of entry and the segmentation of functions. Laws that regulated the degree of competition between and within groups of financial institutions were designed specifically to ensure the soundness of the financial system.[109]

B. Problems Leading to Liberalization of the Financial Markets

Although the conservative banking and financial system in Taiwan contributed to economic growth (especially during its initial period of reconstruction and development[110]), such tight government control frequently led to unforeseen and costly results.[111] Changes in market conditions brought about by factors such as changes in consumer demand, technological innovation and the internationalization of financial markets have also made the existing regulatory framework less applicable and less effective.[112] Some of the problems which plagued Taiwan's financial markets until recent legislative amendments were passed in the 1980s are outlined below.

1. Entry Restrictions

Before recent legislative amendments were passed, the government had imposed a moratorium on the approval of new banking

109. *See, e.g.*, CHAIRMAN OF THE SUBCOMMITTEE ON TELECOMMUNICATIONS, CONSUMER PROTECTION, AND FINANCE OF THE HOUSE COMMITTEE ON ENERGY AND COMMERCE, RESTRUCTURING FINANCIAL MARKETS: THE MAJOR POLICY ISSUES, 99th Cong., 2d Sess., at 197-99 (Comm. Print 1986) [hereinafter REPORT ON RESTRUCTURING FINANCIAL MARKETS].

110. It has been argued that the stability of interest and foreign exchange rates has contributed to the growth of Taiwan's economy. *See* speech by C. Chang, *supra* note 5, at 9.

111. *See, e.g.*, Chang, *Financial Liberalization in the Republic of China*, INDUSTRY OF FREE CHINA, vol. LXXI, No. 6, June 1989, at 1-2 (English part) (arguing that regulation of deposit rate diverted savings to unregulated market and led to misallocation of funds); Yü, *supra* note 11, at 4 (criticizing inherent inefficiencies of bureaucratic management and abuses of government-owned banks); Liang, *supra* note 56, at 7 (arguing that inadequate financial regime has failed to function efficiently).

112. *See, e.g.*, Li-fa-yüan I-an Kuan-hsi Wen-shu (Legislative Proposal Document of the Legislative Yuan) (Legislation Yuan, Ref. No. *Yüan-Tsung-727*) (govt. bill no. 3117) (Mar. 4, 1987) (arguing that original Securities and Exchange Law could no longer meet the practical needs of changing market); speech by C. Chang, The Amendment of the Securities and Exchange Law and the Prospects for the Development of ROC's Securities Market, at the Taiwan Financial Markets and Investment Conference in Taipei, Taiwan 1, 1-2 (May 25-26, 1988) (unpublished manuscript) (on file with the *Journal of Chinese Law*) (arguing that new investment conduits must be established to channel excessive savings); speech by R. Chien at the Taiwan Financial Markets and Investment Conference in Taipei, Taiwan 139, 140 (May 25-26, 1988) (unpublished manuscript) (on file with the *Journal of Chinese Law*) (arguing that dramatic advances in communications and information technologies have altered the structure of Taiwan's financial system).

institutions.[113] This led to several serious defects. Because government-owned banks were subject to onerous regulations and bureaucratic oversight, for example, they frequently extended loans on conservative terms.[114] Government-owned banks also gave priority to other government-owned enterprises. In the same way, the limited number of privately-owned banks and investment trust companies tended to lend their scarce credit to their affiliates.[115] As a result, many companies had to resort to the unregulated market for financing.[116] Although the unregulated market provided a mechanism for adjustment of the distortions imposed by the highly regulated financial sector, it also permitted conduct which other investors viewed as unfair or dishonest, thereby threatening the integrity of the financial markets.[117]

With respect to the securities market, the moratorium on the approval of new securities firms provided few incentives for existing firms to improve their services.[118] Indeed, the oligopoly of banks and securities firms virtually "guaranteed" excessive profits to existing financial institutions and impeded the development of a more efficient market.[119]

2. Segmented Financial System

A distinguishing characteristic of financial institutions in Taiwan previous to the recent regulatory amendments was their high degree of segmentation. Typically, each type of financial institution was restricted to business within its explicitly prescribed scope of activities. For instance, the specific and highly constrained business scope of the Banking Law prevented banks from providing new types of financial services such as factoring.[120] With regard to the securities

113. *See infra* notes 137-38 and accompanying text.

114. *See, e.g.*, Liang, *supra* note 56, at 8 (arguing that most of the government-owned banks are subject to onerous regulations); Yü, *supra* note 11, at 4 (criticizing inherent inefficiencies of bureaucratic management and abuses of government-owned banks).

115. *See* Tai Li-ning, *Pu-tao Shen-hua Chiu-tz'u Ta-chu — K'an Yin-hang Fa Hsiu-cheng* (Stop the Myth of Immortality — The Banking Law Amendment), YÜAN-CHIEN TSA-CHIH (Global Views Monthly), Mar. 15, 1989, at 101, 101-02.

116. *See supra* note 13 and accompanying text.

117. *See, e.g.*, speech by S. Champion, The Taiwan Stock Market: Characteristics, Valuations, and Future Directions, at the Asia Society in New York, New York (Nov. 16, 1988) (unpublished manuscript on file with the *Journal of Chinese Law*).

118. *See* Yao Ming-chia & Sun Ying-chi, *Chin-jung Yeh Shui-chang Ch'uan-kao* (Financial Institutions are Making Tremendous Profits) T'IEN-HSIA TSA-CHIH (Commonwealth), July 1, 1989, at 131-32.

119. For instance, in 1988 all the top 100 financial institutions made huge profits, with the net profits totaling 70 billion new Taiwan dollars and a record growth rate of 22 percent from the past year. *Id.* at 131.

120. Prior to its recent amendment, article 71 of the Banking Law did not include factor-

industry, brokerage and trading activities were in all cases separate until 1988. Both brokers and traders, however, could obtain permission to engage in underwriting.[121] Because no firm was permitted to combine the three activities of brokerage, trading and underwriting, the securities industry became segmented, leading to a lack of technical sophistication and inefficient distribution of shares.

3. Price Restrictions

Pursuant to the Banking Law and the Central Bank Act, the Central Bank was authorized to prescribe ceilings on interest rates for bank deposits and to approve the ranges of bank lending rates proposed by the Bankers' Association.[122] Although the regulation of interest rates by the government was intended to promote economic growth, reduce inflationary pressures and prevent destructive competition, the restrictions generated several problems. For example, when the deposit rates prescribed by the government were lower than the market-clearing rates, savings were either discouraged or diverted from the regulated financial institutions to the unregulated institutions.[123] In addition, lending rate ceilings led to credit rationing on the part of the banks. The banks often favored low-risk borrowers, which were typically the large, well-established businesses and public enterprises that enjoyed government support. This resulted in the misallocation of funds and the concentration of economic power.[124]

In the securities markets, the price of equity securities distributed by means of an underwritten public offering had traditionally been determined by negotiation between the underwriter and the issuer,

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ing as one of the permissible business activities of commercial banks. *See* Li-fa-yüan I-an Kuan-hsi Wen-shu (Legislative Proposal Document of the Legislative Yuan) (Legislative Yuan, Ref. No. *Yüan-Tsung*-801) (government bill no. 3480-1) at 109 (May 13, 1989) [hereinafter Banking Law Legislative Proposal].

121. *See supra* notes 40-43 and accompanying text.

122. *See supra* note 82 and accompanying text.

123. *See supra*, notes 113-17 and accompanying text.

124. *See* Chang, *supra* note 111, at 1-2; Cheng, *Financial Policy and Reform in Taiwan, China*, in FINANCIAL POLICY AND REFORM IN PACIFIC BASIN COUNTRIES 143, 150-52 (H. Cheng ed. 1986); speech by F. Perng, Financial Liberalization in the Republic of China, at the 13th Joint Conference of USA-ROC and ROC-USA Economic Councils in Kona, Big Island of Hawaii 3 (Nov. 18-21, 1989) (unpublished manuscript on file with the *Journal of Chinese Law*). Generally speaking, the disadvantages of distortions in the flow of funds are threefold: first, the effectiveness of monetary policy measures and monetary control is impaired as considerable amounts of credit flows escape control and may not be identified. Second, funds bypassing the banking system are usually managed by agents who may be less qualified than regulated financial intermediaries and thus the quality and the efficiency of fund management are reduced. Third, interest rates in the unregulated sector tend to be higher than the market level which would prevail in the absence of controls so that borrowers using the unregulated markets are penalized. *See* G. BROKER, *supra* note 7, at 54.

under the guidance of the Securities and Exchange Commission.[125] This process frequently resulted in unreasonably low offering prices and a demand for shares greatly exceeding the supply. Once securities began to trade on the Taiwan Stock Exchange, their price movements were confined to narrowly fixed limits.[126] The quoted closing price of a security, if fixed by such a limit, would not necessarily reflect the price at which investors would be willing to buy or sell the security. Consequently, liquidity could be severely impaired by investors' unwillingness to trade. Although designed to stabilize drastic price movements, such restrictions were criticized as being counterproductive and inefficient.[127]

4. International Aspects

The globalization of the world's financial markets led in the past to calls for further liberalization of Taiwan's financial markets. Although foreign banks have been permitted to operate in Taiwan since the 1970s, before the recent legislative amendments discussed below many of their activities, such as trust business or deposit-taking activities, were subject to more restrictions than the activities of domestic banks.[128] Additionally, foreign exchange controls and other measures were obstacles to cross-border operations in banking.[129]

In the securities sector, foreign firms were barred from participating in Taiwan's securities industry.[130] Furthermore, foreign investment in the securities markets is generally permitted only through authorized and regulated securities investment trust funds established in Taiwan. The lack of market access, coupled with the significant trade imbalances between Taiwan and its major trading partners (especially the United States), resulted in tremendous international pressure for Taiwan to open up its financial markets. Foreign governments argued (and continue to argue) forcibly that Taiwan's financial markets should be liberalized so that foreign financial institutions could be granted the same "competitive opportuni-

125. For a description of pricing process in securities offerings, *see* speech by S. Champion, *supra* note 117.

126. For a discussion of such limits, *see* Liu Wei-chi, Wu Chin-shan & Liu Yü-chen, Ku-chia Chang-tieh Fu-hsien T'so-shih ti Ying-hsiang chi T'i-tai Fang-an (The Measures of Trading Price Limitations: Its Impact and Alternatives) 3 CHENG-CHÜAN SHIH-CHANG FA-CHAN CHI-K'AN (Securities Market Development Quarterly) 4, 4-11 (July 1989) (discussing negative impact of such price limits).

127. *Id.*

128. *See, e.g.*, speech by F. Perng, *supra* note 124, at 8.

129. For a discussion of the foreign exchange restrictions prior to recent liberalization, *see* LIANG & HOU, *supra* note 16, at 25-50.

130. *See infra* notes 155-56 and accompanying text.

ties" that domestic firms have.[131]

C. *Recent Legislative Amendments*

Under combined pressures arising from both rigid financial regulations and market forces, the tight control of financial institutions by the government of the ROC began to crumble in the mid-1980s. Up to that time, both the Banking Law and the Securities and Exchange Law had remained largely unchanged from their respective dates of enactment. Although the government had made several amendments aimed at improving particular aspects of the functioning of financial markets, such measures were primarily designed to attain specific policy goals or to cure specific symptoms.[132]

In 1984 the government made its first major policy announcement that it would liberalize the financial markets by deregulating interest and foreign exchange rates. Pursuant to the new policy, the government adopted several measures to liberalize the financial markets of Taiwan. In July 1987, the government took a significant step towards the internationalization of its economy by lifting most of the foreign exchange control measures that had been in effect since 1949.[133] The government's liberalization efforts culminated in the passage of comprehensive amendments to the Securities and

131. *See, e.g.*, remarks by J. Niehuss, Senior Deputy Assistant, U.S. Department of Treasury at the 13th Joint Conference of USA-ROC and ROC-USA Economic Councils in Kona, Big Island of Hawaii (Nov. 18-21, 1989) (unpublished manuscript on file with the *Journal of Chinese Law*) (arguing that foreign financial institutions should be afforded equal treatment).

132. This can be illustrated in the amendment of the Securities and Exchange Law in 1982 and the amendment of the Banking Law in 1985. The 1982 amendment to the Securities and Exchange Law contained only five provisions, which were intended to address specific issues (*e.g.*, promoting foreign investment in securities markets through securities investment trust funds or providing enabling provision to regulate proxy solicitation). For a discussion of the background of this Amendment, *see* SU SUNG-CHIN, CHENG-CHÜAN CHIAO-I FA HSIU-CHENG HSIANG-LUN (A Detailed Discussion of the Amendment on the Securities and Exchange Law) 2 (1988). The 1985 amendment to the Banking Law was created to deal with the then pressing issues, such as legalizing electronic fund transfer or prohibiting specific insider misconduct by trust and investment companies. *See generally* Banking Law Legislative Proposal, *supra* note 120. Accordingly, the regulatory changes during this period were not very comprehensive.

133. In response to increasing foreign reserves, the Legislative Yuan passed a bill in June 1987 to liberalize foreign exchange control by adding Article 26-1 to Wai-hui Kuan-li T'iao-li (the Statute for the Administration of Foreign Exchange). Under the authority granted to it by such amendment, the government relaxed foreign exchange controls through a suspension of certain provisions of the statute. The Central Bank of China subsequently announced new regulations whereby foreign exchange controls were entirely lifted with respect to foreign currency earned from exports of merchandise and services. Similarly, all foreign currency needed for importation of merchandise and services may be purchased freely from the Central Bank of China or from the designated foreign exchange banks. In addition, the new regulations permit all individuals and registered ROC entities, including branch offices of foreign companies, to

Exchange Law on January 14, 1988,[134] and to the Banking Law on July 17, 1989.[135] The primary objective of financial liberalization, as announced by the government, was "to circulate and distribute capital through market mechanism[s] in order to achieve [the] optimum result."[136]

The liberalization measures can be divided into the following four categories: 1) entry regulation, 2) consolidation regulation, 3) price regulation and 4) foreign access regulation.

1. Entry Regulation

Prior to financial liberalization, the majority of the domestic banks were either owned or controlled by the government, and the government had imposed a moratorium on the approval of new banks.[137] The July 1989 amendment to the Banking Law authorized the Ministry of Finance to formulate regulations for the establishment of privately-owned commercial banks.[138]

From 1973 to 1988, the Securities and Exchange Commission had also imposed a moratorium on the approval of new brokers. Pursuant to the January 1988 amendment to the Securities and Exchange Law and subsequent regulations, the government relaxed this moratorium and entertained new applications from brokers and other securi-

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remit up to a certain amount abroad annually, without having to secure approval. *See* Hsu & Liu, *supra* note 12, at 170-74.

134. For a discussion of the main features of the Amendment, *see* speech by C. Chang, *supra* note 112, at 25-34.

135. On July 11, 1989, the Legislative Yuan finalized its third reading of the amendment to the Banking Law. Twenty-eight provisions of the Banking Law are amended, and five new provisions are added. For a discussion of the legislative background of the amendment, *see* Banking Law Legislative Proposal, *supra* note 120.

136. Speech by S. Kuo, The Liberalization of the Financial System in the Republic of China, at the 88th Conference of the Committee on Constitutional Government in the National Assembly, Taipei, Taiwan 1, 4 (Aug. 10, 1989) (unpublished manuscript on file with the *Journal of Chinese Law*). Although the law and policies of liberalization are commendable, it may be necessary for the government to take additional measures to "level the playing field" so that competitive inequality could be eliminated. For instance, with the establishment of privately-owned banks it is necessary to reconsider the question of competitive equality between government-owned and privately-owned banks. This could be done by eliminating the privileges and preferential treatments extended to the government-owned banks. In addition, one of the goals of financial liberalization has been to grant to foreign institutions (*e.g.*, bank branches and securities firms) the similar treatments as that of the domestic institutions based on the principle of "national treatment." Consequently, the government should reconsider whether foreign institutions are disadvantaged in their ability by laws, regulations, or administrative or market practices. *See* G. BROKER, *supra* note 7, at 58-64.

137. *See* Banking Law Legislative Proposal, *supra* note 120, at 90, 94.

138. Banking Law, *supra* note 17, art. 52. Shang-yeh Yin-hang She-li Piao-chun (Guidelines Governing the Establishment of Commercial Banks) [hereinafter Establishment Guidelines].

ties firms.[139] As a result, many new brokers, traders and underwriters have become established.[140] In a related development, the Securities and Exchange Commission has recently announced that it will soon entertain applications seeking to establish securities investment trust enterprises. This will expand the number of players, now limited to four, in the mutual fund business.[141]

2. Regulation Regarding Consolidation of Functions

One feature of the liberalization of Taiwan's financial market is the ongoing consolidation or blurring of demarcation lines between formerly distinct functions of the financial system. In an effort to provide banks flexibility in developing new products and business, the July 1989 amendment to the Banking Law expanded the general business scope of commercial banks by allowing them to conduct new activities as approved by the regulatory authorities, such as the extension of credit-card guaranteed loans, the issuance of special time deposits for year-end bonus payment, and the provision of factoring services.[142] Similarly, the business scope of trust and investment companies has been expanded to encourage the development of new business lines, such as the provision of credit card services.[143]

In relation to the securities markets, the January 1988 amendment to the Securities and Exchange Law permitted the establishment of integrated securities companies—firms that combine the three activities of brokerage, trading and underwriting.[144] The purpose of the change was to foster greater stability in and introduce greater sophistication to the securities market. As a result of the change, firm commitment underwriting was introduced.[145] The amendment also expanded the business scope of other types of securities institutions. For example, even though there is currently only one authorized margin lender in Taiwan, the amendment contains provisions that permit

139. The Securities and Exchange Commission promulgated the Incorporation Regulation and began accepting applications on May 17, 1988. Under the criteria, the minimum required paid-in capital for underwriting, trading and brokerage operations is NT$ 400 million, NT$ 400 million and NT$ 200 million, respectively. Incorporation Regulation, *supra* note 89, art. 3.

140. As of the end of 1988, there were 102 licensed brokers, 18 licensed traders and 30 licensed underwriters. *See* SECURITIES AND EXCHANGE COMMISSION, 1988 SEC STATISTICS, vol. 19, at 3 (1988).

141. *See id.*

142. Banking Law, *supra* note 17, arts. 3(22), 71(14); *see also* Banking Law Legislative Proposal, *supra* note 120, at 109.

143. Banking Law, *supra* note 17, art. 101(15); *see also* Banking Law Legislative Proposal, *supra* note 120, at 112.

144. SEL, *supra* note 35, arts. 45, 60, 101 (deleted).

145. *Id.* art. 71, para. 2.

other regulated securities firms to engage directly in margin transactions or to act as agents for such transactions.[146]

3. Price Regulation

One of the most visible and far reaching changes in the structure and regulation of Taiwan's financial markets is the elimination of certain restrictions on price competition to improve the proper functioning of the allocation of financial resources. With respect to interest rate restrictions, the Central Bank of China had historically taken a cautious approach toward liberalization.[147] However, the July 1989 amendment to the Banking Law removed all restrictions imposed on the interest rates that banks may pay on deposits and charge on loans.[148]

Similarly, the amendment to the Securities and Exchange Law in January 1988 allows, under certain circumstances, issuers and underwriters, when they make new cash offerings, to set the offering price at the "prevailing price" (*i.e.*, price set on the basis of market price and other factors).[149] In the past, the offering price of securities was often subject to the guidance and scrutiny of the Securities and Exchange Commission.[150] In a related development, the Commission relaxed the limitations on price movements of listed securities.[151]

4. Foreign Access Regulation

The internationalization of Taiwan's financial markets, particularly with respect to market access by foreign financial institutions, is a major theme of financial liberalization. In the banking sector, local branches of foreign banks had been permitted to operate as designated foreign exchange banks, but their other activities had been more

146. *Id.* art. 60, para. 2.

147. Such deregulation can be divided into two stages, one starting in the early 1980s and the other beginning in 1985. The first stage of deregulation was in response to the new circumstances that followed the oil crisis and the period of international financial disorder. The second stage of deregulation was prompted by massive foreign exchange reserves and high money supply growth. The deregulation in prices were intended to place a greater reliance on the price mechanism for adjustment of imbalances. *See* speech by S. Kuo, *supra* note 6, at 8-12.

148. Banking Law, *supra* note 17, art. 41.

149. SEL, *supra* note 35, art. 28-1, para. 2.

150. The Commission has sometimes requested a 10 to 15 percent reduction in the underwriting price proposed by the companies seeking a listing. *See* Hsu & Liu, *supra* note 12, at 187.

151. Fluctuations in prices of securities listed on the Taiwan Stock Exchange has been subject to 5 percent or 2.5 percent price limitation. Recently the Securities and Exchange Commission has increased the price limitation to 7 percent. *See* Ministry of Finance Letter to the Taiwan Securities Exchange, Inc. (Ministry of Finance, 78-*T'ai-Ts'ai-Chüan*-2-15706) (Oct. 7, 1989).

restricted than those of domestic banks.[152] Foreign banks in Taiwan are now permitted to open second offices in the city of Kaohsiung.[153] Because foreign banks are viewed as a catalyst for the improvement of domestic banking operations through their introduction of modern financial techniques and services, the July 1989 amendment to the Banking Law also allowed local branches of foreign banks to conduct new banking business, such as trust business, if approved by the appropriate regulatory authorities.[154]

Similarly, pursuant to the January 1988 amendment to the Securities and Exchange Law and its implementing regulations, foreign persons are permitted to engage in securities business in Taiwan and to own up to 40 percent of integrated securities firms, brokerage firms, securities trading firms and underwriting firms in Taiwan.[155] Foreign securities firms or other foreign financial institutions, such as banks, may be permitted to set up branch operations in Taiwan and to conduct securities businesses, if such firms or institutions fulfill certain requirements.[156]

III. THE RATIONALES FOR REGULATING FINANCIAL INSTITUTIONS: A THEORETICAL FRAMEWORK

The soundness of individual financial institutions and of the financial system as a whole has been a dominant concern of the government. The emerging trend toward liberalization, however, has thrown into question many of the basic elements of soundness regulation.[157] In particular there exists concern that in deregulating the financial markets, the replacement of government control by unpredictable market forces may result in a greater number of financial institution failures.[158] The potential conflict between the dual objec-

152. For example, under the previous regulations, branches of foreign banks were not allowed to set up savings or trust departments. *See* speech by F. Perng, *supra* note 124, at 8.

153. *Id.*

154. Banking Law, *supra* note 17, arts. 121, 101, para. 1.

155. SEL, *supra* note 35, art. 45, para. 4. No single foreign person is permitted, however, to own more than 10 percent of any such firm. Incorporation Regulation, *supra* note 89, arts. 36, 37.

156. SEL, *supra* note 35, art. 45, para. 4; Incorporation Regulation, *supra* note 89, arts. 27, 28, 33.

157. Several commentators have observed the potential conflict between the objective of preserving soundness and the objective of promoting competition. *See, e.g.*, REPORT ON RESTRUCTURING FINANCIAL MARKETS, *supra* note 109, at 169-96; *FDIC Securities Proposal and Related Issues: Hearings Before the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House Comm. on Energy and Commerce*, 98th Cong., 1st Sess. 73, 101-03 (1983) (statement of Bevis Longstreth, Commissioner, Securities and Exchange Commission) [hereinafter *Statement of Longstreth*]; G. BROKER, *supra* note 7, at 49; Chang, *supra* note 111, at 6.

158. However, it has been argued that in a truly competitive environment, market forces,

tives for regulating financial institutions—insuring soundness and promoting efficiency—compels a re-examination of the rationales for regulating financial institutions.

The types of regulations that are aimed at achieving both of these objectives now comprise an unwieldy list. Any meaningful assessment of the validity of such regulations, as well as the necessary equilibrium between protective regulations and regulations that promote efficiency must, therefore, begin by articulating why we should[159] subject our financial institutions (and ourselves) to certain regulations.[160]

In a market economy where government policies must balance the objective of maximizing social wealth with that of distributional equality, the rationale for regulation is guided by two competing criteria: efficiency and equity. It must be stressed, however, that it is not presumed that the exchange relationship which characterizes market economies is necessarily the preferred method of social control.[161] An alternative to such an exchange relationship is an authority relationship where an individual might join a formal organization and thereby recognize the authority of such organization or its representatives to act on behalf of the individual, or even to coerce the individual into the furtherance of social goals.[162] Without isolating a single preferred method of social control in a given society, this article assumes, as a procedural matter, that the exchange relationship is the preferred

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rather than direct regulation, are the appropriate instruments for ensuring soundness as well as promoting efficiency. *See, e.g., Statement of Longstreth, supra* note 157, at 100.

159. In this context the term "should" serves to distinguish reasons that justify regulation from causal or historical explanations. Although historical explanations, such as the legislative outcome of specific events or crises, do illuminate the reasons for financial regulations, they do not and cannot fully explain and justify them. *See* Clark, *The Soundness of Financial Intermediaries*, 86 YALE L.J. 1, 10 (1976).

160. *See generally*, Clark, *supra* note 159, at 10 ("Any general reflection upon the protective regulation imposed on financial intermediaries is bound to mire in a swamp of technical concepts unless one first thinks persistently about the reasons for such regulation."); Roberts, *Commentary on "Proposals for Financial Restructuring,"* in RESTRUCTURING THE FINANCIAL SYSTEM 193, 194 (Symposium Sponsored by Federal Research Bank of Kansas City, 1987) ("[T]he first objective of any discussion of financial reform, restructuring, or new approach to regulation . . . ought to focus the debate on what the *goals of financial regulation* are now and what they ought to be in the future.").

161. In a society that depends entirely on the market mechanism, an individual might influence or control others by entering into a simple exchange relationship, where each party would voluntarily offer a benefit in order to induce a desired response from the other persons involved. *See* C. LINDBLOM, POLITICS AND MARKETS: THE WORLD'S POLITICAL-ECONOMIC SYSTEMS 33-51 (1977). In addition to efficiency, other values, such as freedom of individual action and the minimization of government coercion, also support the utilization of the exchange relationship as the primary form of social control. Article 8 of the ROC Constitution states that "[p]ersonal freedom shall be guaranteed to the people." Moreover, the intrinsic advantages offered by a well-functioning competitive marketplace also help to support a presumption in favor of a free market system. ROC CONST. ART. 8.

162. *See* C. LINDBLOM, *supra* note 161, at 17-32.

method of social control. Even with this assumption, the intervention and control of a higher authority is required to impose the rules—*i.e.*, rules of private property and personal liberty—of the exchange relationship.[163]

Under the efficiency criterion, government intervention in the free market is justified only to the extent that such intervention is necessary to correct classical market failures so as to achieve important public objectives which cannot otherwise be attained in an unregulated marketplace. The term "market failures" broadly refers to situations where government regulations can, in principle, enhance efficiency. Such failures include, for instance, monopoly (and other anti-competitive behavior), externalities (*e.g.*, environmental pollution), imperfect or high cost of information, and mismanagement.[164] The need to intervene in this way is a justification referred to in this article as an efficiency rationale for regulation.

A second category of justifications for government regulation may be broadly classed under the rubric of equity rationales. The equity criterion is concerned with a broader set of public objectives other than efficiency that embody societal values such as justice, fairness, and equality.

A. Efficiency Rationales

In a market economy the failure of a financial institution indicates the inability of its management to provide the services required by the community it serves or to efficiently use resources at its disposal. In either case, termination of the operations of the financial institution should result in better allocation of the scarce capital resources available to the community.[165] In other words, if the market corrects itself by forcing inefficient competitors to withdraw, then no regulation would be needed to achieve an efficient allocation of capital. However, financial institutions, particularly financial intermediaries, have been traditionally subject to a more complex and comprehensive

163. Although each society inevitably utilizes a mixture of exchange and authority relationships for social control, certain societies, such as socialist and communist systems, have relied on the authority relationship as the primary method by which individuals within such societies influence or control each other. In such a society, the justification of laws and regulations does not necessarily hinge on the existence of specific "market failures." Rather a regulation is sufficiently justified as long as it is designed to achieve a desired social objective.

164. For a description of the typical instances of classical market failure, *see* T. CAMPBELL, *supra* note 7, at 366-70; C. LINDBLOM, *supra* note 161, at 76-89; Breyer, *Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform*, 92 HARV. L. REV. 549, 553-60 (1979).

165. *See* Macey & Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1155 (1988).

set of legal regulations than other sectors of the economy. The implication of this is that the self-corrective mechanisms in the market for capital are not perfect and must require extensive government intervention to correct market failures. More importantly, the particularly unique risks faced by a financial system, such as the possibility of a bank run that leads to systemic bank failures, call for a higher degree of regulation and supervision than most other kinds of business enterprises. The following discusses the four basic economic functions of financial intermediaries and the problematic by-products—*i.e.*, market failures—of the free market that hamper those functions.

1. Pooling and Channelling Savings to Productive Investments

One of the functions of financial institutions and markets is to transfer funds saved by one sector of the economy to another sector of users seeking to undertake new productive activities that cannot be wholly financed by their past savings and present incomes. Of course savings can be transferred from suppliers to users without the intermediation of financial institutions. But the efficiency function of financial intermediaries and institutions operating in the securities market can significantly reduce certain costs by facilitating such transfers.

a. Efficiency Functions of Pooling

The pooling of savings by financial intermediaries and securities markets serves two efficiency functions: first, it reduces the costs of obtaining accurate, relevant and comprehensive information which is needed to evaluate competing investments; and second, it lowers the costs, including the cost of transactions, of capital suppliers who seek to lessen the risks of their investments through diversification.

In deciding how to allocate savings among the various available investments, capital suppliers require and rely upon a wide variety of information, including information that may not be readily available and that the prospective user of capital may wish to suppress.[166] Financial intermediaries are able to take advantage of economies of scale in the collection and assessment of financial information by apportioning the cost among all the intermediaries' own capital suppliers. Furthermore, by collecting large pools of funds which enable them to diversify the risks of their investments, financial

166. *See* ADVISORY COMM. ON CORPORATE DISCLOSURE, 95TH CONG., 1ST SESS., REPORT ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION 619-21 (Comm. Print 1977) [hereinafter REPORT ON CORPORATE DISCLOSURE]; T. CAMPBELL, *supra* note 7, at 3-4.

intermediaries can provide a portfolio of investments for capital suppliers.[167] Accordingly, the process of intermediation not only lowers the information costs of capital suppliers, but also reduces the subsequent costs of portfolio diversification.[168]

b. Market Failures Under Intermediation

However, the process of pooling funds through an intermediary creates several market failures which may require government intervention. First, fraudulent conduct on the part of financial intermediaries undermines the ability of capital suppliers to assess accurately the risks of the intermediaries, thus possibly impairing market efficiency.[169] Without government intervention, capital suppliers may either forego searching for the information or avoid utilizing intermediaries entirely. In addition, even in the absence of fraud, the agency relationship between the savers and the intermediaries that invest on their behalf gives rise to the inherent problem characterized by the mismanagement of other peoples' money. Without government intervention, capital suppliers may not be well positioned to impose market discipline on the management of the financial intermediaries.

Second, capital suppliers are unable to assess properly the risk level of financial intermediaries because large portions of the assets of such intermediaries are held in a highly liquid form and are therefore subject to abrupt change without timely notice to the capital suppliers. The management of financial intermediaries may easily sell off and replace the assets with new claims, which in the aggregate may generate a portfolio with a radically different level of risk.[170] Government regulation may be necessary to reduce these information

167. Modern portfolio theory teaches that financial intermediaries cannot protect themselves from systematic risks that affect the market as a whole as successfully as they can protect themselves from risks that are latent in the particular type of investment taken. This is because only firm-specific risk can be diversified away through prudent portfolio selection. *See* Macey & Miller, *supra* note 165, at 1171.

168. *See* T. CAMPBELL, *supra* note 7, at 249-54; Eisenbeis, *Eroding Market Imperfections: Implications for Financial Intermediaries, the Payments System, and Regulatory Reform*, in RESTRUCTURING THE FINANCIAL SYSTEM 19, 23-24 (Symposium sponsored by Federal Research Bank of Kansas City, 1987); Clark, *supra* note 159, at 15-18; Fischel, Rosenfield & Stillman, *supra* note 7, at 306.

In addition to information and diversification costs, financial intermediaries can also reduce certain transaction costs, including the cost of contracting between individual capital suppliers and users. *See* T. CAMPBELL, *supra* note 7, at 251-52; Fischel, Rosenfield & Stillman, *supra* note 7, at 306.

169. *See* Clark, *supra* note 159, at 12-14; Macey & Miller, *supra* note 165, at 1166-69.

170. *See* Clark, *supra* note 159, at 14-15.

costs.[171]

Third, the market for deposits is not perfectly competitive. Anti-competitive factors include the location of the financial intermediary, personal relationships with the officers of the intermediary, and the high cost of changing intermediaries once one is chosen. For example, if the employer of a saver has entered into an arrangement with Bank X whereby the employer's payroll checks are automatically deposited in the saver's account with the bank, the saver may maintain his account with Bank X despite the fact that he may prefer the risk position of Bank Y. This "involuntary depositor" would not act as a true investor who places "risk-and-return" among the most important considerations affecting the choice of a financial intermediary.[172]

c. *Market Failures in the Securities Market: Public Goods and Adverse Selection*

In the securities market, potential public goods problems may arise when information regarding a prospective investment conveys information about alternative investment opportunities. An efficient securities market exists where information regarding or influencing investment decisions is made publicly available in an efficient, timely and reasonable manner, and where all relevant and ascertainable information is instantaneously reflected in the prices of the securities.[173] An unregulated marketplace may fail to provide the information required for investment decision-making. Without governmental regulations, the required information may be what economists call "public goods." Public goods have two unique features: first, the marginal cost for an additional individual to enjoy the public goods is zero; second, it is difficult or impossible to exclude individuals from the enjoyment of public goods. Because of these features, the market

171. *See* Edwards & Scott, *Regulating the Solvency of Depository Institutions: A Perspective for Deregulation*, in ISSUES IN FINANCIAL REGULATION 65, 83 (F. Edwards ed. 1979). *Cf.* Breyer, *supra* note 164, at 556 (correcting for inadequate information gives rise to demand for government regulation). *See generally* Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, in ISSUES IN FINANCIAL REGULATION 177 (F. Edwards ed. 1979) (providing economic framework for examining disclosure issues).

In order to evaluate the risks associated with depositing funds in a financial intermediary, the capital supplier needs to assess not only the probability that the intermediary will encounter serious financial difficulties but also the likely fate of the intermediary should these problems cause it to fail. *See* Garten, *Banking on the Market: Relying on Depositors to Control Bank Risks*, 4 YALE J. ON REG. 129, 150 (1986).

172. *See* Garten, *supra* note 171, at 132-39.

173. *See* R. BREALEY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 266 (2d ed. 1984).

will not supply, or it will undersupply, the public goods as the usual incentives to provide them do not exist.[174]

When raising capital in the securities market, corporations and other such organizations will bear the cost of disclosing certain information to potential investors in order to compete for scarce capital resources. However, the information disclosed may benefit other organizations that have not borne the original disclosure costs. For example, disclosure by a corporation detailing its product development may provide valuable information to competing firms regarding their chances of success in similar product development. If some firms refuse to disclose any information, others in the industry, fearing a competitive disadvantage, will also resist providing such information. Indeed, this disincentive to disclose may outweigh an organization's initial motivation to disclose in order to attract capital for productive activities.[175]

Another instance of the public goods phenomenon is that certain prospective investors, without sharing the cost of such disclosure, will benefit from disclosures by organizations seeking funds. Rational investors theoretically compare the terms of an issuer's offering with alternative investment opportunities. They search for investments that either maximize their expected return on a given amount of risk or minimize their risk for some expected return. Accordingly, comparing information regarding a security offered may be extremely useful despite the fact that such security may ultimately not be included in the chosen portfolio. The issuer, however, will be unable to recoup the cost of disclosure. As a result, the information required by an efficient securities market may be undersupplied.[176]

In addition to the public goods aspects of the information required for investment decision-making, an unregulated marketplace may also fail to provide the required information because of the predictable tendency of an issuer to suppress unfavorable information, leading to a phenomenon known as "adverse selection." In order to

174. To provide the optimal level of public goods, each individual should ideally contribute a sum equal to the value placed upon such services. Individuals, however, have little incentive to pay for the cost of such services. One person's contribution is likely to be so proportionately small that it will not appreciably affect the amount of the services provided. Moreover, the individual will, in any case, be able to enjoy the services financed by others' contributions. If all individuals follow this logic, then little or none of the services will be supplied despite actual collective demand for them. The unregulated marketplace, therefore, is ineffective in providing certain services. *See* C. LINDBLOM, *supra* note 161, at 80-81; R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 49-80 (2d ed. 1976); Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 848-49 (1980).

175. *See* REPORT ON CORPORATE DISCLOSURE, *supra* note 166, at 626-27.

176. *See id.* at 627-28.

attract prospective investors, issuers of securities may understate existing risks. Even if the prospective investor is cognizant of such an understatement, the investor may not be able to determine the nature or materiality of the suppressed information. Consequently, the prospective investor may purchase lower quality securities either at a higher price or in a larger quantity than under circumstances of full disclosure. The government, therefore, needs to intervene and prescribe the type of information deemed relevant, as well as to impose sufficient liability on the issuers and their representatives in order to eliminate the incentive to suppress unfavorable information.[177]

2. Maturity Transformation

With respect to bank-type intermediaries,[178] one of their economic functions is intermediation across maturities. Because the large pool of deposits taken by banks will normally not be withdrawn by all depositors at one time, the intermediaries are able to invest a substantial portion of the deposited funds in high-yield, long-term assets, such as traditional commercial and housing loans. This process of turning liquid deposits on the liability side of the bank's balance sheet into less liquid investments on the asset side of the balance sheet is known as maturity transformation.

a. Efficiency Functions of Maturity Transformation

This process of maturity transformation enables bank-type intermediaries to "create" the long-term credit necessary to stimulate investment by reducing credit costs.[179] Without the intermediary to broker this process, there would be a great mismatch between the time horizons of savers and users of capital, and as a result, many sound investment projects would be discouraged because of the lack of long-term funding for them. At this point, bank-type intermediaries enter the picture. They are able to predict the probable amounts of deposit withdrawals on any given day and hold small but sufficient reserves to meet such demands. This is because, under normal conditions, the decision whether or not to withdraw a deposit depends largely upon the circumstances of the individual depositor

177. *See id.* at 37-39.

178. In Taiwan, "bank-type intermediaries" include commercial banks, specialty banks, local branches of foreign banks, investment and trust companies, credit cooperative associations and credit departments of farmers' and fishermen's associations. *See supra* notes 17-29 and accompanying text.

179. *See* REPORT ON RESTRUCTURING FINANCIAL MARKETS, *supra* note 109, at 172; T. CAMPBELL, supra note 7, at 250-51; R. LITAN, *supra* note 7, at 10; Fischel, Rosenfield & Stillman, *supra* note 7, at 307.

and is independent of the circumstances of other depositors. However, this state of affairs does not always hold when the assumption of independence of depositors breaks down.[180]

Because their assets are maintained in relatively illiquid assets, bank-type intermediaries will not have sufficient funds to pay off simultaneously all of their depositors. If all or a large percentage of the depositors suddenly demanded withdrawal of their funds, bank-type intermediaries would face a severe crisis. They would be forced to call in profitable loans prematurely or to liquidate assets, often at well below market value, in order to meet the unanticipated liquidity demand.[181] The resulting state of crisis might well culminate in the failure of a previously solvent institution.

b. Market Failures: "Prisoner's Dilemma"

Such bank runs occur when depositors react to a phenomenon, known as "prisoner's dilemma," without coordinating their actions to ensure optimal results. In the traditional game theory model of prisoner's dilemma, two players are confronted with the options of confession or defection. For each individual player, the optimal payoff will result if that player defected while his counterpart confessed, and the worst payoff will result if that player confessed but his counterpart defected. However, the *combined* payoff will be optimal if both players confessed. In this situation, the independent, rational strategy of each player is to defect, resulting in a combined payoff that is suboptimal.

Applying this model to the psychology of depositors, we can see that depositors face the same kind of choices—*i.e.*, to withdraw or not to withdraw their deposits—and the same payoff matrix. While the optimal *collective* result may be achieved if depositors refrain from withdrawing their money from a bank-type intermediary that is experiencing a temporary liquidity problem, the optimal *individual* strategy is for each depositor to withdraw his money before others deplete the funds in the bank. Thus, the inability of depositors to formulate and adhere to a coordinated response when facing a confidence crisis will precipitate a series of seemingly irrational individual

180. *See* Edwards & Scott, *supra* note 171, at 79; Garten, *supra* note 171, at 153-56; Macey & Miller, *supra* note 165, at 1156; Corrigan, *Are Banks Special?*, 1982 FEDERAL RESERVE BANK OF MINNEAPOLIS, 1982 ANN. RPT. [hereinafter Corrigan, *Are Banks Special?*] 5, 7-9 (1982); Tussing, *The Case for Bank Failure*, 10 J.L. & ECON. 129, 132-34 (1967).

181. *See generally* T. CAMPBELL, *supra* note 7, at 267-70 (Financial intermediaries have essentially three methods to deal with a liquidity crisis: liquidate assets, borrow funds in the money markets and hedge cash flow risks in futures markets).

responses to withdraw the money.[182] In the face of this dilemma, some form of government intervention, such as the provision of a lender-of-last-resort facility or deposit insurance, may be necessary to eliminate depositors' incentives to withdraw their deposits in times of uncertainty.

3. Providing Means of Payment

Another function served by financial intermediaries is an efficient mechanism through which the payment flows required to sustain economic activities are maintained.[183] In order to facilitate the broad range of transactions that occur in a large modern economy, there must exist stocks of financial assets that are available and capable of being readily transferred. These assets have been predominantly in the form of highly liquid and transferable demand deposits utilized in a payments system. The system of drafts, or orders upon a bank to pay a specific amount at a specific time, have played an indispensable role in the financing of trade between merchants.

a. Efficiency Functions of the Payments System

For two reasons, the financial arrangement of payments through bank-type intermediaries is more efficient than if individual merchants paid each other directly. First, in trade financing arrangements, banks often substitute their own credit in the place of the payor's credit, thereby reducing the costs of sellers of goods to undertake their own evaluation of the buyers' credit. This function facilitates more trading that would not have occurred had it been necessary for the sellers of goods to incur the high costs of independent credit evaluation of each buyer. The function of credit substitution goes beyond the bank's role as a clearinghouse for payments. Banks are able to do so because of economies of scale. Banks have the ability to pool the expertise and sophistication in making better credit evaluations than merchants acting individually.

Second, by centralizing the management of the payments mechanism, financial institutions are able to benefit from economies of scale in accounting, record keeping, processing and clearing, and settlement of payments.[184]

182. *See* Fischel, Rosenfield & Stillman, *supra* note 7, at 307-10; Macey & Miller, *supra* note 165, at 1156-57.

183. In Taiwan, financial intermediaries which provide payment services include banks and post offices. *See supra* notes 17-30 and accompanying text.

184. *See* T. CAMPBELL, *supra* note 7, at 54-55; Corrigan, *Financial Market Structure: A Longer View*, in FEDERAL RESERVE BANK OF NEW YORK, 72 ANN. RPT. 3, 12-14 (1986) [hereinafter Corrigan, *Financial Market Structure*]; Corrigan, *Are Banks Special?*, *supra* note

b. Market Failures

Nevertheless, there are inherent risks in using financial institutions for purposes of credit substitution and providing means of payment. To the extent that financial institutions can make mistakes and are themselves subject to the possibility of insolvency, their economic function as the vehicle of the payments system breaks down. When the possibility of market failure brought about by incompetence or mismanagement exists, there is a justification for the government to impose regulations in this case. This is because of the indispensable role banks play in the payments system, without which economic activities—buying and selling—would be substantially hindered.

4. Implementation of Monetary Policy

Financial institutions and markets also serve as the conduit through which the government conducts monetary policies.[185] In Taiwan, the Central Bank of China is responsible for developing and implementing monetary policy and for controlling the money supply. The principal means employed by the Central Bank of China in performing this task include influencing interest rates by setting maximum deposit rates, exercising the power of approval over the range of rates for bank lending set by the Bankers' Association,[186] adjusting deposit reserve ratios, engaging in open market operations, setting the rediscount rate, acting as lender-of-last-resort and adjusting bank holdings of foreign currency to influence their reserve positions.[187]

Because the implementation of monetary policy through financial institutions and financial markets by definition necessitates government involvement, this special role of financial institutions and financial markets requires substantial government regulation and control.

B. Equity Rationales

The efficiency rationales for government regulation suggest that the government should intervene only if regulation is necessary to

180, at 7-9; Edwards & Scott, *supra* note 171, at 81-82; Horvitz, *Payment System Developments and Public Policy*, in FINANCIAL SERVICES: THE CHANGING INSTITUTIONS AND GOVERNMENT POLICY 74-91 (1983).

185. *See* Corrigan, *Are Banks Special?*, *supra* note 180, at 11-12; Friedman & Friesen, *A New Paradigm for Financial Regulation: Getting from Here to There*, 43 MD. L. REV. 413, 454 (1984).

186. *See supra* notes 75-82 and accompanying text.

187. *See* CHANG, HSÜ, LIU & WU, *supra* note 15, at 512-16; R. Emery, *Postwar Financial Policies in Taiwan, China* (unpublished manuscript) (on file with the *Journal of Chinese Law*). *See generally* Lundberg, *supra* note 105, at 263.

overcome conditions such as the lack of information under which markets fail or to lower transaction costs. In correcting market failures, however, economic analysis continues to rely upon the exchange process, to the extent that the market paradigm is used as a guide to identify the efficient outcome that government regulations seek to perpetuate.[188] Nevertheless, certain efficient outcomes of an exchange market, such as the voluntary transfer by an individual of his freedom from servitude and his right of suffrage, must be questioned under a different set of criteria influenced by society's moral and philosophical values. While some people may wish to exchange their rights, the prohibition of certain free exchanges reflects a societal decision to forego efficiency in favor of promoting a perceived greater social good.[189] What could these greater social values be? In other words, what are the principles that give substance to the vague concept of equity?

Regulation is ultimately rooted in a principle of sacrifice. By participating in any economic community, each member has implicitly agreed to subsume his will and submit his conduct to the standard of economic behavior formulated by the community.[190] Although

188. *See* Coleman & Kraus, *Rethinking the Theory of Legal Rights*, 95 YALE L.J. 1335, 1335-36 (1986).

189. *See* A. OKUN, EQUALITY AND EFFICIENCY: THE BIG TRADEOFF 9-10 (1975). *But see* Coleman & Kraus, *supra* note 188, at 1337 (because willingness to exchange a right, such as freedom from servitude, for money may indicate a lack of either full information or of rationality, laws preventing such transfer may also be explained in efficiency terms).

The potential conflict between individual preferences and social goals highlights the sacrifice that a society demands from its members. This is true in several ways. Each member of a large and diverse community necessarily submits to a set of rules which defines how individuals are permitted to exercise power over each other. Such rules include laws through which a judge may deprive an individual of his property, his freedom, and even his life. As a member of a community, an individual also subjugates certain personal values in a manner acceptable to the larger community. At the minimum, every society requires the adherence to certain values and ideals which are deemed so fundamental as to override individual preferences. Finally, each member of a community is expected to contribute, at least monetarily, to the maintenance of the society and to carry out the aspirations of the community on which the consent of its members is based. Accordingly, to think of community is inevitably to think of at least short-term altruism. Perhaps the major force behind that short-term altruism is the expectation of some longer-term payoff for the individual concerned. Nevertheless, any meaningful sense of community involves some sense of sacrifice.

190. Under this understanding of sacrifice, the government is a vehicle through which the larger community provides for "the maintenance of law and order to prevent coercion of one individual by another, the enforcement of contracts voluntarily entered into, the definition of the meaning of property rights, the interpretation and enforcement of such rights, and the provision of a monetary framework." M. FRIEDMAN, CAPITALISM & FREEDOM 27 (1962).

The sacrifice to which each member of a society is committed, however, is far more profound than the mere passive submission to a set of neutral rules through which one can share in the wealth generated in such a society. Indeed, no society is purely an economic enterprise. Rather, ideology, defined as "the set of beliefs by which a society expresses acceptance of itself," is what "transforms a group, of whatever size or status, into a social entity."

every community builds on the sacrifices of its members, the ideology that prompts such sacrifices differs from community to community, depending in part upon the particular context in which the community found its origin and inception.[191] In the case of Taiwan, we can look to the concepts of "unearned increment," "balanced development," and "investor protection" to guide our formulation of equity rationales for government intervention in financial markets.

1. "Unearned Increment" as a Justification for Taxing Speculative Gains

In his lecture delivered on August 3, 1924 on the Principle of Livelihood, Dr. Sun identified mankind's struggle for continual existence as the fundamental driving force in the development of a society. He stated, "mankind's struggle for continuous existence has been the reason for society's unceasing development, the law of social progress."[192] Article 15 of the Constitution echoes this observation: "The right of existence . . . shall be guaranteed to the people."[193] According to this philosophical ideal, the government, in order truly to belong to and serve the people, must explicitly recognize the fundamental difference between the Principle of Livelihood and capitalism, namely, "capitalism makes profit its sole aim, while the Principle of Livelihood makes the nurture of the people its aim."[194]

To carry out the ideal of the guarantee of livelihood to each individual, there must be a program of redistributing society's wealth. The intellectual justification for the imperative of wealth redistribution through taxation can be found in the texts of the Principle of Livelihood and the Constitution, both of which invoke the theory of "unearned increment." "Unearned increment" refers to the increased values "due to improvement made by society and to the progress of industry and commerce."[195] When the value of land, for example, increased because of the decision of the community to improve and use the surrounding land as an industrial and commercial center, the

Deutsch, *Corporate Law as the Ideology of Capitalism* (Book Review), 93 YALE L.J. 395, 396 (1983). Where relevant, therefore, economic policies must be directed toward promoting the ideals that prompt and sustain communal existence. Still more importantly, perhaps, these ideals may need on occasion to override the desire to maximize material wealth by the society and each of its members.

191. *See* Deutsch, *supra* note 190, at 396 ("To be effective, ideology must be in the world and of it, for ideology must move large numbers of people to change or preserve the social structure that surrounds them.").

192. Y. SUN, THE THREE PRINCIPLES OF THE PEOPLE, 161 (F. Price trans.) (first lecture on the Principle of Livelihood).

193. ROC CONST. art. 15.

194. Y. SUN, *supra* note 192, at 198 (third lecture on the Principle of Livelihood).

195. *Id.* at 178 (second lecture on the Principle of Livelihood).

"credit for the improvement and progress" would belong to "the energy and business activity of all the people and not merely to a few private individuals."[196] Under such circumstances, the proceeds of the "unearned increment" should be enjoyed by all members of the society.[197] According to Dr. Sun, the government should impose a tax on any "unearned increments" in the value of a piece of land which did not result from the exertion of labor by the landowner.

The unearned increment concept also articulates a rationale for taxing capital gains income from financial assets, to the extent such gains are attributable to a general boom in the economy. Thus, if equity and not just efficiency is a consideration for policy makers, some form of tax on profits that are made through speculation in Taiwan's securities market would not be inconsistent with overall policy objectives. Arguably, such a tax would even meet the efficiency criterion, since in the case of Taiwan, it would discourage unproductive speculation and would rechannel the capital to purposes that contribute to and sustain the continued growth of the real economy.

2. Government Allocation of Capital and Credit

In a society which relies entirely on an exchange market, the government is afforded little or no role in the allocation of capital or credit among competing users. Rather, government regulation aims only to overcome the causes of market failure. Yet a completely neutral system for allocating credit may disadvantage some borrowers, who may be priced out of the market. In his lectures on the Three Principles of the People, upon which the ROC was founded,[198] Dr. Sun Yat-sen cautioned that under certain circumstances the government must intervene directly "to equalize the financial resources in society."[199] The Constitution of the ROC, which embodies the Three Principles of the People and on which the Nationalist Party has based its governance of Taiwan since establishing rule there in 1949,[200] also

196. *Id.* at 178-79.

197. Similarly, the Constitution states that "[i]f the value of a piece of land has increased not through the exertion of labor or the employment of capital, the State shall levy thereon an incremental tax, the proceeds of which shall be enjoyed by the people in common." ROC CONST. art. 143, para. 3.

198. *See* ROC CONST. art. 1 ("The Republic of China [is] founded on the Three Principles of the People.").

199. Y. SUN, *supra* note 192, at 177 (second lecture on the Principle of Livelihood).

200. The Preamble of the Constitution states that "[t]he National Assembly of the Republic of China . . . *in accordance with the teachings bequested by Dr. Sun Yat-sen in founding the Republic of China* . . . do hereby establish this Constitution." ROC CONST. preamble (emphasis added). *See also* ROC CONST. art. 1 ("The Republic of China [is] founded on the Three Principles of the People."); art. 142 ("National economy shall be based on the Principle of People's Livelihood.").

articulates instances where government regulation is necessary to allocate credit to specific persons or sectors in the economy.

Both the Principle of Livelihood and the Constitution embody the concept of "balanced development" in order to justify direct government intervention in the allocation of capital and credit. To accelerate the process of development in China, Dr. Sun argued that the government should control and develop capital to achieve balanced economic development.[201] Although, under normal circumstances, private enterprises would be allowed to operate freely, the government would be required to restrict them by law if, in the words of the Constitution, the private enterprises were deemed detrimental to a "balanced development of national wealth and people's livelihood."[202] The emphasis on a well-balanced economy thus compels the government to give appropriate assistance to underdeveloped enterprises or industries. One tool for such assistance would be to allocate credit to the sectors that would not have been able to obtain the credit in the absence of government intervention.[203]

3. Investor Protection

Although in some cases full and adequate information needed to reach a rational decision may be available to a capital supplier in the financial market, the capital supplier may nevertheless make the wrong investment decision and suffer substantial financial losses. Under such circumstances, it may be argued that the government should intervene and protect the capital supplier who has erred.

Based on this rationale, one purpose for the promulgation of the Banking Law and the Securities and Exchange Law of Taiwan is to protect investors.[204] Such an interest in protecting the capital supplier may reflect the government's distrust of the capital suppliers' ability to evaluate available information. Capital suppliers who deposit

201. Y. SUN, *supra* note 192, at 180-84 (second lecture on the Principle of Livelihood). Similarly, the Constitution states that the "[n]ational economy shall be based on the Principle of People's Livelihood and shall seek . . . to attain a *well-balanced* sufficiency in national wealth and people's livelihood." ROC CONST. art. 142 (emphasis added).

202. Article 145, paragraph 1 of the Constitution of the Republic of China states that "[w]ith respect to private wealth and privately operated enterprise, the State shall restrict them by law if they are deemed detrimental to a balanced development of national wealth and people's livelihood." ROC CONST. art. 145, para. 1.

203. In this regard, article 147 of the Constitution provides:

> The Central Government, in order to attain a balanced economic development among the Provinces, shall give appropriate aid to poor or unproductive Provinces.
>
> The Provinces, in order to attain a balanced economic development among the Hsien, shall give appropriate aid to poor or unproductive Hsien.

Id. art. 147.

204. Banking Law, *supra* note 17, art. 1; SEL, *supra* note 35, art. 1.

funds with financial intermediaries are often small and unsophisticated depositors. They are sometimes incapable of making informed decisions about which financial intermediaries can provide a safe haven for their savings, even if they are given requisite information. Investors in the current securities market in Taiwan, for example, routinely rely on rumors rather than relevant financial information when deciding which security will provide the fastest or largest profit.[205] Thus, this justification for government intervention is essentially paternalistic—it implies that the government knows better than capital suppliers what they want or what is beneficial or advantageous to them.[206]

In order to protect capital suppliers from irrational tendencies or uninformed choices, the government can restrict capital suppliers' range of choices, such as prohibiting the sale of low-quality or high-risk products, thereby minimizing the possibility of an "incorrect" decision.[207] However, direct government control of products offered to capital suppliers limits the range of choices available to them. Instead of preventing "incorrect" decisions by capital suppliers, the government can also protect them by proffering compensation for any negative consequences of "incorrect" decisions. For example, the government can provide some form of deposit insurance to guarantee that capital suppliers who lack the expertise and sophistication to make informed decisions about the soundness of banks will not lose their savings as a result of selecting unsound banks.[208] This approach essentially renders decisions by capital suppliers as empty, meaningless gestures.[209]

Reliance on investor protection as a justification for government intervention, however, is a dangerously broad and vague approach. It conceivably allows the government eventually to rationalize all regulatory actions as measures to alleviate suffering and to promote jus-

205. *See e.g., Stocks Take Taiwan on Giddy Ride,* N.Y. Times, Sept. 6, 1989, at D1, col. 3 (reporting that large share of trades on Taiwan Stock Exchange are made on tips of one kind or another).

206. *See* Breyer, *supra* note 164, at 549-60; Clark, *supra* note 159, at 18-22; Edwards & Scott, *supra* note 171, at 84-86.

207. In Taiwan, the price of equity securities distributed by means of an underwritten public offering was generally determined by negotiation between the underwriter and the issuer, under the guidance of ROC's Securities and Exchange Commission. *See supra* notes 125-49 and accompanying text. The involvement of the Commission is arguably an attempt by the government to ensure that the issue price paid by the investor is fair.

208. The granting of special regulatory treatment to prevent the loss of depositors stemming from bank failure can also be justified on efficiency grounds. The existence of safe havens for savings arguably permits the capital suppliers to better allocate their consumption over time. *See infra* notes 297-304 and accompanying text.

209. *See* Clark, *supra* note 159, at 21.

tice. Hence, in order to serve as a useful guide to government action, the government must articulate the specific investor protection problems that it is trying to address. For example, the argument that without government intervention small and unsophisticated depositors could lose their lifetime savings may justify the provision of certain limited safe havens for the savings of depositors.[210]

IV. AN EXAMINATION OF THE SOUNDNESS REGULATIONS OF FINANCIAL INSTITUTIONS

The preceding part of this article provides an analysis of the many rationales for regulating financial institutions. Falling under the rubrics of "efficiency" and "equity," these rationales may arguably justify the imposition of regulations that may seem otherwise onerous. These efficiency and equity rationales for regulation constitute the normative foundation of laws because they articulate the goals or aims which a society should seek to promote through the formal institutions of law and the system of legal rules.[211] The final part of this article presents a case study, showing how the rationales discussed in Part III can help to clarify or even design a concrete system of regulatory rules for Taiwan's financial system.

The actual objectives of remedies and the proposals for reform are often quite divergent and contradictory. It is vital, therefore, to form a precise and carefully defined strategy for legislative change. This type of strategy, however, can frequently generate tension between the regulatory authority and the financial community. Such a conflict can only be resolved through cooperation and compromise.

In order to forge responsive regulations, the source of concern or conflict must be identified, and a precise objective for regulatory constraint or change must be defined. When regulatory rationales and objectives have been identified, many approaches will emerge that provide different solutions toward the achievement of policy objectives. It is the policy-maker's task to select the optimal regulatory measures by eschewing excessively distortive or onerous ones in favor of less restrictive, or second-best, alternatives.[212] In this process the

210. *See* Tussing, *supra* note 180, at 144. Edwards & Scott, *supra* note 171, at 82-83 (arguing that an efficiency rationale for regulating banks is to make available at low social cost an attractive, riskless investment vehicle for savings). *But see* Macey & Miller, *supra* note 165, at 1159-62 (arguing that allowing banks to fail could actually improve the prospect for increasing society's stock of wealth).

211. *See generally* Coleman & Kraus, *supra* note 188, at 1340-41 (arguing that adequate theory of legal entitlement must address, among other questions, the foundation of rights).

212. *See generally* Breyer, *supra* note 164, at 550 (proposing framework for analysis and reform of economic regulation, consisting of three basic elements: justifications for regulation,

policy-maker is guided by the criteria previously set out as the rationales for regulation. In this regard, temporary modifications and supplementary regulations are often essential in order to achieve the overall policy objectives. Moreover, it is necessary for regulators to refine ongoing regulatory practices and be cognizant of the possibility of legislative reform. It should be noted that in Taiwan's rapidly changing financial environment, temporary legal rules—rules in addition to those justified by the rationales for regulation—may be necessary in order to move Taiwan closer to the ideal regulatory world.

For example, complete liberalization of the banking sector would not achieve, in the absence of a well-functioning equity market, an efficient allocation of capital.[213] Because the development of longer-term financing and alternatives to bank financing in Taiwan has been hindered by the lack of a developed securities market,[214] it may be necessary to settle for a "second-best" approach to financial liberalization in which some government intervention in the credit market is maintained until an equity market is fully developed. The remaining portion of this article will evaluate the set of regulatory measures collectively called "soundness" regulations.

A. The Importance of Maintaining a Sound Financial System

The health of financial institutions is essential to the general stability and overall growth of an economy. The lack of a viable financial system in any economy will be fatal: savings cannot be channelled into productive investments, users of capital will be deprived of long-term credit, trading of goods will be substantially hindered, and the government will not be able to coordinate macroeconomic policy through monetary policy tools.

It should be noted, however, that none of the economic functions performed by financial institutions would be significantly disrupted by the failure of just one financial institution. Because the failure of any single financial institution is no different from the failure of a single ordinary industrial corporation, the comprehensive regulation of financial institutions is legitimate only if the failure of a single financial institution may cause a widespread failure of financial institutions

modes of classical regulation and problems they entail, and "less restrictive alternatives" to regulation).

213. *See* Y. Cho, Capital Market Structure and Barriers to Financial Liberalization (1984) (unpublished manuscript on file with the *Journal of Chinese Law*); Cho, *Inefficiencies from Financial Liberalization in the Absence of Well-Functioning Equity Markets*, 18 J. MONEY, CREDIT & BANKING 191 (1986).

214. *See supra* notes 10-12 and accompanying text.

or markets.[215]

The financial system, unlike other sectors of the economy, is inherently unstable because the failure of one financial institution could, under certain circumstances, touch off a run on all financial institutions, leading to a socially disruptive wave of failures. There are at least two features of the financial sector which suggest that the failure of one institution will have a domino effect on the entire system. One reason for the possible systemic failure triggered by a single failure is the fact that financial institutions can only function when there is general confidence in the banking system. When the lack of confidence in the banking system is sufficiently deep and widespread and when large unanticipated withdrawals commence at one bank-type intermediary, depositors of other banks may conclude that their own institution is similarly vulnerable.[216] A second reason for the domino effect lies in the interdependence among financial institutions in maintaining liquidity in the market.[217] Systemic risks may also emerge from increased interdependence within the financial services industry.[218]

In light of these considerations, the regulator may approach the task of preventing systemic failure through two fundamental methods: 1) to adopt internal preventive measures within a financial institution with a view toward restricting the possible risk of that individual institution's crisis or demise; and 2) to undertake external systemic actions in order to isolate a failed or floundering institution and thereby to reduce the potential disaster of a widespread bank run or systemic collapse.

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215. *See* Fischel, Rosenfield & Stillman, *supra* note 7, at 310-12.

216. One manifestation of the systemic failure of financial institutions is evinced by the phenomenon of prisoner's dilemma, which may affect bank-type intermediaries and extend to the banking system as a whole. Bank-type intermediaries that intermediate across maturities by issuing demand deposits payable at par are subject to significant risks because they can never completely match the maturities or "term structure" of their assets and liabilities. In response to this inherent risk, depositors, possessing little information about the value of an intermediary's assets and fearing that their deposits might suddenly and irrevocably be lost, are prone to distrust the ability of the intermediary to meet their deposit obligations. *See also* T. CAMPBELL, *supra* note 7, at 381-83; Clark, *supra* note 159, at 24; Edwards & Scott, *supra* note 171, at 79; Fischel, Rosenfield & Stillman, *supra* note 7, at 310-11; Macey & Miller, *supra* note 165, at 1157.

217. *See* Fischel, Rosenfield & Stillman, *supra* note 7, at 307-11.

218. *See, e.g., The Fed Nightmare: Securities Firms Can Take Big Risks With Little Government Supervision*, N.Y. Times, Feb. 14, 1990, at D5, col. 1. (quoting remarks by E. Corrigan, President of the Federal Reserve Bank of New York) ("[L]inkages created by the large-dollar payments systems are such that a serious credit problem at any of the large users of the system has the potential to disrupt the system as a whole.").

B. An Examination of the Soundness Regulations in Taiwan

The essential purpose of soundness regulation is the prevention of systemic institutional failures that would threaten the stability of the financial marketplace, and in turn the very viability of the economy. However, not all regulation can be said to have this purpose, and some unnecessary regulation may use the goal of soundness as an ostensible but unjustified rationale. Because nearly all kinds of financial regulation can be rationalized as preserving soundness, it is not meaningful to ask whether the regulatory measure in question promotes soundness. Rather, the critical question is whether the regulatory measure meets the efficiency and equity criteria.

It should be noted that different structures and techniques have been adopted for and adapted to the diverse types of institutions in Taiwan. For example, such divergences in function and risk among institutions have come to require the application of different regulatory schemes toward financial intermediaries and institutions operating in the securities markets.[219] Thus, regulators of bank-type intermediaries are primarily concerned with the liquidity of institutions that fall within their regulatory domain. Techniques employed by such regulators will, therefore, include the enforcement of stringent rules regarding assets and reserve requirements. On the contrary, strategies for protecting investors in the securities markets revolve around the requirements for public disclosure of information,[220] the prevention of fraudulent conduct and the maintenance of orderly and sound trading markets.[221]

At present, a multitude of soundness regulations are in effect in Taiwan. Such regulations may be broadly categorized in relation to the strategies that they aim to implement.[222] Four principal categories represent and illuminate four principal approaches to financial

219. *See supra* notes 56-98 and accompanying text.

220. *See* REPORT ON RESTRUCTURING FINANCIAL MARKETS, *supra* note 109, at 327-29. For a discussion of the securities disclosure requirements in Taiwan, see Chen Sung-hsing, Critique on Substantive Aspects of the SEL: Deficiencies in the Securities Disclosure Regulation (2), 2 CHENG-CHÜAN SHIH-CH'ANG FA-CHAN CHI-K'AN (Development of the Securities Market Quarterly) 86 (1989).

221. *See generally* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 591-697 (2d ed. 1988). One of the most significant goals of the most recent amendments to Securities and Exchange Law was preserving the integrity of the market by improving enforcement against manipulative practices. To this end, such amendments increased the criminal sanctions imposed for many offenses and clarified the elements constituting a violation. SEL, *supra* note 35, arts. 155, 156, 157, 157-1, 171. For a discussion of such amendments, see Hsu & Liu, *supra* note 12, at 185.

222. *See infra* notes 226-303 and accompanying text.

regulation in Taiwan: internal regulation, anti-competitive regulation, disclosure regulation and post-failure regulation.

Internal regulations are designed to prevent the insolvency of financial institutions by controlling the conduct of such institutions and their management.[223] In contrast, anti-competitive regulations are designated to control the external financial environment in which financial institutions function.[224] Disclosure regulations are intended to regulate the accumulation, evaluation and disclosure of vital information regarding the financial markets and the participants therein.[225] The final strategy of post-failure regulation has been developed to provide a remedy for the emergence of unsound conditions and institutional failure after such has occurred.

1. Internal Regulations

Internal regulations consist of three strategic measures: 1) balance sheet regulations, 2) business activities regulations and 3) insider misconduct regulations.

a. Balance Sheet Regulation

Balance sheet regulations[226] focus on the internal financial condition of financial institutions.[227] Such regulations are designed to control asset risk and capital risk. Two rationales underlie these restraints: first, the requirement that financial institutions retain a diversified portfolio renders them less vulnerable to risks on any particular investment; and second, the requirement that such financial institutions maintain sizeable capital reserves insulates them against insolvency.

The Banking Law contains a number of restrictions on the investment activities of bank-type institutions. For instance, commercial banks may not make equity investments but they may buy, for their own accounts, government bonds and corporate bonds.[228] In addition, they are subject to certain restrictions on real estate investments.[229] These regulations can be justified under the efficiency criterion as remedies to the market failure of bank mismanagement. Such mismanagement occurs when managers make investments that are

223. *See infra* notes 227-68 and accompanying text.

224. *See infra* notes 269-78 and accompanying text.

225. *See infra* notes 279-91 and accompanying text.

226. This type of regulation has also been referred to as "portfolio regulations." *See* Clark, *supra* note 159, at 44-77.

227. *Id.* at 44.

228. Banking Law, *supra* note 17, art. 71(6).

229. *Id.* arts. 74, 75.

riskier than those preferred by depositors because of the inherent conflict of interest between the management and depositors.

To control capital or leveraged risks of bank-type intermediaries, certain regulations require the maintenance of sizable capital reserves.[230] In addition to minimum capitalization requirements, the Banking Law regulates the kinds of liability or equity claims that each intermediary may issue, as well as the method of valuation on the balance sheets of such claims. For instance, the reserve against the deposit ratio of a bank is fixed within a specified range, and such a reserve must be duly adjusted in accordance with a bank's daily deposit balance.[231] To ensure the liquidity of a bank's assets, regulators have also prescribed a minimum standard for the ratio of a bank's current assets to its liabilities.[232] To strengthen the capital base of banks, a Banking Law amendment in Taiwan was recently approved allowing for the adoption of a risk-based capital standard that would be determined by the Bank of International Settlement.[233] Capital risk regulation in general can be justified under the efficiency criterion as remedies to the prisoner's dilemma problem. By bolstering the capital base of the bank, such regulation enhances the confidence of depositors and alleviates the possibility of massive withdrawals prompted by the fear of inadequate capital reserves.

The balance sheet regulations applicable to securities firms are less complex than those applicable to bank-type intermediaries. Although securities firms generally are not subject to specific asset regulation (restraints on specific kinds of assets), they are nevertheless subject to certain capital regulations. In addition to a minimum capitalization requirement,[234] a securities firm's aggregate indebtedness cannot exceed a prescribed multiple of its net capital, nor can a firm's aggregate current liabilities exceed a prescribed percentage of its aggregate current assets.[235] Furthermore, in conducting firm-commitment or stand-by underwriting, underwriters are required to comply with asset tests imposed by the Securities and Exchange

230. *See* Edwards & Scott, *supra* note 171, at 75.

231. Banking Law, *supra* note 17, art. 42, paras. 1, 2.

232. The Central Bank of China, after consultation with the central competent authority may, from time to time, prescribe such minimum standard. *Id.* art. 42.

233. *See* Banking Law Legislative Proposal, *supra* note 120, at 90. In 1988 the Basle group announced a final international risk-based capital standards, establishing a general minimum capital requirement of 8 percent of assets. For a discussion of the risk-based capital standards, see Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 BUS. LAW. 907, 911-915 (1989).

234. Incorporation Regulation, *supra* note 89, art. 3.

235. SEL, *supra* note 35, art. 49.

Commission.[236]

b. Business Activities Regulations

Business activities regulations are designed to prohibit financial institutions from either pursuing certain business-related activities or providing certain financial services. The primary objectives of this type of regulation are the prevention of anti-competitive behavior in financial markets and the prevention of conflicts of interest. Both objectives improve the soundness of financial institutions, and they are both consistent with the efficiency aim of reducing the possibility of market failures.

The Banking Law and the Securities and Exchange Law of Taiwan help to achieve soundness through two approaches: by maintaining a substantial degree of specialization within the financial markets, and by minimizing the intersection between bank-type intermediaries and institutions operating in the securities markets.[237] The Banking Law distinguishes between different types of bank-type intermediaries, assigning separate functions in the credit market to each type of institution.[238] Particularly with regard to commercial banks, the Banking Law allows such institutions to engage in banking businesses, such as taking deposits and making loans, while prohibiting them from pursuing other activities, such as establishing a wholly-owned securities subsidiary.[239] The Securities and Exchange Law also imposes a high degree of specialization within the securities markets,[240] with each type of participant performing highly differentiated functions.[241] It prohibits securities firms from conducting non-securities-related businesses, from investing in other securities firms,[242] or from taking deposits, making loans or transacting securities finance business.[243]

However, certain weaknesses exist in this scheme of business segmentation. In particular, laws in Taiwan do not adequately address the systemic financial failures which can result from conflicts of inter-

236. *Id.* art. 81.

237. *See supra* notes 8-55 and accompanying text.

238. *See supra* notes 17-29 and accompanying text.

239. Banking Law, *supra* note 17, arts. 71(6), 83, 101, paras. 1(2), 2.

240. The securities industry in Taiwan consists of securities firms (brokers, dealers and underwriters), securities investment trust enterprises, securities finance enterprises, securities depositories and other securities services enterprises. SEL, *supra* note 35, arts. 15, 16, 18.

241. *See supra* notes 34-55 and accompanying text.

242. SEL, *supra* note 35, art. 45, paras. 1, 3.

243. *Id.* art. 60. However, with special approvals from the Securities and Exchange Commission, securities firms are allowed to provide margin loans and stock loans. *Id.* art. 60(1), (2).

est, the concentration of financial institutions and institutional interconnections within the financial sector. For instance, current laws and regulations permit bank-type intermediaries to engage concurrently in certain securities activities.[244] Such a consolidation of functions may give rise to concerns of conflicts of interest which further exacerbate the riskiness of intermediaries.[245] These concerns are particularly acute in Taiwan in light of the interlocking of shareholdings or common control of financial institutions by homogeneous industrial groups.[246] The unrestrained freedom of such groups to invest in financial institutions may result in increased interdependence within the financial services industry and may impede their ability to make independent decisions when allocating credit or providing other financial services.[247]

In view of the interlocking of shareholdings or common control of financial institutions, the government must pay particular attention to the potential risks and abuses arising from interlocked transactions. As the interdependence and interlocking of financial institutions increases the probability of systemic failures, it is imperative that the government consider promulgating new regulations to prevent potential conflicts of interest in different segments within the same institution or in commonly controlled institutions.[248]

c. *Insider Misconduct Regulation*

This set of regulations is directed at controlling conflicts of interest[249] and self-dealings.[250] Insider misconduct regulations are also

244. Banks are allowed to operate only one of the following businesses: (1) underwriter; (2) dealer; (3) broker; (4) underwriter and dealer; and (5) dealer and over-the-counter market dealer. Incorporation Regulation, *supra* note 89, arts. 13, 14.

245. A traditional argument against permitting commercial banks to engage in securities business (e.g. underwriting) is that commercial banks would be confronted with several conflict of interest situations. Permitting banks to securitize and sell their own assets could create perverse incentives for banks, for example, to: (1) enter into unfavorable loan and securities transactions in order to ensure the success of their securities department or (2) fail to maintain independence in exercising their fiduciary duties. *See* Note, *The Transparency Theory: An Alternative Approach to Glass-Steagall Issues*, 97 YALE L.J. 603, 616 (1988).

246. *See e.g.*, YU, *supra* note 35, at 259-64.

247. *See* REPORT ON RESTRUCTURING FINANCIAL MARKETS, *supra* note 109, at 198.

248. For instance, one way to handle the conflicts of interest between departments of securities firms is to establish so-called "Chinese Walls" so that information which may give rise to conflicts of interest cannot be exchanged between different departments. *See generally* Lipton & Mazur, *The Chinese Wall Solution to the Conflict Problems of Securities Firms*, 50 N.Y.U. L. REV. 459 (1975).

249. One commentator has described situations involving a conflict of interest as follows:

> Directors, officers, and in some situations, controlling shareholders owe their corporations, and sometimes other shareholders and investors, a fiduciary duty or loyalty. This duty prohibits the fiduciaries from taking advantage of their beneficiaries by

directed toward ensuring adherence to the norms of proper ethical behavior.[251]

The Banking Law contains many provisions which are intended to prevent insider misconduct: prohibitions against the extension of unsecured credit to bank officers or interested persons;[252] restrictions on the extension of secured credit to bank officers or interested persons;[253] restrictions on bank officers from accepting undue benefits from a client in any form;[254] and restrictions on bank officers from concurrently holding certain positions in more than one bank.[255]

The Securities and Exchange Law also contains similar regulations with regard to insider misconduct. For instance, directors or managers of a securities firm are barred from investing in other securities firms or from serving concurrently as directors or managers of other securities firms.[256] In addition, securities firms that simultaneously handle the business of a securities dealer and that of a broker must, upon occurrence of a specific transaction, indicate in writing whether such transaction is made for the firm's or its customer's account.[257]

Insider misconduct concerns are particularly acute in financial institutions in which a large portion of assets are held in a highly liquid form. However, insider misconduct *per se* may not pose greater threats in causing systemic failures than other forms of illegal conduct. A case in point is a failure of a bank that is caused by the embezzlement of funds by a dishonest director. Although depositors and shareholders of the bank may panic, depositors of other banks would not react in like fashion, for they have no reason to believe that their own deposits are less secure. However, the result would be strik-

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means of fraudulent or unfair transactions. They may not abuse the beneficiaries in situations in which they have a conflict of interest.

R. CLARK, CORPORATE LAW 141 (1986).

250. The term "basic self-dealing" has been defined to include the following four things:

(1) transactions between a corporation and its directors or officers;

(2) transactions between a corporation and a business entity in which the directors or officers have a significant direct or indirect financial interest;

(3) transactions between a partially owned subsidiary corporation and its parent corporation; and

(4) transactions between a corporation and another one with common or "interlocking" directors and officers.

Id. at 159.

251. *See* Clark, *supra* note 159, at 27.

252. Banking Law, *supra* note 17, art. 32.

253. *Id.* art. 33.

254. *Id.* art. 35.

255. *Id.* art. 35-1.

256. SEL, *supra* note 35, art. 51.

257. *Id.* art. 46.

ingly different if the bank were to fail because a high percentage of its loans in one sector of the economy were not repaid. In this second scenario, such a bank failure may alert depositors of other banks with similar types of loans that their banks may soon experience some financial distress. In any event, insider misconduct regulation is justified in that it contributes to the prevention of the collapse of an entire financial system by attempting to counteract the failure of a single financial institution.

Aside from its successful restriction of systemic risks, insider misconduct regulations may also be justified as being a means for correcting other non-systemic market failures. Insider misconduct may undermine the ability of capital suppliers to assess the risks of the intermediaries and may, therefore, prevent the market from operating efficiently and correctly. Similarly, fraud is objectionable because, among other reasons, it generates or exacerbates market imperfections by deceiving participants in the financial markets into making investment decisions based upon fundamentally incorrect information.[258] Therefore, insider misconduct regulation is justified insofar as it corrects market failures in the financial markets by lowering or eliminating transaction costs created by insider misconduct.

In addition to the above-mentioned efficiency justifications, insider misconduct regulations may also assist in the attainment of the goals of certain equity rationales. For instance, such insider misconduct regulations may be perceived to be a type of consumer protection because investors in the financial markets require particular protective measures. A large portion of their assets are often held in liquid form and, as such, are more susceptible to fraudulent behavior by an insider in a financial institution, as opposed to an insider in an ordinary corporation.[259] Similarly, such seemingly paternalistic measures are desirable because most investors in Taiwan's financial markets are small and unsophisticated market participants. In fact, the need to address insider misconduct is particularly urgent in Taiwan where, historically, all major banking scandals and failures have been initiated and catalyzed by excessive and imprudent lending to insiders or affiliates.[260]

d. Summary

The three internal activities regulations discussed above are designed to regulate the risks of financial institutions. Among the

258. *See* Clark, *supra* note 249, at 151-54.

259. *See* Macey & Miller, *supra* note 165, at 1166.

260. *See* Tai, *supra* note 115, at 102.

various types of regulation, internal regulations are more costly to enforce, and their violations are more difficult to detect. In order to enforce effectively this body of law, regulators have either to rely on market discipline (*e.g.*, monitoring by investors or shareholders) or to subject financial institutions to enforcement devices (*e.g.*, on-site examination and investigations).

Through the establishment of privately-owned financial institutions, the government's regulations and supervision have significantly been replaced by competitive market forces. Consequently, market discipline[261] should arguably assume a more important role. However, it is doubtful that investors and shareholders of financial institutions in Taiwan will be able effectively to discipline their institutions, for two reasons. First, as has been the case of many large corporations in Taiwan, financial institutions have been invested in or controlled by highly homogeneous groups—market participants from the same industrial interests or group of companies.[262] Because of the lack both of minority shareholders' awareness in general and of independent directors' awareness in particular, these financial institutions may not be subject to active monitoring by non-controlling shareholders or disinterested outsiders.[263] Furthermore, such institutions are generally free from such market control mechanisms as hostile takeover bids, which would otherwise provide a powerful corrective influence on managerial misbehavior.[264]

Second, there seems to be a high incidence of fraud-related insolvencies in the banking sector. Financial institutions in Taiwan often engage in illegal and unsound practices. For instance, incidents of illegal lendings by bank-type intermediaries[265] or illegal margin lendings by securities firms have recurred.[266] Unsound practices include unfair brokerage practices, insider trading and manipulation of stock

261. One commentator has defined the term "market discipline" in the context of the banking sector as follows:

> [T]he complex process by which suppliers of capital . . . are believed to make decisions as to their allocation of funds among investment opportunities. Suppliers of capital will assess alternative investments with a view to both their expected return . . . and their risk . . . . Put another way, depositors should "discipline" banks that exhibit too much risk by demanding higher returns, or "risk premiums," or by refusing to invest at all; such banks in turn should be forced to reduce their risk-taking in order to attract and keep deposits.

Garten, *supra* note 171, at 129, n.1.

262. *See e.g.*, YU, *supra* note 35, at 259-64.

263. *See* YU, *supra* note 35, at 38.

264. For a discussion of the market control in the United States, see Macey & Miller, *supra* note 165, at 1202-12.

265. *See, e.g.*, Tai, *supra* note 115, at 102-03.

266. *See supra* notes 13-15 and accompanying text.

prices.[267]

Consequently, the lack of effective market discipline renders the need for regulatory supervision and enforcement more compelling and immediate. Current enforcement mechanisms for either banks or other financial intermediaries are not sufficient. Although the Banking Law empowers regulators with the administrative authority to contend with and to correct unsafe or unsound practices,[268] regulators have not been forceful in enforcing such laws. On the securities side, the Taiwan Securities and Exchange Commission has no direct authority to seek either temporary or permanent injunctions in court, or subpoenas.

On the whole, internal regulations and other regulations such as anti-competitive regulations are not mutually exclusive. To the extent that such measures are designed to correct market failures, regulators should strive to attain the best equilibrium between internal regulations and other forms of regulation. Accordingly, the government should not only concentrate on the regulatory enforcement of internal regulations, but also promote market discipline so that internal regulations can be more perfectly implemented.

2. Anti-Competitive Regulation

Anti-competitive regulations are designed to reduce the number of failures of financial institutions by weakening the competitive forces that operate on those institutions. This strategy assumes that "excessive competition" leads to the failure of financial institutions. Sheltered from competition, financial institutions may be able to earn monopoly profits, which insulate them from failure. The specific techniques that fall under these strategies may be divided into limitations on market entry and limitations on price constraints.

a. Entry Regulation

The first type of anti-competitive regulations, entry restrictions, are designed to limit the market entry of financial institutions. Among such techniques are the requirements that, pursuant to certain prescribed criteria, specific regulatory approval be accorded to new banks, financial institutions or new branches, and to mergers or acquisitions of financial institutions.[269] If taken to their extreme, such regulation could result in the imposition of a moratorium on new approvals. Such a moratorium on new approvals for both banks and

267. *See, e.g.*, Yü, *supra* note 11, at 25.

268. Banking Law, *supra* note 17, art. 62, paras. 1, 2.

269. *See supra* notes 64-71 and accompanying text.

securities firms had been imposed in Taiwan prior to the recent liberalization.[270] Regulators may also exercise their discretionary power to restrict the number of certain types of financial institutions, taking into consideration such tests as "domestic economic and financial conditions."[271] Such restrictions may also take on subtle forms. Of particular importance may be the requirements that the applicants of financial institutions demonstrate managerial expertise[272] or adequate capital backing.[273]

b. Price Regulation

The major price controls imposed on financial institutions include the prohibition against paying interest on checking deposits[274] and the interest ceilings on other bank deposits.[275] These restrictions may fundamentally be intended to insure solvency or to prevent destructive price competition.[276] For quite some time the regulatory authorities in Taiwan had imposed price restrictions on financial institutions. Prior to the recent liberalization measures, the current deposit rates of all depository intermediaries had been subject to prior approvals of the Central Bank. Historically, because trading on the Taiwan Stock Exchange has always been subject to certain price limits,[277] limitations on price competition have also existed in Taiwan's securities market.

c. Summary

Entry restrictions and price restrictions reduce competitive pressures and create monopoly rents for the existing participants in the markets. Consequently, they impede competition and cause inefficiencies in the financial markets. Similarly, although price restrictions were originally designed to reduce price competition and stabilize price movements, overly stringent restrictions eventually produced distortions in the flow of funds and often resulted in the

270. *See supra* notes 113-19 and accompanying text.

271. *See, e.g.*, Banking Law, *supra* note 17, art. 26.

272. *See, e.g.*, Incorporation Regulation, *supra* note 89, arts. 4, 5.

273. For example, pursuant to Incorporation Regulation, a securities broker is required to have capitalization of at least NT$ 200 million; securities trader and underwriter, respectively, is required to have capitalization of at least NT$ 200 million and NT$ 400 million. Incorporation Regulation, *supra* note 89, art. 3.

274. Banking Law, *supra* note 17, art. 6.

275. *See supra* notes 122-24 and accompanying text.

276. It should be noted that some other forms of governmental intervention regarding prices are not designed to promote the financial safety of the institutions; rather, they may be intended to benefit customers. One example would be usury ceilings on loans. *See* Clark, *supra* note 159, at 29.

277. *See supra* notes 126-27 and accompanying text.

misallocation of funds.[278] Primarily because of these reasons, the government has recently deregulated, to a considerable extent, the entry and price regulations in order to reinforce and revitalize the competitive structure and components of the financial system.

Consequently, anti-competitive regulations provide only one benefit in terms of ensuring soundness—the protection against failures that result from excessive competition. Yet implementation of such regulations has prevented incompetence, inefficiencies and excessive risk-taking. Anti-competitive regulations are also disadvantageous because they tend to deprive citizens of the freedom to pursue business in the manner the citizens desire. Entry restrictions also artificially limit the available licenses to conduct financial activities, thereby not only raising the equity issue upon which the many potentially qualified entities should be entitled to the "scarce" licenses, but also unnecessarily creating the potential for abuse by the relevant governmental agencies' exchange of such licenses for illegitimate prices. Because of the potential inequality and abuse associated with anti-competitive regulations, they should be dismissed as redundant and harmful if other strategies prove to be reasonably effective instead. In an effort to address these concerns, the government has recently taken measures to liberalize both the entry of new banks and securities firms and to relax certain price constraints.

3. Disclosure Regulations

Another area of soundness regulation concerns the disclosure requirements imposed on financial intermediaries and institutions operating in the securities markets. Information disclosure requirements are generally intended to ensure that both suppliers of capital and investors can make informed decisions about their investments.[279] However, information disclosure has significant implications in connection with the maintenance of the soundness of individual financial institutions and of the financial system as a whole.[280] It may be argued that consumers of financial services, such as bank depositors, should be encouraged to evaluate the risk exposure of financial institutions. Such evaluations would bear striking resemblance to the decision-making processes undertaken by securities investors when

278. *See supra* notes 122-27 and accompanying text.

279. *See* REPORT ON RESTRUCTURING FINANCIAL MARKETS, *supra* note 109, at 327.

280. While depositors may not be able to distinguish causes of bank failures costlessly, information about the causes of bank failures does exist. Bank performance is monitored by large creditors, equity investors, analysts, and regulators. The information acquired from this monitoring process can be used by market participants to distinguish causes of bank failures. *See* Fischel, Rosenfield & Stillman, *supra* note 7, at 310, n.30.

selecting stocks. Such evaluations would also force the management of the financial institutions to limit risk-taking and produce a safer financial system.

However, the question of disclosure can be controversial when it concerns whether information about the difficulties of financial institutions should be disclosed to the public. On the one hand, it is commonly feared that the disclosure of difficulties by financial institutions, especially bank-type intermediaries, might cause systemic failures or would cause failures of institutions that otherwise would not fail.[281] For in the event of a bank failure, it is the information conveyed by the bank failure, not the bank failure itself, which impels depositors to withdraw assets from the failed bank.[282] Disclosure of financial difficulties therefore runs the risk of setting off a bank run. On the other hand, it has been argued that the disclosure of the financial positions of such institutions, including but not limited to financial difficulties, could be relied upon as an effective alternative to direct regulation.[283]

The principal sources of continuous information about the financial condition of public companies are the reports prepared by such companies pursuant to the mandatory disclosure requirements imposed by the regulatory authorities. In Taiwan, the Securities and Exchange Law subjects prospective issuers to disclosure requirements in conjunction with the public offering and distribution of securities.[284] The Securities and Exchange Law also provides that issuers are subject to continuous disclosure requirements. Therefore, issuers are required to file, or to make available to the public, reports on a regular basis.[285] The disclosure requirements generally apply to all public companies, including financial institutions which are publicly held.[286] In addition, securities firms that are not publicly held are nevertheless obligated to make continuous disclosures and to file or announce their financial reports.[287]

281. *See* REPORT ON RESTRUCTURING FINANCIAL MARKETS, *supra* note 109, at 329.

282. *See* Fischel, Rosenfield & Stillman, *supra* note 7, at 310. It was also noted that the run on Continental Illinois Bank did not occur until almost two years after its disclosure of losses on loans purchased from Penn Square. *See* REPORT ON RESTRUCTURING FINANCIAL MARKETS, *supra* note 109, at 183.

283. *Id.* at 333.

284. SEL, *supra* note 35, arts. 22, 30, 31. For a discussion of the disclosure system in Taiwan, see Chen, *supra* note 220.

285. SEL, *supra* note 35, art. 36, paras. 1, 2, 3.

286. In contrast, banking institutions in the United States are given special treatment under most provisions of the securities laws regulating both the issuance and distribution of securities. *See* REPORT ON RESTRUCTURING FINANCIAL MARKETS, *supra* note 109, at 329.

287. Article 36 of the Securities and Exchange Law provides that an issuer shall announce to the public or file with the Securities and Exchange Commission certain financial information, including, among other items, annual financial reports or other matters that have

The disclosure requirements' roles in the regulatory scheme that governs depository institutions are different from those of the securities markets. Pursuant to the Banking Law, bank-type intermediaries are subject to more stringent auditing and examination requirements than are securities firms. Although bank-type intermediaries are required to make certain disclosures of their condition under current regulatory schemes, bank examination and supervision has largely functioned in an atmosphere of confidentiality.

To rely upon disclosure mechanisms as the primary means of controlling the riskiness of bank-type intermediaries in Taiwan is probably not sufficient. Effective market discipline depends upon the ability of depositors to respond to changes in bank risk. Even if capital suppliers are able to assess properly the risk level of bank-type intermediaries, the capital suppliers may not be well-positioned to impose market discipline on the management of the bank-type intermediaries. Deposits may be withdrawn upon demand or have short maturities. Therefore, depositors can always retrieve their funds quickly when problems arise in one particular institution. Consequently, depositors, unlike stockholders or long-term creditors, do not need to expend any effort to identify risk which may lead to serious financial problems.[288] This disincentive may be further aggravated if the capital suppliers are protected by some form of deposit insurance.[289]

Investor protection provides another justification for resorting to direct regulations, rather than disclosure mechanisms, in order to control the risks of financial failures. As previously stated, capital suppliers in Taiwan may lack the ability to evaluate the requisite information. Although recent amendments to the Securities and Exchange Law contain provisions designed to address this type of concern,[290] it is doubtful that regulators by themselves could promptly encourage and enhance market discipline.[291] In fact, given investors' lack of sophistication, more disclosure about banking problems may further interfere with the efforts of bank regulators to maintain public confidence in the financial system.

While disclosure under certain circumstances may help investors to monitor the risks of institutions that operate in the securities mar-

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significant impact on shareholder's equity or the prices of its securities. Article 63 provides that the provisions of article 36 regarding the preparation, submission and publication of financial reports shall apply *mutatis mutandis* to securities firms. SEL, *supra* note 35, arts. 36, 63.

288. *See* Garten, *supra* note 171, at 153-56.

289. *See infra* notes 298-304 and accompanying text.

290. *See supra* notes 81-93 and accompanying text.

291. *See supra* notes 237-48 and accompanying text.

kets, greater reliance on disclosure and market discipline to reduce bank risk may prove counterproductive. As government supervision and direct regulation tools should provide finer measures or mechanisms for protecting depositors, more attention should be given to improving other types of soundness regulation as a means of controlling systemic risks.

4. Post-Failure Regulations

In order to protect public suppliers of capital from realized risks of failure, governments usually employ post-failure mechanisms to provide back-up funds to failing financial institutions.[292] These regulatory supports include lender-of-last-resort capacities and deposit insurance programs.[293]

a. Lender-of-Last-Resort

A lender-of-last-resort policy is directed at preventing systemic bank panics at a time of substantial contraction of the money supply.[294] In order to prevent such a contraction, the regulations governing the operations of the Central Bank of China empowers the Central Bank to purchase securities and to lend funds to banks.[295] Since only bank-type intermediaries incur significant and recurrent liquidity problems, these lender-of-last-resort techniques are generally not available to institutions operating in the securities sector.[296] Although the Central Bank of China can prevent serious bank runs through the timely provision of resources to insolvent banks, the mere existence of such a system may not be a sufficient guarantee of financial soundness. Consequently, other regulatory schemes, such as deposit insurance, can constitute important supplementary measures for maintaining soundness in and among financial institutions.

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292. One commentator has referred to this mechanism as "reactive regulation". *See* Clark, *supra* note 159, at 10.

293. While deposit insurance may seem to be directed at safeguarding depositors' assets when a failure does occur, its major purpose is actually to reduce the number of bank insolvencies by reducing or eliminating the threat of a bank run. *See* Edwards & Scott, *supra* note 171, at 70.

294. Either of the following can cause a substantial contraction of money: in response to a threatened bank panic, banks attempt to increase their reserve ratios; and individuals attempt to acquire currency in exchange for their deposits. Either can result in a severe contraction of money and credit at a time when liquidity is most needed. *Id.*

295. *See* Regulations Governing the Operations of the Central Bank of China, *supra* note 63, arts. 19, 26.

296. It should be noted that the Regulations Governing the Operations of the Central Bank of China also provide for the financing of securities firms and securities finance corporation. *Id.* art. 30.

b. Deposit Insurance

In order to protect the interest of depositors and to maintain the stability of credit markets, the government promulgated the Deposit Insurance Law in 1985, pursuant to which the Central Deposit Insurance Corporation was established.[297] Certain types of institutions, including both banks and credit cooperatives, are eligible to apply for the insurance of specified deposits.[298] Deposit insurance insures deposit accounts up to a fixed amount and is funded by a fixed-level premium on banks' deposits.[299] The Corporation, with approvals from the Central Bank, is also authorized to perform certain auditing functions.[300] To date, the deposit insurance system has not been used to compensate depositors of insolvent institutions.

The establishment of the deposit insurance system has made a fundamental contribution to the ROC's financial stability. While deposit insurance may seem, at first glance, to be directed at safeguarding depositors' assets when a bank failure does occur, its major purpose is to reduce the number of bank insolvencies by reducing or eliminating the threat of a bank run. The primary benefit of deposit insurance is that it reduces the likelihood that one failure will result in other systemic or interconnected failures.[301] Deposit insurance, therefore, serves to reduce the danger of bank panics by maintaining public confidence in the financial markets.

Although deposit insurance fulfills an important function, it imposes substantial costs by interfering with the allocation of resources within the financial system and by discriminating among types of depositors or institutions. In an ideal market economy, an institutional failure would constitute a healthy market discipline of both public suppliers of capital and their intermediaries. Government back-up funds would shift the cost of risk away from the public suppliers of capital, who would voluntarily take greater risks. Thus, such funds give suppliers of capital more safety than they initially anticipated or sought. However, the administration of deposit insurance could provide the shareholders and managers of insured banks with the incentive to engage in excessive risk-taking because the sharehold-

297. Article 1 of the Deposit Insurance Law provides that the purpose of this Law is "to protect the interests of depositors in depository institutions, to encourage savings, to maintain the order of credit and to promote the sound development of financial business." *See* Deposit Insurance Law, *supra* note 81, art. 1.

298. *Id.* arts. 3, 4.

299. *Id.* arts. 1, 3, 4, 8-13.

300. *Id.* art. 21.

301. Depositors with their accounts backed by such insurance are much less concerned about the weakness of their own banks and other institutions. *See, e.g.*, Edwards & Scott, *supra* note 171, at 70.

ers and managers would be able to allocate some of their losses to third parties through insurance payments. Consequently, if deposit insurance and other post-failure mechanisms are improperly implemented, they could impose the costs of bank failures on the general public and thereby make bank failures more likely.

Deposit insurance systems can, however, be justified on equity rationales of investor protection. Individual public suppliers of capital, as previously argued, are not capable of properly evaluating or estimating the risk of failure.[302] Consequently, certain government intervention can be justified under such equity rationale. If government intervention is justified, the next question the government might need to address is whether a similar mechanism should be established to protect securities investors.[303]

In the face of the complexity of bank insolvency procedures and alternatives, regulators are often charged with the responsibility of assessing risks of failures, making cost and benefit calculations, or designing settlement strategies. Consequently, regulators should be required to exercise discretion under clearly established guidelines. Insolvent financial institutions are not new incidents in Taiwan. In 1985, prior to the promulgation of the Deposit Insurance Law, three investment and trust companies encountered insolvency problems because of either mismanagement or insider misconduct that occurred in the last decade. The government responded to the exigencies of such crises through different measures—direct financial assistance from and the assumption of transactions by government-designated or government-owned banks. Although these institutions were all insolvent for similar reasons, the government, without offering any clear explanations or justifications for its measures, responded to each case by taking different measures. Therefore, in order to achieve regulatory consistency, the government should consider establishing guidelines and articulating policies that regulators should follow when confronted with such problems.

c. *Summary*

Post-failure mechanisms, such as deposit insurance, provide a high level of certainty to public suppliers of capital, regardless of the causes of bank failures. The mechanisms thereby increase the general confidence in the financial markets. Unlike other types of preventive

302. For a discussion of such considerations, see Clark, *supra* note 159, at 90-96.

303. Although securities brokers perform a function that is different from banks or similar financial institutions, the need for protection of their customers is similar in some ways to bank depositors. For a discussion of the guaranty fund of the securities investors in the United States, see REPORT ON RESTRUCTURING FINANCIAL MARKETS, *supra* note 109, at 345-69.

soundness regulation, post-failure mechanisms are more complete and comprehensive forms of risk control. Except for certain deficiencies that need to be addressed in the future,[304] the current deposit insurance system may be deemed an effective strategy of soundness regulation.

CONCLUSION

Soundness regulations may be deemed to be strategies for preventing the systemic failure of financial institutions and for ensuring the viability of financial systems. In the context of the Taiwan markets, internal regulations that seek to control and correct the interconnections among financial institutions and their interdependence within the financial services industry are the most effective soundness regulations. Such internal regulations seek to reduce or eliminate the potential risk of a series of failures among financial institutions. Similarly, certain post-failure regulations may also reduce the potential for bank runs, for the systemic failure within bank-type intermediaries and for the extension of such failures to the entire banking system.

Among the various measures assessed in this article, disclosure regulations, although insufficient remedies as far as soundness is concerned, still deserve increased consideration for their potential for market discipline. In contrast, anti-competitive regulations remain the sole type of regulations that fail to address directly the soundness of financial institutions. Still, one possible justification for such anti-competitive regulations is the need for temporary regulations that may initially facilitate the orderly liberalization of Taiwan's financial markets. Yet, such justification must be examined and weighed against evidence revealing that most kinds of anticompetitive regulations tend eventually to diverge from their original rationale: inefficient producers, who appreciate protection from competition, will strive to impede progress through the preservation of the *status quo*.

Any discussion of soundness regulations eventually culminates in a cost versus benefit analysis that weighs not only risk regulation strategies but also specific enforcement methods and practices. The

304. In spite of its advantages, the deposit insurance program established under the Deposit Insurance Law is hardly free from defects. For instance, the insurance premium is currently applied at a uniform rate to all institutions; no recognition is taken of the variations in risk presented by variations in the composition of asset portfolios or in other factors relevant to failure. Under these circumstances, unsound institutions should be penalized for the risks they pose to the deposit insurance system by paying a higher share of the costs. For a discussion of the problems being encountered by the insurance and regulatory system and an evaluation of some of the proposed solutions being discussed, see Scott, *supra* note 233.

societal costs of legal enforcement will be shaped and determined by the behavior, demeanor, attitudes and values of societal members subject to such regulations. If governmental regulations imposed upon a society are perceived as legitimate, then enforcement costs may remain restrained and manageable. If, on the other hand, such regulations appear unjust or unresponsive to the common public good, then increased resistance may compel officials either to resort to costly coercive measures or to abandon altogether such regulations.[305]

While relatively rare, problems of legal enforcement in Taiwan are of real significance and concern. For example, the announcement in September of 1988 by the Ministry of Finance reinstating a securities gains tax which had originally been suspended in 1976,[306] has generally been regarded as an attempt by the government to calm both market activity and agitation in the volatile securities market. Although the proposed securities gains tax may be considered a good faith attempt by government officials to serve the common good, the announcement triggered several public protests. In fact, such protests only subsided upon the modification by the government of certain measures, including increasing the annual tax-exempt amount for securities transactions.[307]

The controversy surrounding the securities gains tax demonstrates that legal regulations are only relevant and effective when enacted or modified in response to the requirements of the multi-faceted world to which the regulations belong.[308] This greater normative world is composed of the values shared by its members. Such an unwritten code also reveals and reinstates its economic, political and social infrastructure, as well as its formal legal system.

On occasion, the exercise of legal rules may require individuals or entities to suffer certain sacrifices or losses, and therefore may appear ineffective and inequitable even if warranted by rationales for regulation. Such unpopular legal rules, whether or not designed in good faith for the common good, will always risk rejection by the

305. *See* S. BOWLES & H. GINTIS, DEMOCRACY & CAPITALISM 200 (1986).

306. The announcement stated, however, that an investor's first NTS 3 million in stock transactions each year would be exempted, and a 50% tax discount would be granted for earnings on securities held for over one year. *See* Liang, *supra* note 56, at 3-4.

307. On October 20, 1988, the Ministry of Finance increased the annual tax-exempt amount to NTS 10 million. Cheng-chüan Chiao-i So-te K'e-cheng So-te-shui Ch'u-i Shih-hsiang (Guidelines Governing Securities Transactions Gain Tax) (Executive Yuan, *T'ai-77-Ts'ai*-28616) (promulgated Oct. 20, 1988).

308. *See generally* Cover, *The Supreme Court, 1982 Term — Foreword: Nomos and Narrative*, 97 HARV. L. REV. 4, 4 (1983) ("The rules and principles of justice, the formal institutions of the law, and the conventions of a social order are, indeed, important to that world; they are, however, but a small part of the normative universe that ought to claim our attention.").

people of a community. When evaluating the situation, it may be decided that the force of regulations must prevail because legal rules issued in a normative universe compel all members of the community to comply with the rules' prescription. Yet simultaneously, such legal rules can never transcend the public morality of a given time. Hence, careful attention must be accorded to the normative universe in which legal rules have a small, albeit essential, function.

The final step in analyzing financial regulations, therefore, consists not only of devising methods for enforcing the legal rules, but also of recognizing the necessary interaction between law and the greater normative universe which we inhabit.