

TAIWAN SEMICONDUCTOR MANUFACTURING CO LTD

Form 20-F

April 13, 2015

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SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 20-F

.. REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2014

OR

.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

OR

.. SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 1-14700

(Exact Name of Registrant as Specified in Its Charter)

**Taiwan Semiconductor Manufacturing Company
Limited**

(Translation of Registrant's Name Into English)

Republic of China

(Jurisdiction of Incorporation or Organization)

No. 8, Li-Hsin Road 6

Hsinchu Science Park

Hsinchu, Taiwan

Republic of China

(Address of Principal Executive Offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common Shares, par value NT\$10.00 each*	The New York Stock Exchange, Inc.

Securities registered or to be registered pursuant to Section 12(g) of the Act:

None

(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.

As of December 31, 2014, 25,929,662,436 Common Shares, par value NT\$10 each were outstanding.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or (15)(d) of the Securities Exchange Act of 1934. Yes No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP International Financial Reporting Standards as issued Other

by the International Accounting Standards Board

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

* Not for trading, but only in connection with the listing on the New York Stock Exchange, Inc. of American Depositary Shares representing such Common Shares

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

This annual report includes statements that are, or may be deemed to be, forward-looking statements within the meaning of U.S. securities laws. The terms anticipates, expects, may, will, could, should and other similar expressions identify forward-looking statements. These statements appear in a number of places throughout this annual report and include statements regarding our intentions, beliefs or current expectations concerning, among other things, our results of operations, financial condition, liquidity, prospects, growth, strategies and the industries in which we operate.

By their nature, forward-looking statements involve risks and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future. Forward-looking statements are not guarantees of future performance and our actual results of operations, financial condition and liquidity, and the development of the industries in which we operate may differ materially from those made in or suggested by the forward-looking statements contained in this annual report. Important factors that could cause those differences include, but are not limited to:

the volatility of the semiconductor and electronics industry;

overcapacity in the semiconductor industry;

the increased competition from other companies and our ability to retain and increase our market share;

our ability to develop new technologies successfully and remain a technological leader;

our ability to maintain control over expansion and facility modifications;

our ability to generate growth and profitability;

our ability to hire and retain qualified personnel;

our ability to acquire required equipment and supplies necessary to meet business needs;

our reliance on certain major customers;

the political stability of our local region; and

general local and global economic conditions.

Forward-looking statements include, but are not limited to, statements regarding our strategy and future plans, future business condition and financial results, our capital expenditure plans, our capacity management plans, expectations as to the commercial production using 16/10-nanometer and more advanced technologies, technological upgrades, investment in research and development, future market demand, future regulatory or other developments in our industry as well as business acquisitions and financing plans. Please see Item 3. Key Information Risk Factors for a further discussion of certain factors that may cause actual results to differ materially from those indicated by our forward-looking statements.

Table of Contents**PART I****ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISORS**

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION**Selected Financial and Operating Data**

The selected consolidated statements of profit or loss and other comprehensive income data and other consolidated financial data for the years ended December 31, 2012, 2013 and 2014, and the selected consolidated statements of financial position data as of December 31, 2013 and 2014, set forth below, are derived from our audited consolidated financial statements included herein, and should be read in conjunction with, and are qualified in their entirety by reference to, these consolidated financial statements, including the notes thereto, which have been prepared in accordance with International Financial Reporting Standards, or IFRSs, as issued by the International Accounting Standards Board, or IASB. The selected consolidated statement of financial position data as of December 31, 2012, set forth below, is derived from our audited consolidated financial statements not included herein. Since 2013 was the first year our audited consolidated financial statements were prepared in accordance with IFRSs, pursuant to the transitional relief granted by the U.S. Securities and Exchange Commission in respect of the first-time adoption of IFRSs, we have only provided financial statements and financial information for the financial years ended December 31, 2012, 2013 and 2014. Additionally, financial data as of and for the years ended December 31, 2010 and 2011 derived from our consolidated financial statements prepared in accordance with accounting principles generally accepted (GAAP or R.O.C. GAAP) in the Republic of China (R.O.C. or Taiwan) have not been included below.

In addition to preparing financial statements in accordance with IFRSs as issued by the IASB included in this annual report, we also prepare financial statements in accordance with the IFRSs as adopted for use in Taiwan (Taiwan-IFRSs), which we are required to file with the Financial Supervisory Commission (FSC) of R.O.C. and Taiwan Stock Exchange (TWSE) under the applicable regulations and listing rules of the TWSE. Please see Item 5. Operating and Financial Reviews and Prospects First Time Adoption of IFRSs for more details. English translations of such financial statements are furnished to the SEC on Form 6-K, which are not incorporated by reference to this or any of our previous annual reports on Form 20-F.

Year ended and as of December 31,			
2012	2013	2014	
NT\$	NT\$	NT\$	US\$
(in millions, except for percentages,			
earnings per share and per ADS)			

Consolidated Statements of Profit or Loss and Other Comprehensive Income Data:

Net revenue	506,745	597,024	762,806	24,139
Cost of revenue	(262,592)	(315,642)	(385,113)	(12,187)
Gross profit before realized (unrealized) gross profit on sales to associates	244,153	281,382	377,693	11,952
Realized (unrealized) gross profit on sales to associates	(25)	(21)	29	1
Gross profit	244,128	281,361	377,722	11,953
Operating expenses	(62,517)	(71,339)	(80,849)	(2,558)
Other operating income and expenses, net	(449)	47	(1,002)	(32)
Income from operations	181,162	210,069	295,871	9,363
Non-operating income and expenses, net	499	5,893	6,203	196
Income before income tax	181,661	215,962	302,074	9,559
Income tax expense	(22,375)	(32,112)	(47,890)	(1,515)
Net income	159,286	183,850	254,184	8,044
Other comprehensive income for the year, net of income tax	4,261	16,359	11,805	373
Total comprehensive income for the year	163,547	200,209	265,989	8,417
Net income attributable to shareholders of the parent	159,481	183,978	254,302	8,048
Net loss attributable to noncontrolling interests	(195)	(128)	(118)	(4)
Total comprehensive income attributable to shareholders of the parent	163,692	200,343	266,091	8,421
Total comprehensive loss attributable to noncontrolling interests	(145)	(134)	(102)	(4)
Basic earnings per share	6.15	7.10	9.81	0.31
Diluted earnings per share	6.15	7.10	9.81	0.31
Basic earnings per ADS equivalent	30.76	35.48	49.04	1.55
Diluted earnings per ADS equivalent	30.75	35.48	49.04	1.55
Basic weighted average shares outstanding	25,921	25,928	25,929	25,929
Diluted weighted average shares outstanding	25,928	25,930	25,930	25,930

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	Year ended and as of December 31,			
	2012 NT\$	2013 NT\$	2014 NT\$	US\$
Consolidated Statements of Financial Position Data:				
Working capital	92,223	154,513	401,781	12,715
Long-term investments ⁽¹⁾	65,723	89,024	29,860	945
Property, plant and equipment	617,562	792,666	818,199	25,892
Intangible assets	10,960	11,490	13,531	428
Total assets	961,344	1,262,801	1,494,853	47,305
Hedging derivative financial liabilities		5,482		
Long-term bonds payable	80,000	210,768	213,674	6,762
Accrued pension cost	6,781	6,802	6,568	208
Total liabilities	247,749	428,688	472,492	14,952
Capital stock	259,245	259,286	259,297	8,206
Equity attributable to shareholders of the parent	711,052	833,846	1,022,234	32,349
Noncontrolling interests	2,543	267	127	4
Cash dividend per common share ⁽²⁾	3.0	3.0	3.0	0.1

	Year ended and as of December 31,			
	2012 NT\$	2013 NT\$	2014 NT\$	US\$
and operating data)				
Other Financial Data:				
Gross margin	48.2%	47.1%	49.5%	49.5%
Operating margin	35.8%	35.2%	38.8%	38.8%
Net margin	31.5%	30.8%	33.3%	33.3%
Capital expenditures	246,137	287,595	288,540	9,131
Depreciation and amortization	131,349	156,182	200,252	6,337
Cash generated by operating activities	284,963	347,384	421,524	13,339
Cash used in investing activities	(269,318)	(281,054)	(282,421)	(8,937)
Cash generated by (used in) financing activities	(13,589)	32,106	(32,328)	(1,023)
Effect of exchange rate changes and others	(2,118)	849	8,979	284
Net increase (decrease) in cash	(62)	99,285	115,754	3,663
Operating Data:				
Wafer (300mm equivalent) shipment ⁽³⁾	6,242	6,963	8,263	8,263
Billing Utilization Rate ⁽⁴⁾	91%	91%	97%	97%

(1) Investments accounted for using equity method, and noncurrent available-for-sale financial assets.

(2) Cash dividend per common share was approved by our shareholders on June 12, 2012, June 11, 2013 and June 24, 2014, respectively. The numbers are rounded to one decimal point.

(3) In thousands.

(4) Billing Utilization Rate is equal to annual wafer shipment divided by annual capacity. Annual capacity includes wafers committed by Vanguard International Semiconductor Corporation (VIS) and Systems on Silicon Manufacturing Company Pte. Ltd. (SSMC). Please see Item 7. Major Shareholders and Related Party

Transactions Related Party Transactions .

Exchange Rates

We publish our financial statements in New Taiwan dollars, the lawful currency of the R.O.C. In this annual report, \$, US\$ and U.S. dollars mean United States dollars, the lawful currency of the United States, and NT\$ and NT dollars mean New Taiwan dollars. This annual report contains translations of certain NT dollar amounts into U.S. dollars at specified rates solely for the convenience of the reader. The translations from NT dollars to U.S. dollars and from U.S. dollars to NT dollars were made by the exchange rate as set forth in the statistical release of the Federal Reserve Board. Unless otherwise noted, all translations for the year 2014 were made at the exchange rate as of December 31, 2014, which was NT\$31.60 to US\$1.00. On April 3, 2015, the exchange rate was NT\$30.87 to US\$1.00.

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The following table sets forth, for the periods indicated, information concerning the number of NT dollars for which one U.S. dollar could be exchanged.

	NT dollars per U.S. dollar			
	Average ⁽¹⁾	High	Low	Period-End
2012	29.47	29.91	29.05	29.05
2013	29.73	30.03	29.42	29.83
2014	30.38	31.60	29.87	31.60
October 2014	30.40	30.49	30.31	30.45
November 2014	30.73	30.99	30.48	30.99
December 2014	31.35	31.80	31.03	31.60
January 2015	31.64	32.00	31.06	31.75
February 2015	31.55	31.76	31.31	31.44
March 2015	31.44	31.71	31.19	31.24
April 2015 (through April 3, 2015)	31.05	31.24	30.87	30.87

⁽¹⁾ Annual averages calculated from month-end rates and monthly averages calculated from daily closing rates. No representation is made that the NT dollar or U.S. dollar amounts referred to herein could have been or could be converted into U.S. dollars or NT dollars, as the case may be, at any particular rate or at all.

Capitalization and Indebtedness

Not applicable.

Reasons for the Offer and Use of Proceeds

Not applicable.

Risk Factors

We wish to caution readers that the following important factors, and those important factors described in other reports submitted to, or filed with, the Securities and Exchange Commission, among other factors, could affect our actual results and could cause our actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf, and that such factors may adversely affect our business and financial status and therefore the value of your investment:

Risks Relating to Our Business

Any global systemic political, economic and financial crisis or catastrophic natural disasters (as well as the indirect effects flowing therefrom) could negatively affect our business, results of operations, and financial condition.

In recent times, several major systemic economic and financial crises and natural disasters negatively affected global business, banking and financial sectors, including the semiconductor industry and markets. These types of crises, including the prolonged decrease in economic growth or insolvency of major countries, could cause turmoil in global markets that often result in declines in electronic products sales from which we generate our income through our

products and services. For example, there could be knock-on effects from these types of crises on our business, including significant decreases in orders from our customers; insolvency of key suppliers resulting in product delays; inability of customers to obtain credit to finance purchases of our products; customer insolvencies; and counterparty failures negatively impacting our treasury operations. Any future systemic political, economic or financial crisis or catastrophic natural disaster could cause revenues for the semiconductor industry as a whole to decline dramatically, and if the economic conditions or financial condition of our customers were to deteriorate, additional accounting related allowances may be required in the future and such additional allowances could reduce our operating income and net income. Thus, any future global economic crisis or catastrophic natural disaster could materially and adversely affect our results of operations.

Since we are dependent on the highly cyclical semiconductor and electronics industries, which have experienced significant and sometimes prolonged periods of downturns and overcapacity, our revenues, earnings and margins may fluctuate significantly.

The electronics industries and semiconductor market are cyclical and subject to significant and often rapid increases and decreases in product demand. Our semiconductor foundry business is affected by market conditions in such highly cyclical electronics and semiconductor industries. Variations in order levels from our customers may result in volatility in our revenues and earnings. From time to time, the electronics and semiconductor industries have experienced significant and sometimes prolonged periods of downturns and overcapacity. Because we are, and will continue to be, dependent on the requirements of electronics and semiconductor companies for our services, periods of downturns and overcapacity in the general electronics and semiconductor industries could lead to reduced demand for overall semiconductor foundry services, including our services. If we cannot take appropriate actions such as reducing our costs to sufficiently offset declines in demand, our revenues, margin and earnings will suffer during periods of downturns and overcapacity.

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Decreases in demand and average selling prices for products that contain semiconductors may adversely affect demand for our products and may result in a decrease in our revenues and earnings.

A vast majority of our revenue is derived from customers who use our services in communication devices, personal computers, consumer electronics products and industrial/standard products. Any decrease in the demand for any one of these products may decrease the demand for such other products as well as overall global semiconductor foundry services, including our services and may adversely affect our revenues. Further, because we own most of our manufacturing capacities, a significant portion of our operating costs is fixed. In general, these costs do not decline when customer demand or our capacity utilization rates drop, and thus declines in customer demand, among other factors, may significantly decrease our margins. Conversely, as product demand rises and factory utilization increases, the fixed costs are spread over increased output, which can improve our margins. In addition, the historical and current trend of declining average selling prices (or ASP) of end use applications places downward pressure on the prices of the components that go into such applications. If the ASP of end use applications continues decreasing, the pricing pressure on components produced by us may lead to a reduction of our revenues, margin and earnings.

In light of the rise of new foundry service providers worldwide, if we are unable to compete effectively in the highly competitive foundry segment of the semiconductor industry, we may lose customers and our profit margin and earnings may decrease.

The markets for our foundry services are highly competitive. We compete with other foundry service providers, as well as integrated device manufacturers that devote a significant portion of their manufacturing capacity to foundry operations. Some of these companies may have access to more advanced technologies and greater financial and other resources than us, such as the possibility of receiving direct or indirect government bailout/economic stimulus funds or other incentives that may be unavailable to us. Our competition may, from time to time, also decide to undertake aggressive pricing initiatives in one or more technology nodes. Increases in these competitive activities may decrease our customer base, or our ASP, or both. For example, over the past few years, we have seen the rise of certain firms with the capability of providing foundry services. These firms are committed to try to attract our customers. If we are unable to compete with any and each of these new competitors with better technologies and manufacturing capacity and capabilities, we risk losing customers to these new contenders.

If we are unable to remain a technological leader in the semiconductor industry or if we are unable to timely respond to fast-changing semiconductor market dynamics, we may become less competitive.

The semiconductor industry and its technologies are constantly changing. We compete by developing process technologies using increasingly advanced nodes and on manufacturing products with more functions. We also compete by developing new derivative technologies. If we do not anticipate these changes in technologies and rapidly develop new and innovative technologies, or our competitors unforeseeably gain sudden access to additional technologies, we may not be able to provide foundry services on competitive terms. In addition, our customers have significantly decreased the time in which their products or services are launched into the market. If we are unable to meet these shorter product time-to-market, we risk losing these customers. These factors have also been intensified by the shift of the global technology market to consumer driven products such as mobile devices, and increasing concentration of customers and competition (all further discussed among these risk factors). If we are unable to innovate new technologies that meet the demands of our customers or overcome the above factors, our revenues may decline significantly. Although we have concentrated on maintaining a competitive edge in research and development, if we fail to achieve advances in technologies or processes, we may become less competitive.

If we are unable to manage our capacity and the streamlining of our production facilities effectively, our competitiveness may be weakened.

We perform long term market demand forecasts to estimate general economic and market conditions for our products and services. Based upon these estimates, we manage our overall capacity in accordance with market demand. Because market conditions may vary significantly and unexpectedly, our market demand forecast may change significantly at any time. Further, since certain manufacturing lines or tools in some of our manufacturing facilities may be suspended or shut down temporarily during periods of decreased demand, we may not be able to ramp up in a timely manner during periods of increased demand. During periods of continued decline in demand, our operating facilities may not be able to absorb and complete in a timely manner outstanding orders re-directed from shuttered facilities. Recently, we have been adding capacity to our 300mm wafer fabs in the Hsinchu Science Park, Southern Taiwan Science Park and Central Taiwan Science Park, based on our market demand forecasts taking into account the demand forecasts of our customers. As a result, our total monthly capacity for 300mm wafer fabs was increased from 414,680 wafers as of December 31, 2013 to 494,696 wafers as of December 31, 2014. Expansion and modification of our production facilities will, among other factors, increase our costs. For example, we will need to purchase additional equipment, train personnel to operate the new equipment or hire additional personnel. If we do not increase our net revenue accordingly, in order to offset these higher costs, our financial performance may be adversely affected. See Item 4. Information on the Company Capacity Management and Technology Upgrade Plans for a further discussion.

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We may not be able to implement our planned growth or development if we are unable to obtain sufficient financial resources to meet our future capital requirements.

Planning capital requirements is challenging in the highly dynamic, cyclical and rapidly changing semiconductor industry, especially during times of general market volatility in the fixed income, interest rates, foreign currencies and equities markets. From time to time and increasingly so for the foreseeable next few years, we will continue to need significant capital to fund our operations and manage our capacity in accordance with market demand. Our continued ability to obtain sufficient external financing is subject to a variety of uncertainties, including:

our future financial condition, results of operations and cash flow;

general market conditions for financing activities;

market conditions for financing activities of semiconductor companies; and

social, economic, financial, political and other conditions in Taiwan and elsewhere.

Sufficient external financing may not be available to us on a timely basis, on reasonable market terms, or at all. As a result, we may be forced to curtail our expansion and modification plans or delay the deployment of new or expanded services until we obtain such financing.

We may not be able to implement our planned growth and development or maintain our leading position if we are unable to recruit and retain qualified executives, managers and skilled technical and service personnel.

We rely on the continued services and contributions of our executive officers and skilled technical and other personnel. Our business could suffer if we lose, for whatever reasons, the services and contributions of some of these personnel and we cannot adequately replace them. We may be required to increase or reduce the number of employees in connection with any business expansion or contraction, in accordance with market demand for our products and services. Since there is intense competition for the recruitment of these personnel, we cannot ensure that we will be able to fulfill our personnel requirements in a timely manner during an economic upturn.

We may be unable to obtain in a timely manner and at a reasonable cost equipment that are necessary for us to remain competitive.

Our operations and ongoing expansion plans depend on our ability to obtain an appropriate amount of equipment and related services from a limited number of suppliers in a market that is characterized from time to time by limited supply and long delivery cycles. During such times, supplier-specific or industry-wide lead times for delivery can be as long as six months or more. To better manage our supply chain, we have implemented various business models and risk management contingencies with suppliers to shorten the procurement lead time. Further, the growing complexities especially in next-generation lithographic technologies may delay the timely availability of the equipment and parts needed to exploit time sensitive business opportunities and also increase the market price for such equipment and parts. If we are unable to obtain equipment in a timely manner to fulfill our customers' demands on technology and production capacity, or at a reasonable cost, our financial condition and results of operations could be negatively impacted.

Our revenue and profitability may decline if we are unable to obtain adequate supplies of raw materials in a timely manner and at reasonable prices.

Our production operations require that we obtain adequate supplies of raw materials, such as silicon wafers, gases, chemicals, and photoresist, on a timely basis. In the past, shortages in the supply of some materials, whether by specific vendors or by the semiconductor industry generally, have resulted in occasional industry-wide price adjustments and delivery delays. In addition, major natural disasters, political or economic turmoil occurring within the country of origin of such raw materials may also significantly disrupt the availability of such raw materials or increase their prices. Also, since we procure some of our raw materials from sole-source suppliers, there is a risk that our need for such raw materials may not be met or that back-up supplies may not be readily available. Our revenue and earnings could decline if we are unable to obtain adequate supplies of the necessary raw materials in a timely manner or if there are significant increases in the costs of raw materials that we cannot pass on to our customers.

If the Ministry of Economic Affairs uses a substantial portion of our production capacity, we will not be able to service our other customers.

According to our agreement with the Industrial Technology Research Institute of Taiwan, or ITRI, the Ministry of Economic Affairs of the R.O.C., or an entity designated by the Ministry of Economic Affairs, has an option to purchase up to 35% of certain of our capacity, if our outstanding commitments to our customers are not prejudiced. Although the Ministry of Economic Affairs has never exercised this option, if this option is exercised to any significant degree during tight market conditions, we may not be able to provide services to all of our other customers unless we are able to increase our capacity accordingly or outsource such increased demand in a timely manner.

Table of Contents***Any inability to obtain, preserve, enforce, defend and protect our technologies and intellectual property rights and third-party licenses could harm our competitive position.***

Our ability to compete successfully and to achieve future growth will depend in part on the continued strength of our intellectual property portfolio. While we actively enforce and protect our intellectual property rights, there can be no assurance that our efforts will be adequate to prevent the misappropriation or improper use of our proprietary technologies, trade secrets, software or know-how. Also, we cannot assure you that, as our business or business models expand into new areas, or otherwise, we will be able to develop independently the technologies, trade secrets, patents, software or know-how necessary to conduct our business or that we can do so without unknowingly infringing the intellectual property rights of others. As a result, we may have to rely on, to a certain degree, licensed technologies and patent licenses from others. To the extent that we rely on licenses from others, there can be no assurance that we will be able to obtain any or all of the necessary licenses in the future on terms we consider reasonable or at all. The lack of necessary licenses could expose us to claims for damages and/or injunctions from third parties, as well as claims for indemnification by our customers in instances where we have contractually agreed to indemnify our customers against damages resulting from infringement claims.

We have received, from time-to-time, communications from third parties asserting that our technologies, manufacturing processes, the design of the integrated circuits made by us or the use by our customers of semiconductors made by us may infringe upon their patents or other intellectual property rights. Because of the nature of the industry, we may continue to receive such communications in the future. In some instances, these disputes have resulted in litigation. Recently, there has been a notable increase in the number of claims or lawsuits initiated by certain litigious, non-practicing entities and these litigious, non-practicing entities are also becoming more aggressive in their monetary demands and requests for court-issued injunctions. Such lawsuits or claims may increase our cost of doing business and may potentially be extremely disruptive if the plaintiffs succeed in blocking the trade of our products and services.

If we fail to obtain or maintain certain technologies or intellectual property licenses and, if litigation relating to alleged intellectual property matters occurs, it could prevent us from manufacturing or selling particular products or applying particular technologies, which could reduce our opportunities to generate revenues. See Item 8. Financial Information Legal Proceedings for a further discussion.

We are subject to the risk of loss due to explosion and fire because some of the materials we use in our manufacturing processes are highly combustible.

We and many of our suppliers use highly combustible and toxic materials in our manufacturing processes and are therefore subject to the risk of loss arising from explosion, fire, or environmental influences which cannot be completely eliminated. Although we maintain many overlapping risk prevention and protection systems, as well as comprehensive fire and casualty insurance, our risk management and insurance coverage may not be sufficient to cover all of our potential losses. If any of our fabs or vendor facilities were to be damaged, or cease operations as a result of an explosion, fire, or environmental influences, it could reduce our manufacturing capacity and may cause us to lose important customers, thereby having a potentially adverse and material impact on our financial performance.

Any impairment charges may have a material adverse effect on our net income.

Under IFRSs, we are required to evaluate our investments, tangible assets and intangible assets for impairment whenever triggering events or changes in circumstances indicate that the asset may be impaired. If certain criteria are met, we are required to record an impairment charge. We are also required under IFRSs to evaluate goodwill for impairment at least on an annual basis or more frequently whenever triggering events or changes in circumstances

indicate that goodwill may be impaired and the carrying value may not be recoverable. We hold investments in certain publicly listed and private companies, some of which have incurred certain impairment charges as discussed further in our financial statements. We are not able to estimate the extent or timing of any impairment charge for future years. Any impairment charge required may have a material adverse effect on our net income.

The determination of an impairment charge at any given time is based significantly on our expected results of operations over a number of years subsequent to that time. As a result, an impairment charge is more likely to occur during a period when our operating results are otherwise already depressed. See Item 5. Operating and Financial Reviews and Prospects Critical Accounting Policies And Judgments for a discussion of how we assess if an impairment charge is required and, if so, how the amount is determined.

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Having one or more large customers that account for a significant percentage of our revenues may render us vulnerable to the loss of or significant curtailment of purchases by one or more large customers that could in turn adversely affect our results of operations.

Over the years, our customer profile and the nature of our customers' business have changed dramatically. While we generate revenue from hundreds of customers worldwide, our ten largest customers accounted for approximately 60%, 62% and 63 % of our net revenue in 2012, 2013 and 2014, respectively. Our largest customer accounted for 17%, 22% and 21% of our net revenue in 2012, 2013 and 2014, respectively. This customer concentration results in part from the changing dynamics of the electronics industry with the structural shift to mobile devices and applications and software that provide the content for such devices. There are only a limited number of customers who are successfully exploiting this new business model paradigm. Also, in order to respond to the new business model paradigm, we have seen the changes of nature in our customers' business models. For example, there is a growing trend toward the rise of system houses that operate in a manner which make their products and services more marketable in a changing consumer market. The loss of, or significant curtailment of purchases by, one or more of our top customers, including curtailments due to increased competitive pressures, industrial consolidation, a change in their designs, or change in their manufacturing sourcing policies or practices of these customers, or the timing of customer or distributor inventory adjustments, or change in our major customers' business models may adversely affect our results of operations and financial condition.

Any failure to achieve and maintain effective internal controls could have a material adverse effect on our business and results of operations.

Effective internal controls are necessary for us to provide reasonable assurance with respect to our financial reports and to effectively prevent fraud. If we cannot provide reasonable assurance with respect to our financial reports and effectively prevent fraud and corruption, our reputation and results of operations could be harmed.

We are required to comply with various R.O.C. and U.S. laws and regulations on internal controls. But internal controls may not prevent or detect misstatements because of their inherent limitations, including the possibility of human error, the circumvention or overriding of controls, fraud or corruption. Therefore, even effective internal controls can provide only reasonable assurance with respect to the preparation and fair presentation of financial statements. If we fail to maintain the adequacy of our internal controls, our business and operating results could be harmed, we could fail to meet our reporting obligations, and there could be a material adverse effect on the market price of our common shares and ADSs.

Our global manufacturing, design and sales activities subject us to risks associated with legal, political, economic or other conditions or developments in various jurisdictions, including in particular the R.O.C., which could negatively affect our business and financial status and therefore the market value of your investment.

The majority of our principal executive officers and our principal production facilities are located in the R.O.C., and a substantial majority of our net revenues are derived from our operations in the R.O.C. In addition, we have operations worldwide and a significant percentage of our revenue comes from sales to locations outside the R.O.C. Operating in the R.O.C. and overseas exposes us to changes in policies and laws, as well as the general political, economic and social conditions, outbreak of war or hostilities, terrorism, security risks, social unrests, protests, strikes, health conditions and possible disruptions in transportation networks, in the various countries in which we operate, which could result in an adverse effect on our business operations in such countries and our results of operations as well as the market price and the liquidity of our ADSs and common shares.

For example, the financial markets have viewed certain past developments in relations between the R.O.C. and P.R.C. as occasions to depress general market prices of the securities of Taiwanese companies, including our own. In addition, the R.O.C. government has not lifted some trade and investment restrictions imposed on Taiwanese companies on the amount and types of certain investments that can be made in P.R.C. In addition to the above factors, future expansions of our operations in Taiwan will likely be handicapped by shortages in water and electricity, the limited availability of commercial-use land, and experienced human resources.

Our operational results could also be materially and adversely affected by natural disasters, shortages or interruptions in the supply of utilities (such as water or electricity), in the locations in which we, our customers or our suppliers operate.

The frequency and severity of natural disasters and severe weather has been increasing, in part due to climate change. We have manufacturing and other operations in locations subject to natural disasters, such as severe weather, flooding, earthquakes, tsunamis, and droughts as well as interruptions or shortages in the supply of utilities, such as water and electricity, which could disrupt operations. We source key raw materials from locations subject to natural disasters, such as severe weather, flooding, earthquakes, tsunamis, and droughts, and any major natural disaster occurring in any such locations may cause disruptions to our business, operations and financial performance. In addition, our suppliers and customers also have operations in such locations. For example, most of our production facilities, as well as those of many of our suppliers and customers and upstream providers of complementary semiconductor manufacturing services, are located in Taiwan and Japan, which are susceptible to earthquakes, tsunamis, flooding, typhoons, and droughts from time to time that may cause shortages in electricity and water. In addition, we have occasionally suffered power outages or surges in Taiwan caused by difficulties encountered by our electricity supplier, the Taiwan Power Company, or other power consumers on the same power grid, which have resulted in interruptions to our operations. While our business continuity management and emergency response plans are intended to prevent or minimize losses in the future, there is no assurance that the measures will fully eliminate the losses or our business insurance policies will fully cover any losses. One or more natural disasters, shortage or interruptions to the supply of utilities that results in a prolonged disruption to our operations, or the operations of our customers or suppliers, may adversely affect the results of our operations and financial conditions.

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Our failure to comply with applicable environmental and climate related laws and regulations, as well as international laws, regulations and accords to which we are subject, could also harm our business and operational results.

The manufacturing, assembling and testing of our products require the use of metals, chemicals, minerals and materials that are subject to environmental, climate-related, health and safety, and humanitarian conflict-free sourcing laws (such as the U.S. SEC rule for filing Form SD to disclose the origins of certain strategic minerals), regulations and guidelines issued worldwide. Although we may be eligible for various exemptions and/or extensions of time for compliance, our failure to comply with any of these applicable laws or regulations could result in:

significant penalties and legal liabilities, such as the denial of import permits;

the temporary or permanent suspension of production of the affected products;

unfavorable alterations in our manufacturing, fabrication and assembly and test processes;

challenges from our customers that place us at a significant competitive disadvantage, such as loss of actual or potential sales contracts in case we are unable to satisfy the conditions regarding environmental laws or requirements by our customers;

restrictions on our operations or sales;

loss of tax benefits, including termination of current tax incentives, disqualification of tax credit application and repayment of the tax benefits that we are not entitled to; and

damages to our goodwill and reputation.

Existing and future environmental and climate related laws and regulations as well as applicable international accords to which we are subject, could also require us, among other things, to do the following: (a) purchase, use or install expensive pollution control, reduction or remediation equipment; (b) implement climate change mitigation programs and abatement or reduction of greenhouse gas emissions programs, or carbon credit trading programs; (c) modify our product designs and manufacturing processes, or incur other significant expenses associated with such laws and regulations such as obtaining substitute raw materials or chemicals that may cost more or be less available for our operations. It is still unclear whether such necessary actions would affect the reliability or efficiency of our products and services.

The above contingencies resulting from the actual and potential impact of local or international laws and regulations, as well as international accords on environmental or climate change, could harm our business and operational results by increasing our expenses or requiring us to alter our manufacturing and assembly and test processes. For further details, please see our compliance record with Taiwan and international environmental and climate related laws and regulations in Item 4. Information on the Company Environmental Regulations .

Climate change, other environmental concerns and green initiatives also present other commercial challenges, economic risks and physical risks that could harm our operational results or affect the manner in which we conduct our business.

Increasing climate change and environmental concerns could affect the results of our operations if any of our customers request that we provide products and services that exceed any existing standard(s) of environmental compliance. If we are unable to offer such products or offer products that are compliant, but are not as reliable due to the lack of reasonably available alternative technologies or materials, we may lose market share to our competitors.

In addition, our inability to timely obtain environmental related approvals needed to undertake the development and construction of a new fab or expansion project may delay, limit, or increase the cost of our expansion plans that could also in turn adversely affect our business and operational results. In light of increased public interest in environmental issues, our operations and expansion plans may be adversely affected or delayed responding to public concern and social environmental pressures even if we comply with all applicable laws and regulations.

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Further, energy costs in general could increase significantly due to climate change and other regulations. Therefore, our energy costs may increase significantly if utility or power companies pass on their costs, either fully or partially, such as those associated with carbon taxes, emission caps and carbon credit trading programs. For further details, please see details of our business continuity management of climate change policy in Item 4. Information on the Company Environmental Regulation .

To mitigate risks resulting from climate change, we continue to actively carry out energy conservation measures and voluntary perfluorinated compounds (PFC) emission reduction projects, and conduct greenhouse gas inventories verification every year.

Adverse fluctuations in exchange rates could decrease our operating margin.

Over one-half of our capital expenditures and manufacturing costs are denominated in currencies other than NT dollars, primarily in U.S. dollars, Japanese yen and Euros. In 2014, more than 90% of our revenue were denominated in U.S. dollars and currencies other than NT dollars. Therefore, any significant fluctuation to our disadvantage in such exchange rates would have an adverse effect on our financial condition. Specifically, based on our 2014 results, every 1% depreciation of the U.S. dollar against the NT dollar exchange rate may result in approximately 0.4 percentage point decrease in our operating margin. In addition, fluctuations in the exchange rate between the U.S. dollar and the NT dollar may affect the U.S. dollar value of our common shares and the market price of the ADSs and of any cash dividends paid in NT dollars on our common shares represented by ADSs. Please see Item 11. Quantitative and Qualitative Disclosures About Market Risk for a further discussion on the possible impact of other market factors on our results of operations.

Fluctuations in inflationary and deflationary expectations and resulting general market volatility could negatively affect costs of and demand for our products and services, which may harm our financial results.

The world economy is becoming more vulnerable to sudden unexpected fluctuations in inflationary and deflationary expectations and conditions. Both high inflation and deflation adversely affect an economy, at both the macro and micro levels, by reducing economic efficiency and disrupting saving and investment decisions. These macro-economic changes have resulted in general world market volatility across all assets classes. Such fluctuations and volatility may negatively affect the costs of our operations and the business operations of our customers who may be forced to plan their purchases of our goods and services within an uncertain economy. Therefore, the demand for our products and services could unexpectedly fluctuate severely in accordance with expectations of inflation or deflation as affected by macro market volatility. Please see Item 5. Operating and Financial Reviews and Prospects Inflation & Deflation for a further discussion.

Amendments to existing tax regulations or new tax legislation in the R.O.C. may have an adverse effect on our net income.

While we are subject to tax laws and regulations in various jurisdictions in which we operate or conduct business, our principal operations are conducted in the R.O.C. and we are exposed primarily to taxes levied by the government of the R.O.C. Any unfavorable changes of tax laws and regulations in this jurisdiction could increase our effective tax rate and have an adverse effect on our operating results. See Item 5. Operating and Financial Reviews and Prospects Taxation for further discussion of significant tax regulation changes.

If certain of our strategic investments fail to achieve their respective forecasted returns or objectives, we may suffer financial losses that may materially lower our profit margin and distributable earnings.

From time to time, we have made or will make a series of strategic investments. For example, we have invested to develop potential business in solar power. There is no guarantee that any of such investments will be successful commercially. Any such investment will incur risks, which may result in losses even with careful management. Any such loss resulting from such investments may result in significant impairment charges, lower profit margin and ultimately lower distributable earnings. For further information on these investments, please see Item 4. Information on the Company Our Subsidiaries and Affiliates .

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If our internet security systems succumb to cyber attacks initiated by third party entities worldwide, our manufacturing as well as daily operations may be severely interrupted or shutdown indefinitely that may materially harm our financial results, our commitments to our customers and stakeholders and corporate goodwill.

Even though we have established a comprehensive internet and computing security network, we cannot guarantee that our computing systems which control or maintain vital corporate functions like our manufacturing operations and enterprise accounting would be completely immune to crippling cyber viral attacks launched by third party to gain unauthorized access to our internal network systems to sabotage our operations and goodwill. In the event of a serious cyber attack, our systems may lose important corporate data and our production lines may be shutdown indefinitely pending the resolution of such attack. These cyber attacks may also attempt to steal our trade secrets and other intellectual properties and other sensitive information, such as personal information of our employees and proprietary information of our customers and other stakeholders. Malicious hackers may also try to introduce computer viruses or corrupted software into our network systems to disrupt our operations or spy for sensitive information. These attacks may result in us having to pay damages for our delayed or disrupted orders or incur significant expenses in attempting to re-establish control over our network. If we are not able to timely resolve the technical difficulties caused by such cyber attacks, our financial results as well as our commitments to our customers and other stakeholders may be materially impaired.

Risks Relating to Ownership of ADSs

Your voting rights as a holder of ADSs will be limited.

Holders of American Depositary Receipts (ADRs) evidencing ADSs may exercise voting rights with respect to the common shares represented by these ADSs only in accordance with the provisions of our ADS deposit agreement. The deposit agreement provides that, upon receipt of notice of any meeting of holders of our common shares, the depositary bank will, as soon as practicable thereafter, mail to the holders (i) the notice of the meeting sent by us, (ii) voting instruction forms and (iii) a statement as to the manner in which instructions may be given by the holders.

ADS holders will not generally be able to exercise the voting rights attaching to the deposited securities on an individual basis. According to the provisions of our ADS deposit agreement, the voting rights attaching to the deposited securities must be exercised as to all matters subject to a vote of shareholders collectively in the same manner, except in the case of an election of directors. Election of directors is by means of cumulative voting. See Item 10. Additional Information Voting of Deposited Securities for a more detailed discussion of the manner in which a holder of ADSs can exercise its voting rights.

You may not be able to participate in rights offerings and may experience dilution of your holdings.

We may, from time to time, distribute rights to our shareholders, including rights to acquire securities. Under our ADS deposit agreement, the depositary bank will not distribute rights to holders of ADSs unless the distribution and sale of rights and the securities to which these rights relate are either exempt from registration under the United States Securities Act of 1933, as amended, (the Securities Act), with respect to all holders of ADSs, or are registered under the provisions of the Securities Act. Although we may be eligible to take advantage of certain exemptions for rights offerings by certain foreign companies, we can give no assurance that we can establish an exemption from registration under the Securities Act, and we are under no obligation to file a registration statement with respect to any such rights or underlying securities or to endeavor to have such a registration statement declared effective. Accordingly, holders of ADSs may be unable to participate in our rights offerings and may experience dilution of their holdings as a result.

If the depositary bank is unable to sell rights that are not exercised or not distributed or if the sale is not lawful or reasonably practicable, it will allow the rights to lapse, in which case you will receive no value for these rights.

The value of your investment may be reduced by possible future sales of common shares or ADSs by us or our shareholders.

One or more of our existing shareholders may, from time to time, dispose of significant numbers of our common shares or ADSs. For example, the National Development Fund of Taiwan, R.O.C. which owned 6.38% of TSMC's outstanding shares as of February 28, 2015, has from time to time in the past sold our shares in the form of ADSs in several transactions.

We cannot predict the effect, if any, that future sales of ADSs or common shares, or the availability of ADSs or common shares for future sale, will have on the market price of ADSs or common shares prevailing from time to time. Sales of substantial amounts of ADSs or common shares in the public market, or the perception that such sales may occur, could depress the prevailing market price of our ADSs or common shares.

The market value of our shares may fluctuate due to the volatility of, and government intervention in, the R.O.C. securities market.

The Taiwan Stock Exchange experiences from time to time substantial fluctuations in the prices and volumes of sales of listed securities. There are currently limits on the range of daily price movements on the Taiwan Stock Exchange. In response to past

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declines and volatility in the securities markets in Taiwan, and in line with similar activities by other countries in Asia, the government of the R.O.C. formed the Stabilization Fund, which has purchased and may from time to time purchase shares of Taiwan companies to support these markets. In addition, other funds associated with the R.O.C. government have in the past purchased, and may from time to time purchase, shares of Taiwan companies on the Taiwan Stock Exchange or other markets. These funds have disposed and may from time to time dispose shares of Taiwan companies so purchased at a later time. In the future, market activity by government entities, or the perception that such activity is taking place, may take place or has ceased, may cause fluctuations in the market prices of our ADSs and common shares.

ITEM 4. INFORMATION ON THE COMPANY

Our History and Structure

Our legal and commercial name is (Taiwan Semiconductor Manufacturing Company Limited). We believe we are currently the world's largest dedicated foundry in the semiconductor industry. We were founded in 1987 as a joint venture among the R.O.C. government and other private investors and were incorporated in the R.O.C. on February 21, 1987. Our common shares have been listed on the Taiwan Stock Exchange since September 5, 1994, and our ADSs have been listed on the New York Stock Exchange since October 8, 1997.

Our Principal Office

Our principal executive office is located at No. 8, Li-Hsin Road 6, Hsinchu Science Park, Hsinchu, Taiwan, Republic of China. Our telephone number at that office is (886-3) 563-6688. Our web site is www.tsmc.com. Information contained on our website is not incorporated herein by reference and does not constitute part of this annual report.

Business Overview of the Company

As a foundry, we manufacture semiconductors using our manufacturing processes for our customers based on their own or third parties' proprietary integrated circuit designs. We offer a comprehensive range of wafer fabrication processes, including processes to manufacture CMOS logic, mixed-signal, radio frequency, embedded memory, BiCMOS mixed-signal and other semiconductors. We estimate that our revenue market segment share among total foundries worldwide was 54% in 2014. We also offer design, mask making, bumping, probing, and assembly and testing services.

We believe that our large capacity, particularly for advanced technologies, is a major competitive advantage. Please see "Manufacturing Capacity and Technology" and "Capacity Management and Technology Upgrade Plans" for a further discussion of our capacity.

We count among our customers many of the world's leading semiconductor companies, ranging from fabless semiconductor, system companies to integrated device manufacturers, including, but not limited to, Advanced Micro Devices, Inc., Broadcom Corporation, Freescale Semiconductor, Inc., Huawei Tech, Marvell Semiconductor Inc., MediaTek Inc., NVIDIA Corporation, NXP Semiconductors, OmniVision Technologies, Qualcomm Inc. and Texas Instruments Inc. Fabless semiconductor and system companies accounted for approximately 85%, and integrated device manufacturers accounted for approximately 15% of our net revenue in 2014.

Our Semiconductor Facilities

We currently operate one 150mm wafer fab, six 200mm wafer fabs and three 300mm wafer fabs. Our corporate headquarters and five of our fabs are located in the Hsinchu Science Park, two fabs are located in the Southern Taiwan Science Park, one fab is located in the Central Taiwan Science Park, one fab is located in the United States, and one fab is located in Shanghai. Our corporate headquarters and our five fabs in Hsinchu occupy parcels of land of a total of approximately 559,304 square meters. We lease these parcels from the Hsinchu Science Park Administration in Hsinchu under agreements that will be up for renewal between June 2015 and December 2033. We have leased from the Central Taiwan Science Park Administration a parcel of land of approximately 184,408 square meters for our Taichung fabs under agreements that will be up for renewal in September 2029. We have leased from the Southern Taiwan Science Park Administration approximately 765,270 square meters of land for our fabs in the Southern Taiwan Science Park under agreements that will be up for renewal between July 2017 and July 2034. We also own approximately 143,215 square meters of land located in Miaoli, Taiwan. WaferTech owns a parcel of land of approximately 1,052,186 square meters in the State of Washington in the United States, where the WaferTech fab and related offices are located. TSMC China owns the land use rights of 369,087 square meters of land in Shanghai, where Fab 10 and related offices are located. Other than certain equipment under leases located at testing areas, we own all of the buildings and equipment for our fabs. We are expanding our 300mm fabrication capacity and research and development through Fab 12 in the Hsinchu Science Park, Fab 14 in the Southern Taiwan Science Park and Fab 15 in the Central Taiwan Science Park. Total monthly capacity for 300mm wafer fabs was increased from 414,680 wafers as of December 31, 2013 to 494,696 wafers as of December 31, 2014. We will continuously evaluate our capacity in light of prevailing market conditions.

Table of Contents**Semiconductor Manufacturing Capacity and Technology**

We manufacture semiconductors on silicon wafers based on proprietary circuitry designs provided by our customers or third party designers. Two key factors that characterize a foundry's manufacturing capabilities are output capacity and fabrication process technologies. Since our establishment, we have possessed the largest capacity among the world's dedicated foundries. We also believe that we are the technology leader among the dedicated foundries in terms of our net revenue of advanced semiconductors with a resolution of 28-nanometer and below, and are one of the leaders in the semiconductor manufacturing industry generally. We are the first dedicated foundry with proven low-k interconnect technology in commercial production from the 0.13 micron node down to 28-nanometer node. In 2012, we continued 20-nanometer technology development to provide a migration path from 28-nanometer for both performance driven products and mobile computing applications. In 2014, we started volume production of 20-nanometer technology and continued the development of 16- and 10-nanometer technologies.

The following table lists our fabs and those of our affiliates, together with the year of commencement of commercial production, technology and capacity during the last three years:

Fab ⁽¹⁾	Year of commencement	Current most advanced technology for volume production ⁽²⁾	Monthly capacity ⁽³⁾⁽⁴⁾⁽⁵⁾		
			2012	2013	2014
2	1990	450	21,516	21,623	21,623
3	1995	150	45,788	42,975	42,768
5	1997	150	22,155	14,891	16,157
6	2000	110	44,640	64,044	67,650
8	1998	110	39,817	32,348	34,926
10	2004	150	35,689	37,200	41,333
11	1998	150	16,667	16,889	17,222
12	2001	20	128,776	124,912	127,998
14	2004	20	186,161	190,001	252,350
15	2012	28	51,903	99,767	114,348
Total ⁽⁵⁾			593,112	644,650	736,375

(1) Fab 2 produces 150mm wafers. Fabs 3, 5, 6, 8, 10 and Fab 11 (WaferTech) produce 200mm wafers. Fab 12, Fab 14 and Fab 15 produce 300mm wafers. Fabs 2, 3, 5, 8 and 12 are located in Hsinchu Science Park. Fab 6 and Fab 14 are located in the Southern Taiwan Science Park. Fab 15 is located in Central Taiwan Science Park.

WaferTech is located in the United States and Fab 10 is located in Shanghai.

(2) In nanometers, as of year-end.

(3) Estimated capacity in 300mm equivalent wafers as of year-end for the total technology ranges available for production.

(4) Under an agreement with VIS, TSMC is required to use its best commercial efforts to maintain utilization of a certain amount of reserved capacity as agreed by both parties. Please see Item 7. Major Shareholders and Related Party Transactions - Related Party Transactions - Vanguard International Semiconductor Corporation for a discussion of certain of the VIS contract terms. The amounts to be used at VIS are not included in our monthly

capacity figures.

- (5) Under an agreement with SSMC, TSMC is required to maintain utilization of a certain amount of reserved capacity as agreed by the parties. Please see Item 7. Major Shareholders and Related Party Transactions Related Party Transactions Systems on Silicon Manufacturing Company Pte. Ltd. for a discussion of certain of the SSMC contract terms. The amounts to be used at SSMC are not included in our monthly capacity figures.

As of December 31, 2014, our monthly capacity (in 300mm equivalent wafers) was 736,375 wafers, compared to 644,650 wafers at the end of 2013. This increase was primarily due to the expansion of our 20-nanometer advanced technology. Our semiconductor manufacturing facilities require substantial investment to construct and are largely fixed-cost assets once they are in operation. Because we own most of our manufacturing capacity, a significant portion of our operating costs is fixed. In general, these costs do not decline when customer demand or our capacity utilization rates drop, and thus declines in customer demand, among other factors, may significantly decrease our margins. Conversely, as product demand rises and factory utilization increases, the fixed costs are spread over increased output, which can improve our margins.

Capacity Management and Technology Upgrade Plans

We perform long term market demand forecasts to estimate general economic and market conditions for our products and services. Based upon these estimates, we manage our overall capacity in accordance with market demand. For example, such planning enables us to match significant customer demands for our services with the corresponding capacity increase needed to fulfill such demands. Since market conditions may vary significantly and unexpectedly, our market demand forecast may change significantly at any time. Based on our current market demand forecasts, we intend to maintain our strategy of expanding manufacturing capacity and improving manufacturing process technologies to meet both the fabrication and the technological needs of our customers.

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Our capital expenditures in 2012, 2013 and 2014 were NT\$246,137 million, NT\$287,595 million and NT\$288,540 million (US\$9,522 million, translated from a weighted average exchange rate of NT\$30.303 to US\$1.00), respectively. Our capital expenditures in 2015 are expected to be approximately US\$11.5 billion to US\$12.0 billion, which, depending on market conditions, may be adjusted later. Our capital expenditures for 2012 and 2013 were funded by our operating cash flow and the issuance of corporate bonds and the capital expenditures for 2014 were funded by operating cash flow. Our capital expenditures for 2015 are expected to be funded primarily by our operating cash flow. In 2015, we anticipate our capital expenditures to focus primarily on the following:

adding production capacity to our 300mm wafer fabs;

developing new process technologies in 10-nanometer node and below;

expanding buildings/facilities for Fab 12, Fab 14 and Fab 15;

other research and development projects; and

capacity expansion for mask and backend operations.

These investment plans are still preliminary and may change according to market conditions.

Markets and Customers

The primary customers of our foundry services are fabless semiconductor companies, systems companies and integrated device manufacturers. The following table presents the breakdown of net revenue, including foundry services and others, by type of customers during the last three years:

Customer Type	Year ended December 31,					
	2012		2013		2014	
	Net Revenue	Percentage	Net Revenue	Percentage	Net Revenue	Percentage
	(NT\$ in millions, except percentages)					
Fabless semiconductor companies/systems companies	432,090	85.3%	519,142	87.0%	646,936	84.8%
Integrated device manufacturers	74,007	14.6%	76,967	12.9%	114,620	15.0%
Others	648	0.1%	915	0.1%	1,250	0.2%
Total	506,745	100.0%	597,024	100.0%	762,806	100.0%

We categorize our net revenue mainly based on the country in which the customer is headquartered, which may be different from the net revenue for the countries to which we actually sell or ship our products or different from where products are actually ordered. Under this approach, the following table presents a regional geographic breakdown of our net revenue during the last three years:

Region	Year ended December 31,					
	2012		2013		2014	
	Net Revenue	Percentage	Net Revenue	Percentage	Net Revenue	Percentage
	(NT\$ in millions, except percentages)					
North America	345,478	68.2%	425,053	71.2%	527,256	69.1%
Asia Pacific	73,381	14.5%	78,500	13.2%	98,423	12.9%
China	24,674	4.9%	37,646	6.3%	50,514	6.6%
EMEA ⁽¹⁾	46,430	9.1%	41,288	6.9%	46,777	6.2%
Japan	16,782	3.3%	14,537	2.4%	39,836	5.2%
Total	506,745	100.0%	597,024	100.0%	762,806	100.0%

⁽¹⁾ EMEA stands for Europe, Middle East, and Africa.

We provide worldwide customer support. Our office in Hsinchu and wholly-owned subsidiaries in the United States, Canada, Japan, Mainland China, the Netherlands and South Korea are dedicated to serving our customers worldwide. Foundry services, which are both technologically and logistically intensive, involve frequent and in-depth interaction with customers. We believe that the most effective means of providing foundry services is by developing direct and close relationships with our customers. Our customer service and technical support managers work closely with the sales force to offer integrated services to customers. To facilitate customer interaction and information access on a real-time basis, a suite of web-based applications have also been offered to provide more active interactions with customers in design, engineering and logistics.

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Commitments by Customers. Because of the fast-changing technology and functionality in semiconductor design, foundry customers generally do not place purchase orders far in advance to manufacture a particular type of product. However, we engage in discussions with customers regarding their expected manufacturing requirements in advance of the placement of purchase orders.

Some of our customers have entered into arrangements with us to ensure that they have access to specified capacity. These arrangements are primarily in the form of deposit agreements; and advanced cash deposits are made by customers for specified capacity at our fabs. Deposits are generally refunded when the terms and conditions set forth in the deposit agreement are satisfied and shipments have been made. As of December 31, 2014, we held approximately US\$950 million on deposit to reserve future capacity.

The Semiconductor Fabrication Process

In general, the semiconductor manufacturing process begins with a thin silicon wafer on which an array of semiconductor devices is fabricated. The following processes cover assembly, packaging, and testing of the semiconductor devices. Our focus is on wafer fabrication although we also provide all other services either directly or through outsourcing arrangements.

Our Foundry Services

Range of Services. Because of our ability to provide a full array of services, we are able to accommodate customers with a variety of needs at every stage of the overall foundry process. The flexibility in input stages allows us to cater to a variety of customers with different in-house capabilities and thus to service a wider class of customers as compared to a foundry that cannot offer design or mask making services, for example.

Fabrication Processes. We manufacture semiconductors using the complementary metal oxide silicon (CMOS) and the bipolar complementary metal oxide silicon (BiCMOS , which uses CMOS transistors in conjunction with bipolar junction transistor) processes. The CMOS process is currently the dominant semiconductor manufacturing process. The BiCMOS process combines the high speed of the bipolar circuitry and the low power consumption and high density of the CMOS circuitry. We use the CMOS process to manufacture logic semiconductors, mixed-signal/radio frequency (RF) semiconductors, which combine analog and digital circuitry in a single semiconductor, micro-electro-mechanical-system (MEMS), which combines micrometer featured mechanical parts, analog and digital circuitry in a single semiconductor, and embedded memory semiconductors, which combine logic and memory in a single semiconductor. The BiCMOS process is used to make high-end mixed-signal and other types of semiconductors.

Types of Semiconductors We Manufacture. We manufacture different types of semiconductors with different specific functions by changing the number and the combinations of conducting, insulating and semiconducting layers and by defining different patterns in which such layers are applied on the wafer. At any given point in time, there are thousands of different products in various stages of fabrication at our fabs. We believe that the keys to maintaining high production quality and utilization rates are our effective management and control of the manufacturing process technologies which comes from our extensive experience as the longest existing dedicated foundry and our dedication to quality control and process improvements.

The following is a general, non-exhaustive description of the key types of semiconductors that we currently manufacture. Depending on future market conditions, we may provide other services or manufacture other types of products that may be additive to or differ significantly from the following:

Logic Semiconductors. Logic semiconductors process digital data to control the operation of electronic systems. The largest segment of the logic market, standard logic devices, includes mobile computing chips, application processors, microcontrollers, digital signal processors (DSP), graphic chips and chipsets.

Mixed-Signal/RF Semiconductors. Analog/digital semiconductors combine analog and digital devices on a single semiconductor to process both analog and digital data. We make mixed-signal/RF semiconductors using both the CMOS and BiCMOS processes. We currently offer CMOS mixed-signal process down to the 28-nanometer technology for manufacturing mixed-signal/RF semiconductors. The primary uses of mixed-signal/RF semiconductors are in hard disk drives, wireless communications equipment and network communications equipment, with those made with the BiCMOS process occupying the higher end of the mixed-signal/RF market.

CMOS Image Sensor Semiconductors. Image sensors are primarily used in camera phones and tablets. We are currently the leading foundry for the production of CMOS image sensors, characterized by technology features including low dark current, high sensitivity, small pixel size and high dynamic range achieved through integration with mixed mode processes.

High Voltage Semiconductors. We currently offer a range of high-voltage processes including high voltage CMOS (HVCMOS), bipolar-CMOS-DMOS (Diffusion Metal Oxide Semiconductor) (BCD) and ultra-high voltage technology (UHV), ranging from 5V to 800V, which are suitable for various panel-size display driver and power supply applications.

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The table below presents a breakdown of our net revenue during the last three years by each semiconductor type:

Semiconductor Type	Year ended December 31,					
	2012		2013		2014	
	Net Revenue	Percentage	Net Revenue	Percentage	Net Revenue	Percentage
(NT\$ in millions, except percentages)						
CMOS						
Logic	352,139	69.5%	424,868	71.2%	573,539	75.2%
Mixed-Signal ⁽¹⁾	150,905	29.8%	167,333	28.0%	183,676	24.1%
Others	3,701	0.7%	4,823	0.8%	5,591	0.7%
Total	506,745	100.0%	597,024	100.0%	762,806	100.0%

⁽¹⁾ Mixed-signal semiconductors made with the CMOS process.

Design and Technology Platforms. Modern IC designers need sophisticated design infrastructure to optimize productivity and cycle time. Such infrastructure includes design flow for electronic design automation (EDA), silicon proven building blocks such as libraries and intellectual properties, simulation and verification design kits such as process design kit (PDK) and technology files. All of this infrastructure is built on top of the technology foundation, and each technology needs its own design infrastructure to be usable for designers. This is the concept of our technology platforms.

For years, we and our alliance partners have spent considerable effort, time and resources to build our technology platforms. We unveiled an Open Innovation Platform[®] (OIP) initiative in 2008 to further enhance our technologies offerings. More OIP deliverables were introduced in 2014. In the design methodology area, we announced the release of 16-nanometer Fin Field-Effect Transistor (FinFET) Plus (16FF+) reference flow for both full-chip and IP design.

Multi-project Wafers Program (CyberShuttle). To help our customers reduce costs, we offer a dedicated multi-project wafer processing service that allows us to provide multiple customers with circuits produced with the same mask. This program reduces mask costs by a very significant amount, resulting in accelerated time-to-market for our customers. We have extended this program to all of our customers and library and intellectual property partners using our broad selection of process technologies, ranging from the latest 16FF+/16-, 20-, 28-, 40-, 45-, 55- and 65-nanometer processes to 0.18-, 0.25-, 0.35- and 0.5-micron. This extension offers a routinely scheduled multi-project wafer run to customers on a shared-cost basis for prototyping and verification.

We developed our multi-project wafer program in response to the current system-on-chip development methodologies, which often require the independent development, prototyping and validation of several intellectual properties before they can be integrated onto a single device. By sharing mask costs among our customers to the extent permissible, the system-on-chip supplier can enjoy reduced prototyping costs and greater confidence that the design will be successful.

Customer Service

We believe that our dedication to customer service has been an indispensable factor in attracting new customers, helping to ensure the satisfaction of existing customers, and building a mutually beneficial relationship with our

customers. The key elements are our:

customer-oriented culture through multi-level interaction with customers;

ability to deliver products of consistent quality, competitive ramp-up speed and fast yield improvement;

responsiveness to customer's issues and requirements, such as engineering change and special wafer handling requests;

flexibility in manufacturing processes, supported by our competitive technical capability and production planning;

dedication to help reduce customer costs through collaboration and services, such as our multi-project wafer program, which combines multiple designs on a single mask set for cost-saving; and

availability of our online service which provides necessary information in design, engineering and logistics to ensure seamless services to our customers throughout product life cycle.

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We also conduct an annual customer satisfaction survey to assess customer satisfaction and to ensure that their needs are adequately understood and addressed. Continuous improvement plans based upon customer feedback are an integral part of this business process. We use data derived from the survey as a key indicator of our corporate performance as well as a leading indicator of future performance. We believe that satisfaction leads to better customer relationships, which would result in more business opportunities.

Research and Development

The semiconductor industry is characterized by rapid changes in technology, frequently resulting in the introduction of new technologies to meet customers' demands and in the obsolescence of recently introduced technology and products. We believe that, in order to stay technologically ahead of our competitors and to maintain our market position in the foundry segment of the semiconductor industry, we need to maintain our position as a technology leader not only in the foundry segment but in the semiconductor industry in general. We spent NT\$40,387 million, NT\$47,952 million and NT\$56,829 million (US\$1,798 million) in 2012, 2013 and 2014, respectively, on research and development, which represented 8.0%, 8.0% and 7.4% of our net revenue, respectively. We plan to continue to invest significant amounts on research and development in 2015, with the goal of maintaining a leading position in the development of advanced process technologies. Our research and development efforts have allowed us to provide our customers access to certain advanced process technologies, such as 28-nanometer and 20-nanometer technology for volume production, prior to the implementation of those advanced process technologies by many integrated device manufacturers and our competitors. In addition, we expect to advance our process technologies further down to 16/10-nanometer and below in the coming years to maintain our technology leadership. We will also continue to invest in research and development for our mature technologies offerings to provide function-rich process capabilities to our customers. Our research and development efforts are divided into centralized research and development activities and research and development activities undertaken by each of our fabs. Our centralized research and development activities are principally directed toward developing new Logic, system-on-chip (SOC), derivatives and package/system-in-package (SIP) technologies, and cost-effective 3D-IC wafer level packaging solutions, including Integrated Fan-Out (InFO) and Chip-on-Wafer-on-Substrate (CoWoS) technologies. Fab-related research and development activities mostly focus on upgrading the manufacturing process technologies.

In continuing to advance our process technologies, we intend to rely primarily on our internal engineering capability and know-how and our research and development efforts, including collaboration with our customers, equipment vendors and research and development consortia.

We also continuously create in-house inventions and know-how. Since our inception, we have applied for and have been issued a substantial number of United States and other patents, the majority of which are semiconductor-related.

Equipment

The quality and technology of the equipment used in the semiconductor manufacturing process are important in that they effectively define the limits of our process technologies. Advances in process technologies cannot be brought about without commensurate advances in equipment technology. To accelerate the development of next-generation lithographic technology, in August 2012 TSMC joined the ASML Holding N.V. Customer Co-Investment Program. The program's scope includes development of extreme ultraviolet (EUV) lithography technology and 450mm lithography tools. Under the agreement with ASML, TSMC made an investment of EUR838 million to acquire 5% of ASML's equity, and has committed EUR276 million, to be spread over five years, to ASML's research and development program.

The principal pieces of equipment used by us to manufacture semiconductors are scanners, cleaners and track equipment, inspection equipment, etchers, furnaces, wet stations, strippers, implanters, sputterers, chemical vapor deposition (CVD) equipment, chemical mechanism polish (CMP) equipment, testers and probers. Other than certain equipment under leases located at testing areas, we own all of the equipment used at our fabs.

In implementing our capacity management and technology advancement plans, we expect to make significant purchases of equipment required for semiconductor manufacturing. Some of the equipment is available from a limited number of vendors and/or is manufactured in relatively limited quantities, and certain equipment has only recently been developed. We believe that our relationships with our equipment suppliers are good and that we have enjoyed the advantages of being a major purchaser of semiconductor fabrication equipment. We work closely with manufacturers to provide equipment customized to our needs for certain advanced technologies.

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Raw Materials

Our manufacturing processes use many raw materials, primarily silicon wafers, chemicals, gases and various types of precious metals. Raw materials costs constituted 13.6%, 12.5% and 13.2% of our net revenue in 2012, 2013 and 2014, respectively. Although most of our raw materials are available from multiple suppliers, some materials are purchased through sole-sourced vendors. Our raw material procurement policy is to select only those vendors who have demonstrated quality control and reliability on delivery time and to maintain multiple sources for each raw material whenever possible so that a quality or delivery problem with any one vendor will not adversely affect our operations. The quality and delivery performance of each vendor is evaluated quarterly and quantity allocations are adjusted for subsequent periods based on the evaluation.

The most important raw material used in our production is silicon wafers, which is the basic raw material from which integrated circuits are made. The principal suppliers for our wafers are Shin-Etsu Handotai and SUMCO Corporation of Japan, SunEdison Semiconductor Ltd. of the United States, Siltronic AG of Germany and Formosa Sumco Technology Corporation of Taiwan. Together they supplied approximately 94.2%, 93.3% and 94.3% of our total wafer needs in 2012, 2013 and 2014, respectively. We have in the past obtained, and believe we will continue to be able to obtain, a sufficient supply of wafers. Please see Item 3. Key Information Risk Factors Risks Relating to Our Business for a discussion of the risk related to raw materials. In order to secure a reliable and flexible supply of high quality wafers, we have entered into long-term agreements and intend to continue to develop strategic relationships with major wafer vendors to cover our anticipated wafer needs for future years. Also, we actively address supply chain issues and bring together fab operations, materials management, quality system and risk management teams to mitigate potential supply chain risks and enhance supply chain agility. This taskforce works with our primary suppliers to review their business continuity plans, qualify their dual-plant materials, prepare safety inventories, improve the quality of their products and manage the supply chain risk of their suppliers.

Competition

We compete internationally and domestically with foundry service providers, as well as with integrated device manufacturers that devote a significant or exclusive portion of their manufacturing capacity to foundry operations. We compete primarily on the basis of process technologies, manufacturing excellence and customer trust. The level of competition differs according to the process technologies involved. For example, in more mature technologies, the competition tends to be more intense. Some companies compete with us in selected geographic regions or application end markets. In recent years, substantial investments have been made by others to establish new foundry capacities worldwide, or to transform certain manufacturing operations of integrated device manufacturers (IDMs) into foundry capacities to compete with us.

Environmental Regulations

The semiconductor production process generates gaseous chemical wastes, liquid wastes, wastewater and other industrial wastes in various stages of the manufacturing process. We have installed in our fabs various types of pollution control equipment for the treatment of gaseous chemical wastes and wastewater and equipment for the recycling of treated water. Operations at our fabs are subject to regulation and periodic monitoring by the R.O.C. Environmental Protection Administration, the U.S. Environmental Protection Agency and the State Environmental Protection Administration of mainland China, and local environmental protection authorities, including the various science park administrations in the R.O.C., the Washington State Department of Ecology and the Shanghai Environmental Protection Bureau.

We have adopted pollution control measures that are expected to result in the effective maintenance of environmental protection standards consistent with the practice of the semiconductor industry in Taiwan, the U.S. and mainland China. We conduct environmental audits at least once annually to ensure that we are in compliance in all material respects with, and we believe that we are in compliance in all material respects with, applicable environmental laws and regulations. An environmental, safety and health (ESH) team operates at the corporate level that is responsible for policy establishment and enforcement, coordination with ESH teams located at each manufacturing facility and for coordinating and interacting with government agencies worldwide.

Electricity and Water

We use electricity supplied by the Taiwan Power Company in our manufacturing process in Taiwan. We have occasionally suffered power outages or surges caused by difficulties encountered by the Taiwan Power Company, which have led to interruptions in our production schedule. The semiconductor manufacturing process uses extensive amounts of electricity and fresh water. Due to the growth of manufacturers in the Hsinchu Science Park, Southern Taiwan Science Park and Central Taiwan Science Park, and the droughts that Taiwan experiences from time to time, there is concern regarding future availability of sufficient electricity and fresh water and the potential impact that insufficient electricity and water supplies may have on our semiconductor production. To help address these potential shortages, we have adopted various natural resources conservation methodologies.

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We employ an enterprise risk management system to integrate the prevention and control of risk that we or our subsidiaries may face. We have also prepared emergency response and business continuity plans to respond to natural disasters and other disruptive events that could interrupt the operation of our business. These plans have been developed in order to prevent or minimize the loss of personnel or damage to our facilities, equipment and machinery caused by natural disasters and other disruptive events. We also maintain insurance with respect to our facilities, equipment and inventories. The insurance for the fabs and their equipment covers, subject to some limitations, various risks, including fire, typhoons, earthquakes and other risks generally up to the respective policy limits for their replacement values and lost profits due to business interruption. In addition, we have insurance policies covering losses with respect to the construction of all our fabs. Equipment and inventories in transit are also insured. No assurance can be given, however, that insurance will fully cover any losses and our emergency response plans will be effective in preventing or minimizing losses in the future. To further help mitigate our major operational and financial risks, our enterprise risk management (ERM) group reports regularly to our Audit Committee composed of independent board directors.

For further information, please see detailed risk factors related to the impact of climate change regulations and international accords, and business trends on our operations in Item 3. Key Information Risk Factors Risks Relating to Our Business .

Our Subsidiaries and Affiliates

Vanguard International Semiconductor Corporation (VIS). In 1994, we, the R.O.C. Ministry of Economic Affairs and other investors established VIS, then an integrated dynamic random access memory (DRAM) manufacturer. VIS commenced volume commercial production in 1995 and listed its shares on the R.O.C. Over-the-Counter (Taipei Exchange) in March 1998. In 2004, VIS completely terminated its DRAM production and became a dedicated foundry company. On April 14, 2014, we sold 82 million common shares of VIS. After this sale, we owned approximately 33.7% of the equity interest in VIS. As of February 28, 2015, we owned approximately 33.3% of the equity interest in VIS. Please see Item 7. Major Shareholders and Related Party Transactions for a further discussion.

WaferTech in the United States. In 1996, we entered into a joint venture called WaferTech (of which the manufacturing entity is Fab 11) with several U.S.-based investors to construct and operate a US\$1.2 billion foundry in the United States. Initial trial production at WaferTech commenced in July 1998 and commercial production commenced in October 1998. As of February 28, 2015, we owned 100% of the equity interest in WaferTech.

Systems on Silicon Manufacturing Company Pte. Ltd. (SSMC). In March 1999, we entered into an agreement with Philips and EDB Investment Pte. Ltd. to found a joint venture, SSMC, and build a fab in Singapore. The SSMC fab commenced production in December 2000. As of February 28, 2015, we owned approximately 38.8% of the equity interest in SSMC. Please see Item 7. Major Shareholders and Related Party Transactions for a further discussion.

Global Unichip Corporation (GUC). In January 2003, we acquired a 52.0% equity interest in GUC, a System-on-Chip (SoC) design service company that provides large scale SoC implementation services. GUC has been listed on Taiwan Stock Exchange since November 3, 2006. As of February 28, 2015, we owned approximately 34.8% of the equity interest in GUC.

TSMC China. In August 2003, we established TSMC China (of which the manufacturing entity is Fab 10), a wholly-owned subsidiary primarily engaged in the manufacturing and selling of integrated circuits. TSMC China commenced production in late 2004.

VisEra Technologies Company, Ltd. (VisEra). In October 2003, we and OmniVision Technologies Inc., entered into a shareholders' agreement to form VisEra Technologies Company, Ltd., a joint venture in Taiwan, for the purpose of providing back-end manufacturing service. As of February 28, 2015, we owned approximately 42.7% of the equity interest in VisEra Technologies Company Ltd.

Xintec, Inc. (Xintec). In January 2007, we acquired a 51.2% equity interest in Xintec, a supplier of wafer level packaging service, to support our CMOS image sensor manufacturing business. Since June 2013, we were no longer deemed to be a controlling entity of Xintec due to the addition of independent directors to Xintec's board, which resulted in our appointed directors on its board representing less than a majority. As a result, we no longer consolidated Xintec in our financial statements. As of February 28, 2015, we owned approximately 39.9% of the equity interest in Xintec. On March 30, 2015, Xintec listed its shares on the R.O.C. Over-the-Counter (Taipei Exchange). Subsequent to Xintec's IPO, our shareholding in Xintec was diluted to approximately 34.6%.

Motech Industries, Inc. (Motech). In February 2010, we acquired a 20.0% equity interest in Motech, a Taiwan solar cell manufacturer. Motech has been a publicly traded company on the R.O.C. Over-the-Counter (Taipei Exchange) since May 2003. In August 2011, we transferred our 20.0% equity interest in Motech to TSMC Solar Ltd. As of February 28, 2015, we owned approximately 19.8% of the equity interest in Motech. On March 2, 2015, Motech and Topcell Solar International Co., Ltd merged, with Motech being the surviving entity. After the closing of such merger currently scheduled in July, 2015, our shareholding in Motech is expected to be diluted to approximately 18.0%.

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TSMC Solar Ltd. (TSMC Solar). We transferred our solar businesses into our subsidiary, TSMC Solar, in August 2011. TSMC Solar is engaged in research, development, design, manufacture and sales of technologies and products related to renewable energy and energy saving. As of February 28, 2015, we owned approximately 99.1% of the equity interest in TSMC Solar.

TSMC Solid State Lighting Ltd. (TSMC SSL). TSMC SSL is engaged in research, development, design, manufacture and sales of solid state lighting devices and related application products and systems. On December 31, 2014, we reclassified TSMC SSL as a disposal group held for sale. On February 17, 2015, TSMS SSL ceased to be our subsidiary because all of our shares in TSMC SSL were sold to Epistar Corporation. On March 18, 2015, TSMC SSL was renamed as CHIP STAR Ltd.

ITEM 4A. UNRESOLVED STAFF COMMENTS

None.

ITEM 5. OPERATING AND FINANCIAL REVIEWS AND PROSPECTS

Overview

We manufacture a variety of semiconductors based on designs provided by our customers. Our business model is commonly called a dedicated semiconductor foundry. The foundry segment of the semiconductor industry as a whole experienced rapid growth over the last 28 years since our inception. As the leader of the foundry segment of the semiconductor industry, our net revenue and net income attributable to shareholders of the parent were NT\$506,745 million and NT\$159,481 million in 2012, NT\$597,024 million and NT\$183,978 million in 2013 and NT\$762,806 million (US\$24,139 million) and NT\$254,302 million (US\$8,048 million) in 2014, respectively. Our net revenue in 2013 increased by 17.8% from 2012, mainly due to continuous growth in customer demand and increase in sales of our 28-nanometer products, which commanded a higher selling price. Our net revenue in 2014 increased by 27.8% from 2013, mainly due to the introduction of the 20-nanometer products and continuing strong demand for 28-nanometer products.

The principal source of our revenue is wafer fabrication, which accounted for approximately 94.9% of our net revenue in 2014. The rest of our net revenue was majorly derived from mask making, design, and royalty income. Factors that significantly impact our revenue include:

the worldwide demand and capacity supply for semiconductor products;

pricing;

capacity utilization;

availability of raw materials and supplies;

technology migration; and

fluctuation in foreign currency exchange rate.

Though equally important, three of the above factors are discussed as follows:

Pricing. We establish pricing levels for specific periods of time with our customers, some of which are subject to adjustment during the course of that period to take into account market developments and other factors. We believe that our large capacity, flexible manufacturing capabilities, focus on customer service and timely delivery of high yield products have contributed to our ability to obtain premium pricing for our wafer products.

Production Capacity. We currently own and operate our semiconductor manufacturing facilities, the aggregate production capacity for which had been expanded from 593,112 300mm equivalent wafers per month as of the end of 2012 to 644,650 300mm equivalent wafers per month as of the end of 2013 and to 736,375 300mm equivalent wafers per month as of the end of 2014.

Technology Migration.

Our operations utilize a variety of process technologies, ranging from mature process technologies of 0.5 micron or above circuit resolutions to advanced process technologies of 20-nanometer circuit resolutions. The table below presents a breakdown of wafer revenue by circuit resolution during the last three years:

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Resolution	Year ended December 31,		
	2012	2013	2014
	Percentage of total wafer revenue ⁽¹⁾	Percentage of total wafer revenue ⁽¹⁾	Percentage of total wafer revenue ⁽¹⁾
20-nanometer	0%	0%	9%
28-nanometer	12%	30%	33%
40/45-nanometer	27%	20%	16%
65-nanometer	23%	16%	14%
90-nanometer	9%	8%	7%
0.11/0.13 micron	6%	4%	3%
0.15 micron	4%	4%	3%
0.18 micron	11%	12%	10%
0.25 micron	4%	3%	3%
0.35 micron	2%	2%	1%
≥0.5 micron	2%	1%	1%
Total	100%	100%	100%

(1) Percentages represent wafer revenue by technology as a percentage of total wafer revenue, which excludes revenue associated with mask making, design, royalty income, etc. Total wafer revenue excludes sales returns and allowances.

First-Time Adoption of IFRSs

On May 14, 2009, the R.O.C. FSC announced that all companies with shares listed on TWSE, including us, were required to prepare consolidated financial statements in accordance with the IFRSs adopted for use in Taiwan (Taiwan-IFRSs) starting January 1, 2013, with a transition date of January 1, 2012. We have prepared and reported our consolidated financial statements under Taiwan-IFRSs and published such financial statements as required under the applicable regulations and listing rules of the TWSE since first quarter of 2013. Prior to 2013, we prepared and reported our consolidated financial statements in accordance with R.O.C. GAAP.

In addition, for our continuing US SEC reporting obligations, we are required to report our financial statements under IFRSs as issued by the IASB. Therefore, the consolidated financial statements included herein have been prepared in accordance with IFRSs as issued by the IASB. See note 42 to our 2013 consolidated financial statements not included herein for the explanation of how the transition from R.O.C. GAAP to IFRSs has affected the reported financial position, financial performance, and cash flows.

Critical Accounting Policies And Judgments

Summarized below are our accounting policies that we believe are important to the portrayal of our financial results and also involve the need for management to make estimates about the effect of matters that are uncertain in nature. Actual results may differ from these estimates, judgments and assumptions. Certain accounting policies are particularly critical because of their significance to our reported financial results and the possibility that future events may differ significantly from the conditions and assumptions underlying the estimates used and judgments made by our management in preparing our financial statements. The following discussion should be read in conjunction with the consolidated financial statements and related notes, which are included in this annual report.

Revenue Recognition. We recognize revenue from the sale of goods when the goods are delivered and titles have passed, at which time all the following conditions are satisfied:

We have transferred to the buyer the significant risks and rewards of ownership of the goods;

We retain neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;

The amount of revenue can be measured reliably;

It is probable that the economic benefits associated with the transaction will flow to us; and

The costs incurred or to be incurred in respect of the transaction can be measured reliably.

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We record a provision for estimated future returns and other allowances in the same period the related revenue is recorded. Provision for estimated sales returns and allowances is generally made and adjusted at a specific percentage based on historical experience, management judgment, and any known factors that would significantly affect the returns and allowances, and our management periodically reviews the adequacy of the percentage used. However, because of the inherent nature of estimates, actual returns and allowances could be different from our estimates. If the actual returns are greater than our estimated amount, we could be required to record an additional provision, which would have a negative impact on our recorded revenue and gross margin.

The provisions recorded as the deduction of revenue were NT\$7,187 million, NT\$6,633 million and NT\$10,506 million (US\$332 million), respectively, representing 1.4%, 1.1% and 1.4% of our gross revenue for the years ended December 31, 2012, 2013 and 2014.

Allowance for Doubtful Accounts. We assess the allowance for doubtful accounts by examining our historical collection experience and current trends in the credit quality of our customers as well as our internal credit policies. If economic conditions or financial conditions of our customers deteriorate, additional allowance may be required in the future and such additional allowance would increase our operating expenses and therefore reduce our operating income and net income.

We evaluate indication of impairment of accounts receivable based on an individual and collective basis at the end of each reporting period. When objective evidence indicates that the estimated future cash flow of accounts receivable decreases as a result of one or more events that occurred after the initial recognition of the accounts receivable, such accounts receivable are deemed to be impaired.

Because of the short average collection period, the amount of the impairment loss recognized is the difference between the carrying amount of accounts receivable and estimated future cash flows without considering the discounting effect. Changes in the carrying amount of the allowance account are recognized as bad debt expense which is recorded in the operating expenses-general and administrative. When accounts receivable are considered uncollectable, the amount is written off against the allowance account.

As of December 31, 2013 and 2014, the allowances set aside for doubtful receivables were NT\$487 million and NT\$487 million (US\$15 million), respectively, representing 0.7% and 0.4% of our gross notes and accounts receivables as of those dates.

Inventory valuation. Inventories are stated at the lower of cost or net realizable value for finished goods, work-in-progress, raw materials, supplies and spare parts. Inventory write-downs are made on an item-by-item basis, except where it may be appropriate to group similar or related items.

A significant amount of our manufacturing costs are fixed because our extensive manufacturing facilities (which provide us such large production capacity) require substantial investment to construct and are largely fixed-cost assets once they become operational. When the capacity utilization increases, the fixed manufacturing costs are spread over a larger amount of output, which would lower the inventory cost per unit thereby improving our gross margin.

We evaluate our ending inventory based on standard cost under normal capacity utilization, and reduce the carrying value of our inventory when the actual capacity utilization is higher than normal capacity utilization. No adjustment is made to the carrying value of inventory when the actual capacity utilization is at or lower than normal capacity utilization. Normal capacity utilization is established based on historic loadings compared to total available capacity in our wafer manufacturing fabs.

Due to rapid technology changes, we also evaluate our ending inventory and reduce the carrying value of inventory for estimated obsolescence and unmarketable inventory by an amount that is the difference between the cost of the inventory and the net realizable value. The net realizable value of the inventory is mainly determined based on assumptions of future demand within a specific time horizon, which is generally 180 days or less.

Realization of Deferred Income Tax Assets. When we have net operating loss carry forwards, investment tax credits or temporary differences in the amount of tax recorded for tax purposes and accounting purposes, we may be able to reduce the amount of tax that we would otherwise be required to pay in future periods. We generally recognize deferred tax assets to the extent that it is probable that sufficient taxable benefits will be available to utilize. The income tax benefit or expense is recorded when there is a net change in our total deferred tax assets and liabilities in a period. The ultimate realization of the deferred tax assets depends upon the generation of future taxable income during the periods in which the net operating losses and temporary differences become deductible or the investment tax credits may be utilized. Specifically, our realization of deferred income tax assets is impacted by our expected future revenue growth and profitability, tax holidays, Alternative Minimum Tax (AMT), 10% tax imposed on unappropriated earnings and the amount of tax credits that can be utilized within the statutory period. In determining the amount of deferred tax assets as of December 31, 2014, we considered past performance, the general outlook of the semiconductor industry, business conditions, future taxable income and prudent and feasible tax planning strategies.

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Because the determination of the amount of realization of the deferred tax assets is based, in part, on our forecast of future profitability, it is inherently uncertain and subjective. Changes in market conditions and our assumptions may cause the actual future profitability to differ materially from our current expectation, which may require us to increase or decrease the realization of the deferred tax assets that we have recorded. As of December 31, 2013 and 2014, the deferred tax assets were NT\$7,145 million and NT\$5,139 million (US\$163 million), respectively. The deferred tax assets decreased by NT\$2,006 million in 2014, mainly due to the utilization of the deferred tax assets relating to investment tax credit.

Impairment of Tangible and Intangible Assets Other than Goodwill. We assess the impairment of tangible and intangible assets other than goodwill whenever triggering events or changes in circumstances indicate that the asset may be impaired and carrying value may not be recoverable. Our tangible and intangible assets other than goodwill subject to this evaluation include property, plant and equipment and amortizable intangible assets.

Indicators we consider important which could trigger an impairment review include, but are not limited to, the following:

significant underperformance relative to historical or projected future operating results;

significant changes in the manner of our use of the acquired assets or our overall business strategy; and

significant unfavorable industry or economic trends.

When we determine that the carrying value of tangible and intangible assets may not be recoverable based upon the existence of one or more of the above indicators of impairment, we measure any impairment for tangible and intangible assets based on a projected future cash flow. If the tangible or intangible assets are determined to be impaired, we recognize an impairment loss through a charge to our operating results to the extent the recoverable amount, measured at the present value of discounted cash flows attributable to the assets, is less than their carrying value. Such cash flow analysis includes assumptions about expected future economic and market conditions, the applicable discount rate, and the future revenue generation from the use or disposition of the assets. We also perform a periodic review to identify assets that are no longer used and are not expected to be used in future periods and record an impairment charge to the extent that the carrying amount of the tangible and intangible assets exceeds the recoverable amount. If the recoverable amount subsequently increases, the impairment loss previously recognized will be reversed to the extent of the increase in the recoverable amount, provided that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset in prior years.

The process of evaluating the potential impairment of tangible and intangible assets other than goodwill requires significant judgment. We are required to review for impairment groups of assets related to the lowest level of identifiable independent cash flows. Due to our asset usage model and the interchangeable nature of our semiconductor manufacturing capacity, we must make subjective judgment in determining the independent cash flows that can be related to specific asset groups. In addition, because we must make subjective judgment regarding the remaining useful lives of assets and the expected future revenue and expenses associated with the assets, changes in these estimates based on changed economic conditions or business strategies could result in material impairment charges in future periods. Our projection for future cash flow is generally lower during periods of reduced earnings. As a result, an impairment charge is more likely to occur during a period when our operating results are already

otherwise depressed.

For purposes of evaluating the recoverability of tangible and intangible assets other than goodwill, assets purchased for use in the business but subsequently determined to have no future economic benefits are written down to their recoverable amount. For the years ended December 31, 2012, 2013 and 2014, we recognized the impairment loss of NT\$445 million, nil and NT\$240 million (US\$8 million), respectively. As of December 31, 2013 and 2014, net tangible and intangible assets amounted to NT\$798,529 million and NT\$825,841 million (US\$26,134 million), respectively.

Noncurrent Assets Held for Sale. Noncurrent assets or disposal groups are classified as noncurrent assets held for sale if their carrying amount will be recovered principally through a sale transaction rather than through continuing use. This condition is regarded as met only when the sale is highly probable and the noncurrent asset held for sale is available for immediate sale in its present condition. To meet the criteria for the sale being highly probable, the appropriate level of management must be committed to the sale, which should be expected to qualify for recognition as a completed sale within one year from the date of classification.

When the committed sale plan involves loss of control of a subsidiary, all of the assets and liabilities of that subsidiary are classified as held for sale, regardless of whether a noncontrolling interest in its former subsidiary is retained after the sale.

Noncurrent assets classified as held for sale are measured at the lower of their previous carrying amount and fair value less costs to sell. Recognition of depreciation would cease. We have reclassified TSMC SSL as a disposal group held for sale in the consolidated statements of financial position as of December 31, 2014. The expected fair value of TSMC SSL, determined based on the price agreed in the sale agreement, less costs to sell was substantially lower than the carrying amount of the related net assets; as such, for the year ended December 31, 2014, an impairment loss of NT\$735 million (US\$23 million) was recognized under other operating gains and losses. As of December 31, 2014, noncurrent assets held for sale and liabilities directly associated with noncurrent assets held for sale were NT\$944 million (US\$30 million) and NT\$219 million (US\$7 million), respectively. Please see Item 4. Our Subsidiaries and Affiliates TSMC Solid State Lighting Ltd. (TSMC SSL) for further details.

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Impairment of Goodwill. Goodwill arising on an acquisition of a business is carried at cost as established at the date of acquisition of the business less accumulated impairment losses, if any. We assess the impairment of goodwill on an annual basis, or more frequently when there is an indication that goodwill may be impaired. Indicators we consider important which could trigger an impairment review include, but are not limited to, the following:

significant decline in our stock price for a sustained period; and

significant decline in our market capitalization relative to net book value.

Application of the goodwill impairment test is also highly subjective and requires significant judgment, including the identification of cash generating units, assigning assets and liabilities to the relevant cash generating units, assigning goodwill to the relevant cash generating units, and determining the recoverable amount of the relevant cash generating units. Our assessment of recoverable amount is based upon a cash flow analysis that includes assumptions about expected future operating performance, such as revenue growth rates and operating margins, risk-adjusted discount rates, future economic and market conditions, and determination of appropriate market comparables. The recoverable amount of the cash generating units is compared to the associated carrying value including goodwill and an impairment charge is recorded to the extent, if any, that the carrying value exceeds the recoverable amount.

Goodwill recorded from the acquisition of TSMC-Acer and WaferTech is evaluated for impairment on an annual basis. Based on our most recent evaluation, the recoverable amount calculated by discounting projected cash flow in five years was higher than the associated carrying value. As a result, we did not record any impairment charge. As of December 31, 2013 and 2014, goodwill amounted to NT\$5,627 million and NT\$5,889 million (US\$186 million), respectively. The change in the NT dollar amount of goodwill was due to changes in the exchange rate between NT dollar and U.S. dollar.

Impairment assessment on investments accounted for using equity method. We assess the impairment of investments accounted for using equity method whenever triggering events or changes in circumstances indicate that an investment may be impaired and its carrying value may not be recoverable. The recoverable amount is determined by taking into consideration the discounted cash flow projections of the investee and the investee's market price, if available. The underlying assumptions of the future cash flow projections of the investees are formulated by the investees' internal management team, taking into account market conditions for the industries which the investees operate in to ensure the reasonableness of such assumptions. An impairment charge is recorded to the extent, if any, that the carrying amount of the investments accounted for using equity method exceeds the recoverable amount. If the recoverable amount subsequently increases, the impairment loss previously recognized will be reversed to the extent of the increase in the recoverable amount.

In 2012, an impairment loss of NT\$1,187 million was recorded from a certain invested company. In 2013, because the recoverable amount of the aforementioned investment had increased to be higher than its carrying amount before the 2012 impairment, the impairment loss of NT\$1,187 million recognized in prior year was reversed. As of December 31, 2013 and 2014, investments accounted for using equity method amounted to NT\$28,157 million and NT\$28,060 million (US\$888 million), respectively.

Accounting for investments in private and publicly-traded securities. We hold equity interests in companies, some of which are publicly traded and have highly volatile share prices. From time to time, we also hold investments in debt securities. We review all of our investments for impairment on a quarterly basis and record an impairment charge when we believe an investment has experienced a significant or prolonged decline in fair value. Determining whether

a significant or prolonged decline in fair value of the investment has occurred is highly subjective. Such evaluation is dependent on the specific facts and circumstances. Factors we consider include, but are not limited to, the following: the market value of the security in relation to its cost basis, the duration of the decline in fair value, the financial condition of the investees and our intent and ability to retain the investment for a sufficient period of time to allow for recovery in the market value of the investment. Impairment reviews with respect to private security investments also require significant judgment. Factors indicative of a significant or prolonged decline in fair value include recurring operating losses, credit defaults and subsequent rounds of financing at valuation below the cost basis of the investment.

We have experienced declines in the fair value of certain privately held investments, publicly traded securities and mutual funds and recorded impairment loss of NT\$3,045 million, NT\$1,540 million and NT\$211 million (US\$7 million) in 2012, 2013 and 2014, respectively. While we have recognized all declines that are currently believed to be significant or prolonged as a charge to income, adverse changes in market conditions or poor operating results of underlying investments could result in further losses in future periods. As of December 31, 2013 and 2014, available-for-sale financial assets amounted to NT\$61,628 million and NT\$75,598 million (US\$2,392 million), respectively.

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Recognition and Measurement of Defined Benefit Plans. We use the Projected Unit Credit Method for accrued pension costs and the resulting pension expenses under defined benefit pension plans. The discount rate, rate of employee turnover, and long-term average future salary increase are included in actuarial assumptions. The discount rate assumption is determined by reference to yields on government bonds of appropriate duration at the end of the maturity of the pension benefits. We assume the average remaining years of service and rate of increase in compensation levels based on historical data. Due to changing market and economic conditions, the underlying key assumptions may differ from actual developments and may lead to significant changes in pension and defined benefit obligations.

As of December 31, 2013 and 2014, the accrued pension costs were NT\$6,802 million and NT\$6,568 million (US\$208 million), respectively.

Results of Operations

The following table sets forth, for the periods indicated, certain financial data from our consolidated statements of profit or loss and other comprehensive income, expressed in each case as a percentage of net revenue:

	For the year ended December 31,		
	2012	2013	2014
Net revenue	100.0%	100.0%	100.0%
Cost of revenue	(51.8)%	(52.9)%	(50.5)%
Gross profit	48.2%	47.1%	49.5%
Operating expenses			
Research and development	(8.0)%	(8.0)%	(7.4)%
General and administrative	(3.4)%	(3.1)%	(2.5)%
Marketing	(0.9)%	(0.8)%	(0.7)%
Total operating expenses	(12.3)%	(11.9)%	(10.6)%
Other operating income and expenses, net	(0.1)%	0.0%	(0.1)%
Income from operations	35.8%	35.2%	38.8%
Income before income tax	35.8%	36.2%	39.6%
Income tax expense	(4.4)%	(5.4)%	(6.3)%
Net income	31.4%	30.8%	33.3%
Other comprehensive income for the period, net of income tax	0.9%	2.7%	1.5%
Total comprehensive income for the period	32.3%	33.5%	34.8%
Net income attributable to shareholders of the parent	31.5%	30.8%	33.3%
Net loss attributable to noncontrolling interests	(0.1)%	(0.0)%	(0.0)%

Year to Year Comparisons*Net Revenue and Gross Margin*

	For the year ended December 31,				
	2012	2013	% change	2014	% Change
			from 2012		
	NT\$	NT\$		NT\$	US\$

(in millions, except percentages)

Net revenue	506,745	597,024	17.8%	762,806	24,139	27.8%
Cost of revenue	(262,592)	(315,642)	20.2%	(385,113)	(12,187)	22.0%
Gross profit before realized (unrealized) gross profit on sales to associates	244,153	281,382	15.2%	377,693	11,952	34.2%
Realized (unrealized) gross profit on sales to associates	(25)	(21)	(16.0)%	29	1	
Gross profit	244,128	281,361	15.3%	377,722	11,953	34.2%
Gross margin percentage	48.2%	47.1%		49.5%	49.5%	

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Our net revenue in 2014 increased by 27.8% from 2013, which was largely attributed to growth in customer demand, reflected in a 18.7% increase in wafer shipments. We shipped approximately 8.3 million 300mm equivalent wafers in 2014 compared to 7.0 million in 2013. Furthermore, the introduction of 20-nanometer and higher share of 28-nanometer sales contributed to a higher average selling price. 20-nanometer accounted for 9% of our total wafer revenue in 2014, and 28-nanometer accounted for 33% of our total wafer revenue in 2014 compared to 30% in 2013.

Our net revenue in 2013 increased by 17.8% from 2012, which was largely attributable to continuing growth in customer demand, resulting in a 11.5% increase in wafer shipments. We shipped approximately 7.0 million 300mm equivalent wafers in 2013 compared to 6.2 million in 2012. In addition, sales of our 28-nanometer products, which commanded a higher selling price, also increased to 30% of our total wafer revenue in 2013 compared to 12% in 2012.

Gross Margin

Our gross margin fluctuates with the level of capacity utilization, price change and product mix, among other factors. In 2014, our gross margin was 49.5%, up 2.4 percentage points from 2013, mainly reflecting higher capacity utilization, partially offset by the margin dilution associated with the ramping of 20nm in its initial year of production. In 2013, our gross margin was 47.1%, down 1.1 percentage points from 2012, mainly due to lower capacity utilization.

Operating Expenses

	For the year ended December 31,				% Change from 2013	
	2012 NT\$	2013 NT\$	% change from 2012	2014 NT\$ US\$		
	(in millions, except percentages)					
Research and development	40,387	47,952	18.7%	56,829	1,798	18.5%
General and administrative	17,633	18,882	7.1%	18,933	599	0.3%
Marketing	4,497	4,505	0.2%	5,087	161	12.9%
Total operating expenses	62,517	71,339	14.1%	80,849	2,558	13.3%
Percentage of net revenue	12.3%	11.9%		10.6%	10.6%	
Other operating income and expenses, net	(449)	47		(1,002)	(32)	(2,231.9%)
Income from operations	181,162	210,069	16.0%	295,871	9,363	40.8%
Operating Margin	35.8%	35.2%		38.8%	38.8%	

Operating expenses increased by NT\$9,510 million in 2014, or 13.3%, from NT\$71,339 million in 2013, after an increase in operating expenses of NT\$8,822 million in 2013, or 14.1%, from NT\$62,517 million in 2012.

Research and Development Expenses

We remain strongly committed to being the leader in advanced process technologies development. We believe that continuing investments in process technologies are essential for us to remain competitive in the markets we serve.

Research and development expenditures increased by NT\$8,877 million in 2014, or 18.5%, from \$47,952 million in 2013, after an increase of NT\$7,565 million in 2013, or 18.7%, from \$40,387 million in 2012. The increases in both years were mainly due to higher level of research activities for 16-nanometer and 10-nanometer technologies as we continue to advance to smaller processing nodes, partially offset by fewer research activities for 20-nanometer. In 2014, there was also an increase in employee profit sharing expenses and bonus.

We plan to continue investing a significant amount in research and development in 2015.

General and Administrative and Marketing Expenses

General and administrative, and marketing expenses in 2014 increased by NT\$633 million, or 2.7%, from 2013, mainly due to higher employee profit sharing expenses and bonus; partially offset by lower fab opening expenses.

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General and administrative, and marketing expenses in 2013 increased by NT\$1,257 million, or 5.7%, from 2012, mainly due to higher opening expenses for ramping up 20-nanometer capacity.

Other operating income and expenses

Net other operating income and expense in 2014 decreased by NT\$1,049 million, or 2,231.9 %, from NT\$47 million in 2013, mainly due to an impairment loss on noncurrent assets held for sale of NT\$735 million and an impairment loss on property, plant and equipment of NT\$240 million in 2014. Please see Item 5-Critical Accounting Policies And Judgments-Impairment of Tangible and Intangible Assets Other than Goodwill, and Noncurrent Assets Held for Sale for further details.

Non-Operating Income and Expenses

	For the year ended December 31,					% Change from 2013
	2012 NT\$	2013 NT\$	% change from 2012	2014 NT\$	2014 US\$	
	(in millions, except percentages)					
Share of profits of associates and joint venture	2,073	3,807	83.6%	3,920	124	3.0%
Other income	1,716	2,342	36.5%	3,380	107	44.3%
Foreign exchange gain, net	582	285	(51.0)%	2,111	67	640.7%
Finance costs	(1,020)	(2,646)	159.4%	(3,236)	(103)	22.3%
Other gains and losses	(2,852)	2,105		28	1	(98.7)%
Net non-operating income	499	5,893	1,081.0%	6,203	196	5.3%

Net non-operating income in 2014 increased by NT\$310 million, or 5.3%, from NT\$5,893 million in 2013 primarily attributed to higher gain on disposal of VIS shares of NT\$2,055 million, higher foreign exchange gain of NT\$1,826 million due to NT dollar depreciated against U.S. dollar and higher interest income of NT\$895 million. The increases are partially offset by higher loss on financial instruments of NT\$2,086 million, absence of settlement income from SMIC of NT\$900 million, lower gain on disposal of available-for-sale financial assets of NT\$949 million and NT\$590 million increase in interest expenses.

Net non-operating income in 2013 increased by NT\$5,394 million, or 1,081.0% from NT\$499 million in 2012 primarily attributable to a lower impairment loss of NT\$3,879 million recognized for financial assets. Please see Item 5- Critical Accounting Policies And Judgments-Impairment assessment on investments accounted for using equity method where the improvement of the financial condition of an invested company allowed us to reverse an impairment loss recorded in 2012. The increase is also attributable to a smaller impairment loss in private and publicly-traded securities. See Item 5-Critical Accounting Policies And Judgments-Accounting for investments in private and publicly-traded securities for further details. We also had a NT\$1,734 million increase in share of profits of associates and joint venture investees reflecting their better operating results in 2013 and a NT\$771 million increase in gains on disposal of financial assets in 2013. These increases are partially offset by a NT\$1,626 million increase in finance costs due to further issuance of corporate bonds in 2013.

Income Tax Benefit (Expense)

	For the year ended December 31,					% Change from 2013
	2012 NT\$	2013 NT\$	% change from 2012	2014 NT\$	US\$	
	(in millions, except percentages)					
Income tax expense	(22,375)	(32,112)	43.5%	(47,890)	(1,515)	49.1%
Net income	159,286	183,850	15.4%	254,184	8,044	38.3%
Net income attributable to shareholders of the parent	159,481	183,978	15.4%	254,302	8,048	38.2%
Net margin attributable to shareholders of the parent	31.5%	30.8%		33.3%	33.3%	

Income tax expenses increased by NT\$15,778 million in 2014, or 49.1%, from 2013. The increase was mainly due to higher taxable income and an increase in tax on unappropriated earnings as a result of higher unappropriated earnings.

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Income tax expenses increased by NT\$9,737 million in 2013, or 43.5%, from 2012. The increase was mainly due to higher taxable income, an increase in AMT from 10% to 12%, and an increase in tax on unappropriated earnings as a result of higher unappropriated earnings.

Liquidity and Capital Resources

Our sources of liquidity include cash flow from operations, cash and cash equivalents, short-term investments, and revolving credit facilities provided by multiple banks. Issuance of corporate bonds is another source of fund.

Our primary source of liquidity is cash flow from operations. Cash flow from operations for 2014 was NT\$421,524 million (US\$13,339 million), an increase of NT\$74,140 million from 2013.

Our cash, cash equivalents and short-term investments in financial instruments increased to NT\$436,924 million (US\$13,827 million) as of December 31, 2014, from NT\$245,343 million as of December 31, 2013. The short-term investments in financial instruments primarily consisted of publicly-traded stocks and money market instruments.

As of December 31, 2014, we also had aggregate unused short-term credit lines of approximately NT\$73,535 million (US\$2,327 million).

We believe that our cash generated from operations, cash and cash equivalents, short-term investments, ability to access capital market and revolving credit facilities will be sufficient to fund our working capital needs, capital expenditures, debt repayments, dividend payments and other business requirements associated with existing operations over the next 12 months.

	For the year ended December 31,			
	2012	2013	2014	US\$
	NT\$	NT\$	NT\$	
	(in millions)			
Net cash generated by operating activities	284,963	347,384	421,524	13,339
Net cash used in investing activities	(269,318)	(281,054)	(282,421)	(8,937)
Net cash generated by (used in) financing activities	(13,589)	32,106	(32,328)	(1,023)
Effect of exchange rate changes and others	(2,118)	849	8,979	284
Net increase (decrease) in cash	(62)	99,285	115,754	3,663

Cash and cash equivalents increased by NT\$115,754 million in 2014, following an increase of NT\$99,285 million in 2013 and a decrease of NT\$62 million in 2012.

Operating Activities

In 2014, we generated NT\$421,524 million (US\$13,339 million) net cash from operating activities, as compared to NT\$347,384 million and NT\$284,963 million in 2013 and 2012, respectively. In 2014, net cash generated from operating activities increased primarily due to an increase of NT\$86,112 million in income before income tax and an increase of NT\$44,070 million in non-cash depreciation and amortization expenses, partially offset by change in working capital and others of NT\$56,042 million.

In 2013, net cash from operating activities increased primarily due to an increase of NT\$34,301 million in income before income tax and an increase of NT\$24,833 million in non-cash depreciation and amortization expenses, and

change in working capital and others resulting in an in-flow of NT\$3,287 million.

With respect to depreciation and amortization expenses, our depreciation and amortization expenses in 2014 were NT\$200,252 million (US\$6,337 million), as compared to NT\$156,182 million in 2013. The higher depreciation and amortization expenses in 2014 were mainly the result of expansion of production capacity in advanced technologies.

Investing Activities

In 2014, net cash used in investing activities was NT\$282,421 million (US\$8,937 million), as compared to NT\$281,054 million and NT\$269,318 million in 2013 and 2012, respectively. The increase in 2014 was primarily due to higher investment in financial assets, partially offset by disposal of VIS shares during the year.

The increase in 2013 was primarily due to higher spending on capital expenditures during the year, partially offset by the absence of EUR838 million investment in ASML in 2012.

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With respect to capital expenditures, our capital expenditures for 2014 were primarily related to:

adding production capacity to 300mm wafer fabs;

developing new process technologies including 16-nanometer and 10-nanometer nodes;

expanding buildings/facilities for Fab 12, Fab 14 and Fab 15;

other research and development projects;

capacity expansion for mask and backend operations; and

solar business.

Our capital expenditures for 2012 and 2013 were funded by our operating cash flow and the issuance of corporate bonds and the capital expenditures for 2014 were funded by operating cash flow. The capital expenditures for 2015 are expected to be funded mainly by our operating cash flow. See Item 3. Risk Factors section for the risks associated with the inability of raising the requisite funding for our expansion programs. Please also see Item 4. Information on the Company Capacity Management and Technology Upgrade Plans for discussion of our capacity management and capital expenditures.

Financing Activities

In 2014, net cash used by financing activities was NT\$32,328 million (US\$1,023 million), as compared to net cash of NT\$32,106 million generated in 2013. In 2013, we had cash inflow of NT\$130,845 million from issuance of corporate bonds, partially offset by a decrease of short-term loans of NT\$19,636 million; whereas in 2014, our comparable cash inflow items were an increase of short-term loans of NT\$18,564 million and receipt of capacity guarantee deposit of NT\$30,132 million.

In 2013, net cash generated by financing activities was NT\$32,106 million, as compared to net cash of NT\$13,589 million used in 2012. Net cash increased in financing activities was primarily the result of higher proceeds from issuance of corporate bonds by NT\$68,845 million, and the absence of corporate bonds repayment of NT\$4,500 million in 2012, partially offset by a decrease of short-term loans of NT\$29,383 million.

With respect to short-term loan balances, as of December 31, 2014, our short-term loans were NT\$36,159 million (US\$1,144 million), and our aggregate long-term debt was NT\$213,714 million (US\$6,763 million). The short-term loans were denominated in U.S. dollars. As a substantial portion of our receivables was denominated in U.S. dollars, we use short-term loans denominated in U.S. dollars to naturally hedge the fluctuation of foreign exchanges rates. See Item 11. Quantitative and Qualitative Disclosures About Market Risk for a discussion of the hedging instruments used. The long-term debt primarily included NT\$213,674 million of long-term corporate bonds with fixed interest rates ranging from 0.95% to 2.10% and tenors ranging from 3 years to 10 years.

Cash Requirements

The following table sets forth the maturity of our long-term debt (bank loans and bonds) including relevant interest payments outstanding as of December 31, 2014:

	Long-term debt (in NT\$ millions)
During 2015	3,081
During 2016	26,069
During 2017	40,671
During 2018	62,444
During 2019 and thereafter	94,361

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The following table sets forth information on our material contractually obligated payments (including principals and interests) for the periods indicated as of December 31, 2014:

Contractual Obligations	Total	Payments Due by Period			
		Less than 1 Year	1-3 Years	4-5 Years	More than 5 Years
		(in NT\$ millions)			
Short-Term Loans ⁽¹⁾	36,164	36,164			
Long-Term Debt ⁽²⁾	226,626	3,081	66,740	98,482	58,323
Capital Lease Obligations ⁽³⁾	889	30	59	800	
Operating Leases ⁽⁴⁾	10,959	892	1,912	1,579	6,576
Other Obligations ⁽⁵⁾	36,571	6,897	16,987	12,687	
Capital Purchase or Other Purchase Obligations ⁽⁶⁾	186,069	182,258	2,514	1,078	219
Total Contractual Cash Obligations	497,278	229,322	88,212	114,626	65,118

- (1) The maximum amount and average amount of short-term loans outstanding during the year ended December 31, 2014 were NT\$38,062 million and NT\$33,145 million, respectively. See note 19 to our consolidated financial statements for further information regarding interest rates and future repayment dates.
- (2) Includes corporate bonds payable and bank loans payable. See note 21 to our consolidated financial statements for further information regarding interest rates and future repayment of long-term debts.
- (3) Capital lease obligations represent our commitment for leases of property, which are described in note 16 to our consolidated financial statements.
- (4) Operating lease obligations are described in note 39 to our consolidated financial statements.
- (5) Other obligations represent payables for software and system design costs, our commitment of EUR166 million to ASML's research and development programs from 2015 to 2017 and approximately US\$950 million on refundable customer deposit. See Item 4- Information on the company- Commitments by Customers for further information regarding deposit.
- (6) Represents commitments for construction or purchase of equipment, raw material and other property or services. These commitments are not recorded on our statement of financial position as of December 31, 2014, as we have not received related goods or taken title of the property.

During 2014, we entered into derivative financial instruments transactions to manage exposures related to foreign-currency denominated receivables or payables and price fluctuations of equity investments. As of December 31, 2014, we anticipated our cash requirements in 2015 for outstanding forward exchange agreements and cross currency swaps of approximately NT\$4,144 million and US\$2,067 million and EUR5 million with our expected cash receipts of approximately JPY27,151 million, US\$138 million, EUR24 million and RMB1,129 million. See Item 11. Quantitative and Qualitative Disclosures about Market Risk for more information regarding our derivative financial instruments transactions. See also note 5 to the consolidated financial statements for our accounting policy of derivative financial instruments, and note 8, note 11 and note 36 to the consolidated financial statements for additional details regarding our derivative financial instruments transactions.

Generally, we do not provide letters of credit to, or guarantees for any entity other than our consolidated subsidiaries.

Significant amount of capital is required to build, expand, and upgrade our production facilities and equipment. Our capital expenditures for 2015 are expected to be approximately US\$11.5 billion to US\$12.0 billion, which, depending on market conditions, may be adjusted later.

Taxation

The corporate income tax rate in R.O.C. is 17%. We are eligible for five-year tax holidays for income generated from construction and capacity expansions of production facilities according to regulations under the Statute for Upgrading Industries of the R.O.C. The exemption period may begin at any time within five years, as applicable, following the completion of a construction or expansion of production facilities. The Statute for Upgrading Industries expired at the end of 2009. However, under the Grandfather Clause, we can continue to enjoy five-year tax holidays if the relevant investment plans were approved by R.O.C. tax authority before the expiration of the Statute. Pursuant to the Grandfather Clause, we commenced the exemption period for part of Fab 14 (Phase III), part of Fab 12 (Phase III) and others in 2010; part of Fab 12 (Phase IV), part of Fab 14 (Phase III and IV) in 2011, part of Fab 12 (Phase IV) and part of Fab 14 (Phase III to VI) in 2014. The aggregate tax benefits of such exemption periods in 2012, 2013 and 2014 were NT\$9,830 million, NT\$8,612 million and NT\$20,416 million (US\$646 million), respectively.

Pursuant to regulations promulgated under the R.O.C. Statute for Industries Innovation, we are eligible for tax credit for specified percentages of research and development expenditures. The tax credit rate of research and development expenditures is 15% during the period from 2010 to 2019.

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The R.O.C. government enacted the R.O.C. Alternative Minimum Tax Act (AMT Act) which became effective on January 1, 2006. The alternative minimum tax (AMT) imposed under the R.O.C. AMT Act is a supplemental income tax which applies if the amount of regular income tax calculated pursuant to the R.O.C. Income Tax Act is below the amount of basic tax prescribed under the R.O.C. AMT Act. The taxable income for calculating AMT includes most income that is exempt from income tax under various legislations, such as tax holidays. However, the R.O.C. AMT Act grandfathered certain tax exemptions granted prior to the enactment of the R.O.C. AMT Act. In August 2012, the AMT rate for business entities was amended from 10% to 12% effective from 2013.

Off Balance Sheet Arrangements

There are no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

Inflation & Deflation

During 2014, neither inflation nor deflation had a material impact on our operations, or the business operations of our customers and suppliers.

However, in light of the uncertain global economic outlook and the fluctuating global oil price, we cannot assure that there will be no significant variations in the future, which may have a material impact on our results of operations. Any increase in energy taxes, oil, electricity and water prices in Taiwan may negatively affect our operating margins, resulting in lower margins on our products and services.

Recent Accounting Pronouncements

Please refer to note 4 to the consolidated financial statements.

Climate Change Related Issues

The manufacturing, assembling and testing of our products require the use of chemicals and materials that are subject to environmental, climate related, health and safety laws and regulations issued worldwide as well as international accords such as the Kyoto Protocol. Climate change related laws or regulations currently are too indefinite for us to assess the impact on our future financial condition with any degree of reasonable certainty. For example, the Taiwan legislative authority has been studying relevant laws relating to environmental protection and climate related changes, such as the Greenhouse Gas Reduction Act and Energy Tax . Since there has been no concrete guidance or laws issuing from the Taiwan government as of the date of this filing, the impact of such laws is indeterminable at the moment. Please see detailed risk factors related to the impact of climate change regulations and international accords, and business trends on our operations in Item 3. Key Information Risk Factors Risks Relating to Our Business . Please also see our compliance record with Taiwan and international environmental and climate related laws and regulations in Item 4. Information on the Company Environmental Regulations .

ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

Directors and Executive Officers

MANAGEMENT

Members of our board of directors are elected by our shareholders. Our board of directors is currently composed of eight directors. A former director, Dr. Rick Tsai, resigned on January 27, 2014. Of our current eight directors, five are independent directors. The chairman of the board of directors is elected by the directors. The chairman of the board of directors presides at all meetings of the board of directors, and also has the authority to act as our representative. The term of office for directors is three years.

Pursuant to R.O.C. Securities and Exchange Law, effective from January 1, 2007, a public company is required to either establish an audit committee or to have supervisors. A public company's audit committee should be composed of all of its independent directors but not less than three, of which at least one member should have accounting or related financial management expertise, and the relevant provisions under the R.O.C. Securities and Exchange Law, the R.O.C. Company Law and other laws applicable to the supervisors are also applicable to the audit committee.

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Pursuant to the R.O.C. Company Law, a person may serve as our director in his personal capacity or as the representative of another legal entity. A director who serves as the representative of a legal entity may be removed or replaced at any time at the discretion of that legal entity, and the replacement director may serve the remainder of the term of office of the replaced director. For example, the National Development Fund of Taiwan, R.O.C., one of our largest shareholders, has served as our director since our founding. As a corporate entity, the National Development Fund is required to appoint a representative to act on its behalf. Mr. Johnsee Lee has been the representative of the National Development Fund since August 6, 2010.

The following table sets forth the name of each director and executive officer, their positions, the year in which their term expires and the number of years they have been with us as of February 28, 2015. The business address for each of our directors and executive officers is No. 8, Li Hsin Road 6, Hsinchu Science Park, Hsinchu, Taiwan, Republic of China.

Name	Position with our company	Term Expires	Years with our company
Morris Chang	Chairman	2015	28
F.C. Tseng	Vice Chairman	2015	28
Johnsee Lee	Director (Representative of the National Development Fund)	2015	5
Stan Shih	Independent Director	2015	15
Sir Peter Leahy Bonfield	Independent Director	2015	13
Thomas J. Engibous	Independent Director	2015	6
Gregory C. Chow	Independent Director	2015	4
Kok-Choo Chen	Independent Director	2015	4
Mark Liu	President & Co-Chief Executive Officer		21
C.C. Wei	President & Co-Chief Executive Officer		17
Stephen T. Tso	Senior Vice President & Chief Information Officer		18
Lora Ho	Senior Vice President, Chief Financial Officer & Spokesperson		16
Wei-Jen Lo ⁽¹⁾	Senior Vice President, Research & Development		11
Rick Cassidy ⁽¹⁾	Senior Vice President of TSMC & President of TSMC North America		18
M.C. Tzeng	Vice President, Operations/Affiliate Fabs		28
Jack Sun	Vice President, Research & Development & Chief Technology Officer		18
Y.P. Chin	Vice President, Operations/Product Development		28
N.S. Tsai	Vice President, Quality & Reliability		26
J.K. Lin	Vice President, Operations/Mainstream Fabs & Manufacturing Technology		28
J.K. Wang	Vice President, Operations/300mm Fabs		28
Irene Sun	Vice President, Corporate Planning Organization		11
Burn J. Lin	Vice President, Research & Development		15
Y. J. Mii	Vice President, Research & Development		21
Cliff Hou	Vice President, Research & Development		18
Been-Jon Woo	Vice President, Business Development		6
Sylvia Fang ⁽²⁾	Vice President & General Counsel, Legal		20

(1) Dr. Wei-Jen Lo and Mr. Rick Cassidy were promoted to Senior Vice Presidents, effective February 18, 2014.

(2) Ms. Sylvia Fang and Ms. Connie Ma were promoted to Vice Presidents, effective August 12, 2014.

Morris Chang is the Chairman. He has been the founding Chairman of our board of directors since our establishment and was our Chief Executive Officer from March 1998 to June 2005. He again served as our Chief Executive Officer since June 2009 before retiring as Chief Executive Officer on November 12, 2013. Executive Vice Presidents and Co-Chief Operating Officers Drs. Mark Liu and C.C. Wei assumed the role as Co-Chief Executive Officers. From 1985 to 1994, he was President and then Chairman of the board of directors of ITRI. Prior to that, Dr. Chang was President and Chief Operating Officer of General Instrument Corporation; Group Vice-President for Texas Instruments. He holds a bachelor's degree and a master's degree in mechanical engineering from the Massachusetts Institute of Technology and a Ph.D. in electrical engineering from Stanford University and has been active in the international semiconductor industry for over 59 years.

F.C. Tseng is the Vice Chairman. He has been our Vice Chairman since July 2005. He was Deputy Chief Executive Officer from August 2001 to June 2005. He is also the Chairman of TSMC China Co., Ltd. and Global Unichip Corp., the Vice Chairman of VIS, and a director of TSMC Solar Ltd. He also serves as an independent director, Chairman of Audit Committee and a member of Compensation Committee of Acer Inc. He formerly served as the President of VIS from 1996 to 1998 and our President from May 1998 to August 2001. Prior to his presidency at VIS, Dr. Tseng served as our Senior Vice President of Operations. He holds a Ph.D. in electrical engineering from National Cheng-Kung University and has been active in the semiconductor industry for over 43 years.

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Johnsee Lee, the representative of the National Development Fund, is a director. He is the Chairman of Personal Genomics, Inc.. He also serves as the Managing Director of Development Center for Biotechnology, the Honorary Chairman of Taiwan Bio Industry Organization and an independent director of Zhen Ding Technology Holding Ltd. and Far Eastern New Century Corp. He was the President of ITRI from 2003 to 2010 and has also served on many government and industrial boards and committees. Before returning to Taiwan, he held various technical and managerial positions at Argonne National Laboratory and Johnson Matthey Inc. in the U.S. from 1981 to 1990. He holds a Ph.D. in chemical engineering from the Illinois Institute of Technology, and a MBA from the University of Chicago. He is also a graduate of Harvard Business School's Advanced Management Program.

Stan Shih is an independent director. He is the co-founder and Chairman Emeritus of the Acer Group. He served as the Chairman and Chief Executive Officer of the Acer Group from 1976 to 2004. He is currently the Director and Honorary Chairman of Acer Inc., and the Group Chairman of iD SoftCapital and a director of Qisda Corp., Wistron Corp., Nan Shan Life Insurance Co., Ltd. and Egis Technology Inc. Mr. Shih holds a bachelor's degree, a master's degree and an honorary Ph.D. in electrical engineering from National Chiao Tung University. He also holds an honorary doctoral degree in technology from the Hong Kong Polytechnic University, an honorary fellowship from the University of Wales and an honorary doctoral degree in international law from the Thunderbird, American Graduate School of International Management.

Sir Peter Leahy Bonfield is an independent director. Sir Peter Bonfield was the Chief Executive Officer and Chairman of the Executive Committee of British Telecommunications from January 1996 to January 2002. He was the Vice President of the British Quality Foundation from its creation in 1993 until 2012. He is currently the Chairman of the Board of Directors of NXP Semiconductor N.V. in the Netherlands. He is also a director of L.M. Ericsson in Sweden (until April 14, 2015), Mentor Graphics Corporation Inc. in U.S. and Global Logic Inc. in U.S. He is a member of the Longreach Group Advisory Board, and New Venture Partners LLP Advisory Board. He also serves as a board mentor of CMi and a senior advisor to Rothschild in London. He is a fellow of The Royal Academy of Engineering and the Chair of Council and Senior Pro-Chancellor at Loughborough University in UK. He holds an honors degree in engineering from Loughborough University.

Thomas J. Engibous is an independent director. He joined Texas Instruments (TI) in 1976 and served there until retirement in 2008. During his 32-year career at TI, his duties included Chairman from 2004 to 2008, Chairman, President and Chief Executive Officer from 1998 to 2004, President and Chief Executive Officer from 1996 to 1998 and Executive Vice President and President of the company's Semiconductor Group from 1993 to 1996. Mr. Engibous currently serves as the Chairman of J.C. Penney Company Inc. and Honorary Trustee of the Southwestern Medical Foundation. He is also a member of National Academy of Engineering and Texas Business Hall of Fame. He received the Woodrow Wilson Award in 2004. He holds a master's degree in electrical engineering and an honorary doctorate in engineering from Purdue University.

Gregory C. Chow is an independent director. He is currently Professor of Economics and Class of 1913 Professor of Political Economy, and Emeritus at Princeton University. He is an Academician of Academia Sinica, R.O.C. and a member of American Philosophical Society, and a fellow of the American Statistical Association and Econometric Society. Professor Chow has over 50 years of teaching experience at such institutes as M.I.T., Cornell University, IBM Thomas Watson Research Center, Columbia University and Princeton University. Professor Chow also served as an adviser on economic policy, economic reform and economic education in Taiwan and China. He holds a Ph.D. and master degree in Economics from the University of Chicago and an honorary Doctorate of Business Administration from the Hong Kong University of Science and Technology. He also holds honorary professorships at various major universities in China and City University of Hong Kong. His publications include 17 books and over 200 articles.

Kok-Choo Chen is an independent director. She served as our Senior Vice President and General Counsel from 1997 to 2001. Currently, Ms. Chen is the Chairman of National Performing Arts Center and an advisor to the Taiwan Executive Yuan. Ms. Chen has over 24 years of experience working in international law firms. She has also taught law at Soochow University, National Chengchi University and National Tsing-Hua University in Taiwan for over 28 years. In addition, Ms. Chen is the founder of Taipei Story House. Ms. Chen is licensed to practice law in England, Singapore and California.

Mark Liu is our President and Co-Chief Executive Officer. Prior to that, he was our Executive Vice President and Co-Chief Operating Officer. From October 2009 to March 2012, he was Senior Vice President of Operations. From March 2008 to October 2009, he served as Senior Vice President of Advanced Technology Business. From January 2002 to March 2008, he was Senior Vice President of Operations II. He was Vice President of our Fab 8 and Fab 12 Sites Operations from July 2000 to January 2002 and Vice President of South-Site Operations from 1999 to July 2000. Dr. Liu joined us in 1993 and held the positions as Director of Fab 3 Operations and Senior Director of South-Site Operations. He holds a Ph.D. in electrical engineering and computer science from University of California, Berkeley.

C.C. Wei is our President and Co-Chief Executive Officer. Prior to that, he was our Executive Vice President and Co-Chief Operating Officer. From October 2009 to March 2012, he was Senior Vice President of Business Development. From March 2008 to October 2009, he was Senior Vice President of Mainstream Technology Business. From January 2002 to March 2008, Dr. Wei was Senior Vice President of Operations I. He was Vice President of South-Site Operations from April 2000 to January 2002 and Vice President of North-Site Operations from February 1998 to April 2000. Prior to that, he was Senior Vice President at Chartered Semiconductor Manufacturing Ltd. in Singapore starting from 1993. He holds a Ph.D. in electrical engineering from Yale University.

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Stephen T. Tso is our Senior Vice President of Information Technology, Material Management and Risk Management and Chief Information Officer. He joined us as Vice President of Research & Development in December 1996. Prior to that, he was General Manager of Metal CVD Products in Applied Materials. He was assigned as the President of WaferTech in November 2001. Dr. Tso holds a Ph.D. in material science and engineering from University of California, Berkeley.

Lora Ho is our Senior Vice President, Chief Financial Officer and Spokesperson. Prior to joining us in 1999 as controller, she had served as Vice President of Finance and Chief Financial Officer at Acer Semiconductor Manufacturing Inc. since 1990. Ms. Ho holds an MBA from National Taiwan University.

Wei-Jen Lo is our Senior Vice President of Research & Development. He was promoted to Senior Vice President of Research & Development in February 2014. He was Vice President of Research & Development from February 2013 to February 2014, Vice President of Operations/Manufacturing Technology from October 2009 to February 2013, Vice President of Advanced Technology Business from September 2009 to October 2009, Vice President of Research & Development from June 2006 to September 2009, and Vice President of Operations from July 2004 to June 2006. Prior to that, he was Director in charge of advanced technology development with Intel Corporation. Dr. Lo holds a Ph.D. in solid state physics & surface chemistry from University of California, Berkeley.

Rick Cassidy is our Senior Vice President of TSMC and President of TSMC North America. He was promoted to Senior Vice President in February 2014. He was Vice President of TSMC and President of TSMC North America from February 2008 to February 2014, and President of TSMC North America from January 2005 to February 2008. He joined us in 1997 and has held various positions in TSMC North America, including Business Operations, Field Technical Support, and Business Management. He holds a B.A. degree in engineering technology from United States Military Academy at West Point.

M.C. Tzeng is our Vice President of Operations/Affiliate Fabs. From March 2008 to October 2009, he was Vice President of Mainstream Technology Business. Prior to that, he was Vice President of Operations I from January 2002 to March 2008. He was the Senior Director of Fab 2 Operations from 1997 to January 2002. He joined us in 1987 and has held various positions in manufacturing functions. He holds a master degree in applied chemistry from Chung Yuan University.

Jack Sun is our Chief Technology Officer, effective November 2009, and also has been our Vice President of Research & Development since 2006. He was promoted to Senior Director in 2000. He joined us in 1997 as Director of Advanced Module Technology Division before taking the position of Director, Logic Technology Development Division. Prior to that, he served at International Business Machines for 14 years in Research & Development. Dr. Sun holds a Ph.D. in electrical engineering from University of Illinois at Urbana-Champaign.

Y.P. Chin is Vice President of Operations/Product Development. He was Vice President of Advanced Technology Business from March 2008 to October 2009. Prior to that, he was Senior Director of Operations II from June 2006 to March 2008 and Product Engineering & Services from 2000 to 2006. He joined us in 1987 and has held various positions in product and engineering functions. He holds a master degree in electrical engineering from National Cheng Kung University.

N.S. Tsai has been Vice President of Quality & Reliability since February 2008. Prior to that, he was Senior Director of Quality & Reliability since 2004, Senior Director of Assembly Test Technology & Service from 2002 to 2004. Dr. Tsai also served as a Vice President of VIS from 1997 to 2000. He joined us in 1989 and held various positions in research and development and manufacturing functions. He holds a Ph.D. in material science from Massachusetts Institute of Technology.

J.K. Lin is our Vice President of Operations/Mainstream Fabs and Manufacturing Technology. He was promoted to Vice President of Operations in August 2010. Prior to that, he was Senior Director of Mainstream Fabs from May to August in 2010. He joined us in 1987 and held various positions in manufacturing functions. He holds a B.S. degree from National Changhua University of Education.

J.K. Wang is our Vice President of Operations/300mm Fabs. He was promoted to Vice President of Operations in August 2010. Prior to that, he was Senior Director of 300mm Fabs from May to August in 2010. He joined us in 1987 and held various positions in manufacturing and research and development functions. He holds a master degree in chemical engineering from National Cheng-Kung University.

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Irene Sun is our Vice President of Corporate Planning Organization. She was promoted to Vice President of Corporate Planning Organization in August 2010. Prior to that, she was Senior Director of Corporate Planning Organization from 2009 to 2010. She joined us in 2003 and held various positions in Corporate Planning Organization. She holds a Ph.D. in materials science and engineering from Cornell University.

Burn J. Lin is our Vice President of Research & Development. He was promoted to Vice President of Research & Development in February 2011. Prior to that, he was our Senior Director of Nanopatterning Technology Division from 2000 to 2011. He joined us in 2000. Dr. Lin is the editor in chief of the Journal of Micro/Nanolithography, MEMS, and MOEMS, a fellow of IEEE and of SPIE. He holds a Ph.D. in electrical engineering from Ohio State University.

Y. J. Mii is our Vice President of Research & Development. He was promoted to Vice President of Research and Development in August 2011. Prior to that, he was our Senior Director of Platform I Division from 2006 to 2011. He joined us in 1994 and has been involved continuously in the development and manufacturing of advanced CMOS technologies in both Operations and Research & Development. He holds a Ph.D. in electrical engineering from the University of California, Los Angeles.

Cliff Hou is our Vice President of Research & Development. He was promoted to Vice President of Research & Development in August 2011. Prior to that, he was Senior Director of Design and Technology Platform from 2010 to 2011. He joined us in 1997 and established the Company's technology design kit and reference flow development organizations. He holds a Ph.D. in electrical and computer engineering from Syracuse University.

Been-Jon Woo is our Vice President of Business Development. She was promoted to Vice President of Business Development in November 2013. Prior to that, she was Director of Business Development from March 2013 to November 2013. She joined us in 2009 and was in charge of advanced technology roadmap and technology definition for 28/20-nanometer for high performance and low power applications. She holds a Ph.D. in chemistry from University of Southern California.

Sylvia Fang is our Vice President and General Counsel. She was promoted to Vice President and General Counsel of Legal Organization in August 2014. Prior to that, she was Associate General Counsel of Legal Organization from February to July 2014. She joined us in 1995 and held various positions in legal functions. She holds a master degree in comparative law from University of Iowa.

Connie Ma is our Vice President of Human Resources. She was promoted to Vice President of Human Resources in August, 2014. Prior to joining us as Director of Human Resources in June 2014, she was a Senior Vice President of Global Human Resources at Trend Micros, Inc. She holds an EMBA from National Taiwan University.

There is no family relationship between or amongst any of our directors or executive officers.

Share Ownership

The following table sets forth certain information as of February 28, 2015 with respect to our common shares owned by our directors and executive officers.

Name of Shareholders ⁽⁵⁾	Number of Common Shares Owned ⁽⁴⁾	Percentage of Outstanding
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		Common Shares⁽⁴⁾
Morris Chang, Chairman	125,137,914	0.48%
F.C. Tseng, Vice Chairman	34,472,675	0.13%
Johnsee Lee, Director ⁽¹⁾	1,653,709,980	6.38%
Stan Shih, Independent Director	1,480,286	0.01%
Sir Peter Leahy Bonfield, Independent Director		
Thomas J. Engibous, Independent Director		
Gregory C. Chow, Independent Director		
Kok-Choo Chen, Independent Director		
Mark Liu, President and Co-Chief Executive Officer	12,977,114	0.05%
C.C. Wei, President and Co-Chief Executive Officer	7,179,207	0.03%
Stephen T. Tso, Senior Vice President & Chief Information Officer	13,237,064	0.05%
Lora Ho, Senior Vice President, Chief Financial Officer & Spokesperson	6,381,080	0.02%
Wei-Jen Lo, Senior Vice President ⁽²⁾	1,468,127	0.01%
Rick Cassidy, Senior Vice President of TSMC & President of TSMC North America ⁽²⁾		

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Name of Shareholders ⁽⁵⁾	Number of Common Shares Owned ⁽⁴⁾	Percentage of Outstanding Common Shares ⁽⁴⁾
M.C. Tzeng, Vice President	7,592,595	0.03%
Jack Sun, Vice President & Chief Technology Officer	4,290,831	0.02%
Y.P. Chin, Vice President	7,273,122	0.03%
N.S. Tsai, Vice President	2,051,180	0.01%
J.K. Lin, Vice President	12,498,018	0.05%
J.K. Wang, Vice President	2,553,947	0.01%
Irene Sun, Vice President	420,709	0.00%
Burn J. Lin, Vice President	2,654,746	0.01%
Y.J. Mii, Vice President	1,000,419	0.00%
Cliff Hou, Vice President	652,532	0.00%
Been-Jon Woo, Vice President	220,000	0.00%
Sylvia Fang, Vice President & General Counsel, Legal Organization ⁽³⁾	700,285	0.00%
Connie Ma, Vice President & Human Resources ⁽³⁾	40,000	0.00%

(1) Represents shares held by the National Development Fund of the Executive Yuan.

(2) Dr. Wei-Jen Lo and Mr. Rick Cassidy were promoted to Senior Vice Presidents, effective February 18, 2014.

(3) Ms. Sylvia Fang and Ms. Connie Ma were promoted to Vice Presidents, effective August 12, 2014.

(4) Except for the number of shares held by the National Development Fund of the Executive Yuan, the disclosed number of shares owned by the directors and executive officers does not include any common shares held in the form of ADS by such individuals as such individual ownership of ADSs has not been disclosed or otherwise made public. Each of these individuals owned less than one percent of all common shares outstanding as of February 28, 2015.

(5) None of our directors and executive officers owned any stock option as of February 28, 2015.

Compensation

The aggregate compensation paid and benefits in kind granted to our directors and executive officers in 2014, which included a cash bonus to the directors, was NT\$1,835 million (US\$58 million). According to our Articles of Incorporation, not more than 0.3 percent of our annual net earnings (after recovering any losses incurred in prior years and deducting the legal reserve and special reserve provisions, if any) may be distributed as compensation to our directors and at least one percent of our annual net earnings (after recovering any losses incurred in prior years and deducting the legal reserve and special reserve provisions, if any) may be distributed as bonuses to employees, including executive officers. Compensation to directors is always paid in cash, while bonuses to our executive officers may be granted in cash, stock, or stock options or the combination of all these three. Individual awards are based on each individual's responsibility, contribution and performance. See note 37 to our consolidated financial statements. Under our Articles of Incorporation, directors who also serve as executive officers are not entitled to any director compensation.

Board Practices**General**

For a discussion of the term of office of the board of directors, see [Directors and Executive Officers Management](#). No benefits are payable to members of the Board upon termination of their relationship with us.

Audit Committee

Our Audit Committee was established on August 6, 2002 to assist our board of directors in the review and monitoring of our financial and accounting matters, and the integrity of our financial reporting process and controls.

All members of the Audit Committee must have a basic understanding of finance and accounting and at least one member must have accounting or related financial management expertise.

Currently, the Audit Committee consists of five members comprising all of our independent directors. The members of the Audit Committee are Sir Peter Bonfield, the Chairman of our Audit Committee, Mr. Stan Shih, Mr. Thomas J. Engibous, Mr. Gregory C. Chow and Ms. Kok-Choo Chen. In addition, Mr. J. C. Lobbezoo was appointed to serve as a financial expert consultant to the Audit Committee from February 14, 2006 onwards. See Item 16A. Audit Committee Financial Expert .

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The Audit Committee is required to meet at least once every quarter. Our Audit Committee charter grants the Audit Committee the authority to conduct any investigation which it deems appropriate to fulfill its responsibilities. It has direct access to all our books, records, facilities, and personnel, as well as our registered public accountants. It has the authority to, among other things, appoint, terminate and approve all fees to be paid to our registered public accountants, subject to the approval of the board of directors as appropriate, and to oversee the work performed by the registered public accountants. The Audit Committee also has the authority to engage special legal, accounting, or other consultants it deems necessary in the performance of its duties. Beginning on January 1, 2007, the Audit Committee also assumed the responsibilities of supervisors pursuant to the R.O.C. Securities and Exchange Law.

The Audit Committee convened four regular meetings and one special meeting in 2014. In addition to these meetings, the Audit Committee members and consultant participated in five telephone conferences to discuss our Annual Report to be filed with the Taiwan and U.S. authorities and investor conference materials with management.

Compensation Committee

Our board of directors established a Compensation Committee in June 2003 to assist our board of directors in discharging its responsibilities related to our compensation and benefit policies, plans and programs, and the compensation of our directors of the Board and executives.

The Compensation Committee, by its charter, shall consist of no fewer than three independent directors of the Board. Currently, the Compensation Committee is comprised of all five independent directors. The members of the Compensation Committee are Mr. Stan Shih, the Chairman of our Compensation Committee, Sir Peter Bonfield, Mr. Thomas J. Engibous, Mr. Gregory C. Chow and Ms. Kok-Choo Chen.

The Compensation Committee convened four regular meetings in 2014.

Employees

The following table sets out, as of the dates indicated, the number of our full-time employees serving in the capacities indicated.

Function	As of December 31,		
	2012	2013⁽¹⁾	2014⁽¹⁾
Managers	3,865	4,078	4,385
Professionals	15,844	17,205	18,552
Assistant Engineers/Clericals	3,079	3,236	3,530
Technicians	16,479	15,964	17,124
Total	39,267	40,483	43,591

The following table sets out, as of the dates indicated, a breakdown of the number of our full-time employees by geographic location:

As of December 31,

Location of Facility and Principal Offices	2012	2013⁽¹⁾	2014⁽¹⁾
Hsinchu Science Park, Taiwan	21,534	21,096	22,329
Southern Taiwan Science Park, Taiwan	8,964	10,772	12,577
Central Taiwan Science Park, Taiwan	3,558	4,721	4,480
Taoyuan County, Taiwan	1,378		
China	2,353	2,407	2,669
North America	1,395	1,397	1,450
Europe	50	53	50
Japan	32	33	32
Korea	3	4	4
Total	39,267	40,483	43,591

⁽¹⁾ The data shown no longer included Xintec Inc, as Xintec Inc. was deconsolidated in June 2013. As of December 31, 2014, our total employee population was 43,591 with an educational makeup of 4.2% Ph.Ds, 37.9% masters, 26.7% university bachelors, 11.4% college degrees and 19.8% others. Among this employee population, 52.6% were at a managerial or professional level. Continuous learning is the cornerstone of our employee development strategy. Individual development plans for each employee are tailored to their individual development needs. Employee development is further supported and enforced by a comprehensive and integrated network of resources including on-the-job training, coaching, mentoring, job rotation, on-site courses, e-learning and external learning opportunities.

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Pursuant to our Articles of Incorporation, our employees participate in our profits sharing program by way of a bonus. Employees in the aggregate are entitled to not less than 1% of our net income after the deduction for prior years' losses and contributions to legal and special reserves. Our practice in the past has been to determine the amount of the bonus based on our operating results and industry practice in the R.O.C. In 2013 and 2014, we distributed an employees' cash bonus of NT\$12,635 million (US\$400 million) and an employees' cash profit sharing of NT\$12,598 million (US\$399 million) to our employees in relation to year 2013 earnings. In 2014 and 2015, we also distributed an employees' cash bonus of NT\$17,646 million (US\$558 million) to our employees in relation to year 2014 earnings. Employee cash profit sharing of NT\$17,646 million in relation to year 2014 earnings will be distributed after approval by our shareholders at the 2015 annual general meeting of shareholders.

In November 2004, we adopted the 2004 Employee Stock Option Plan that authorizes the grant of options exercisable for up to 11 million common shares (approximately 0.05% of our total then outstanding common shares) in one or more tranches before January 6, 2006, when the 2004 Employee Stock Option Plan expired. These options vested between two and four years after the date of grant, with 50% of the options granted being exercisable two years after the grant, 75% exercisable three years after the grant and 100% exercisable four years after the grant. Any options granted will expire ten years after the date of grant. Under the 2004 Employee Stock Option Plan, a total of 10,374,550 options have been granted. The remaining balance under the 2004 Employee Stock Option Plan expired on January 6, 2006. As of December 31, 2014, 718,022 options were outstanding under the 2004 Employee Stock Option Plan.

We value two-way communication and are committed to keeping our communication channels open and transparent between the management level and their subordinates. In addition, we are dedicated to providing diverse employee engagement programs, which support our goals in reinforcing close rapport with employees and maintaining harmonious labor relations.

ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**Major Shareholders**

The following table sets forth certain information as of February 28, 2015, with respect to our common shares owned by (i) each person who, according to our records, beneficially owned five percent or more of our common shares and by (ii) all directors and executive officers as a group.

Names of Shareholders	Number of Common Shares Owned	Percentage of Total Outstanding Common Shares
National Development Fund ⁽¹⁾	1,653,709,980	6.38%
BlackRock, Inc. ⁽²⁾	1,356,173,392	5.23%
Directors and executive officers as a group ⁽³⁾	244,281,851	0.94%

(1) Excluded any common shares that may be owned by other funds controlled by the R.O.C. government.

(2) According to the Schedule 13G of BlackRock, Inc. filed with the Securities and Exchange Commission on February 6, 2015, BlackRock, Inc. is deemed to be the beneficial owner of the number of common shares listed

above as a result of BlackRock, Inc. being a parent holding company or control person in accordance with Rule 13d-1(b)(1)(ii)(G). We do not have further information with respect to BlackRock, Inc.'s ownership in us subsequent to its Schedule 13G filed on February 6, 2015.

(3) Excluded ownership of the National Development Fund.

As of February 28, 2015 a total of 25,930,043,279 common shares were outstanding. With certain limited exceptions, holders of common shares that are not R.O.C. persons are required to hold their common shares through a brokerage account in the R.O.C. As of February 28, 2015, 5,366,766,963 common shares were registered in the name of a nominee of Citibank, N.A., the depository under our ADS deposit agreement. Citibank, N.A., has advised us that, as of February 28, 2015, 1,073,353,387 ADSs, representing 5,366,766,963 common shares, were held of record by Cede & Co. and 212 other registered shareholders domiciled in and outside of the United States. We have no further information as to common shares held, or beneficially owned, by U.S. persons.

Our major shareholders have the same voting rights as our other shareholders. For a description of the voting rights of our shareholders see [Item 10. Additional Information](#) [Description of Common Shares](#) [Voting Rights](#) .

We are currently not aware of any arrangement that may at a subsequent date result in a change of control of us.

Table of Contents**Related Party Transactions*****Vanguard International Semiconductor Corporation (VIS)***

In 1994, we, the R.O.C. Ministry of Economic Affairs and other investors established VIS, then an integrated DRAM manufacturer. VIS commenced volume commercial production in 1995 and listed its shares on the R.O.C. Over-the-Counter (Taipei Exchange) in March 1998. In 2004, VIS completely terminated its DRAM production and became a dedicated foundry company. On April 14, 2014, we sold 82 million common shares of VIS. After this sale, we owned approximately 33.7% of the equity interest in VIS. As of February 28, 2015, we owned approximately 33.3% of the equity interest in VIS.

On April 1, 2004, we entered into an agreement with VIS with an initial term of two years. During the term of this agreement, VIS is obligated to use its best commercial efforts to manufacture wafers at specified yield rates for us up to a fixed amount of reserved capacity per month, and TSMC is required to use its best commercial efforts to maintain utilization of such reserved capacity within a specified range of wafers per month. Pursuant to its terms, upon expiration of its initial two-year term, this agreement is to be automatically renewed for additional one year periods unless earlier terminated by the parties. This Agreement has been so renewed per its terms. We pay VIS at a fixed discount to the actual selling price as mutually agreed between the parties in respect of each purchase order. We also agreed to license VIS certain of our process technologies and transfer certain technical know-how and information. TSMC receives from VIS certain royalty payments for granting such licenses. In 2014, we had total purchases of NT\$7,425 million (US\$235 million) from VIS, representing 1.9% of our total cost of revenue.

Systems on Silicon Manufacturing Company Pte. Ltd. (SSMC)

SSMC is a joint venture in Singapore that we established with Philips and EDB Investment Pte. Ltd. to produce integrated circuits by means of advanced submicron manufacturing processes. These integrated circuits are made pursuant to the product design specifications provided primarily by us and Philips under an agreement with Philips, and EDB Investment Pte. Ltd. (the SSMC Shareholders Agreement) in March 1999 and, primarily by us and NXP, subsequent to the assignment by Philips of its rights to NXP and NXP's assumption of Philips' obligations under the SSMC Shareholders Agreement pursuant to the Assignment and Assumption Agreement effective September 25, 2006. SSMC's business is limited to manufacturing wafers for us, our subsidiaries, NXP and NXP's subsidiaries. In November 15, 2006, we and NXP exercised the option rights under the SSMC Shareholders Agreement to purchase all of the SSMC shares owned by EDB Investment Pte. Ltd. As a result, we now own 38.8%, and NXP owns 61.2% of SSMC. While we, together with NXP, have the right to purchase up to 100% of SSMC's annual capacity, we and NXP are required to purchase, in the aggregate, at least 70% of SSMC's full capacity; we, alone, are required to purchase up to 28% of the annual installed capacity. As of February 28, 2015, we owned approximately 38.8% of the equity interest in SSMC. See below for a detailed discussion of the contract terms we entered into with SSMC.

We entered into a technology cooperation agreement with SSMC effective March 30, 1999 in which SSMC agreed to base at least a major part of its production activities on processes compatible to those in use in our metal oxide semiconductor (MOS) integrated circuits wafer volume production fabs. In return, we have agreed to provide SSMC with access to and benefit of the technical knowledge and experience relating to certain processes in use in our MOS integrated circuits wafer volume production fabs and to assist SSMC by rendering certain technical services in connection with its production activities. In addition, we granted to SSMC limited licenses of related intellectual property rights owned or controlled by us for the purpose of MOS integrated circuit production for the sole use in manufacturing products for us. SSMC pays to us during, and up to three years after, the term of this agreement a remuneration of a fixed percentage of the net selling price of all products manufactured by SSMC. In 2014, we had total purchases of NT\$4,220 million (US\$134 million) from SSMC, representing 1.1% of our total cost of revenue.

Global Unichip Corporation (GUC)

In January 2003, we acquired 52.0% equity interest in GUC, a System-on-Chip (SoC) design service company that provides large scale SoC implementation services. GUC has been listed on the Taiwan Stock Exchange since November 3, 2006. Since July 2011, we were no longer deemed to be a controlling entity of GUC and its subsidiaries due to the termination of a Shareholders Agreement. As a result, we no longer consolidated GUC and its subsidiaries in our financial statements. As of February 28, 2015, we owned approximately 34.8% of the equity interest in GUC.

In 2014, we had total sales of NT\$3,867 million (US\$122 million) to GUC, representing 0.5% of our total revenue.

Xintec, Inc. (Xintec)

In January 2007, we acquired a 51.2% equity interest in Xintec, a supplier of wafer level packaging service, to support our CMOS image sensor manufacturing business. Since June 2013, we were no longer deemed to be a controlling entity of Xintec due to the addition of independent directors to Xintec's board, which resulted in our appointed directors on its board representing less than a majority. As a result, we no longer consolidated Xintec in our financial statements. As of February 28, 2015, we owned approximately 39.9% of the equity interest in Xintec. On March 30, 2015, Xintec listed its shares on the R.O.C. Over-the-Counter (Taipei Exchange). Subsequent to Xintec's IPO, our shareholding in Xintec was diluted to approximately 34.6%. We leased machinery and equipment from Xintec and the related rental expense was classified under manufacturing expenses.

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In 2014, we incurred total manufacturing expenses of NT\$2,437 million (US\$77 million) from Xintec, representing 0.6% of our total cost of revenue.

ITEM 8. FINANCIAL INFORMATION

Consolidated Financial Statements and Other Financial Information

Please see Item 18. Financial Statements . Other than as disclosed elsewhere in this annual report, no significant change has occurred since the date of the annual consolidated financial statements.

Legal Proceedings

As is the case with many companies in the semiconductor industry, we have received from time to time communications from third parties asserting that our technologies, our manufacturing processes, or the design of the integrated circuits made by us or the use of those integrated circuits by our customers may infringe upon their patents or other intellectual property rights. These assertions have at times resulted in litigation by or against us and settlement payments by us. Irrespective of the validity of these claims, we could incur significant costs in the defense thereof or could suffer adverse effects on our operations.

In June 2010, Keranos, LLC. filed a complaint in the U.S. District Court for the Eastern District of Texas alleging that TSMC, TSMC North America, and several other leading technology companies infringe three expired U.S. patents. In response, TSMC, TSMC North America, and several co-defendants in the Texas case filed a lawsuit against Keranos in the U.S. District Court for the Northern District of California in November 2010, seeking a judgment declaring that they did not infringe the asserted patents, and that those patents were invalid. These two litigations have been consolidated into a single lawsuit in the U.S. District Court for the Eastern District of Texas. In February 2014, the Court entered a final judgment in favor of TSMC, dismissing all of Keranos' claims against TSMC with prejudice. The final judgment is currently being appealed to the U.S. Court of Appeals for the Federal Circuit. The outcome cannot be determined at this time.

In December 2010, Ziptronix, Inc. filed a complaint in the U.S. District Court for the Northern District of California accusing TSMC, TSMC North America and one other company of infringing several U.S. patents. In September 2014, the Court granted summary judgment of noninfringement in favor of TSMC and TSMC North America. Ziptronix, Inc. can appeal the Court's order. The outcome cannot be determined at this time.

In September 2013, Zond Inc. filed a complaint in U.S. District Court for the District of Massachusetts against TSMC, certain TSMC subsidiaries and other companies alleging infringing of several U.S. patents. Subsequently, TSMC and Zond initiated additional legal actions in the U.S. District Courts for the District of Delaware and the District of Massachusetts over several additional patents owned by Zond. In March 2015, all pending litigations between the parties in the U.S. District Courts for the District of Massachusetts and the District of Delaware were dismissed.

In December 2013, Tela Innovations, Inc. filed complaints in the U.S. District Court for the District of Delaware and in the United States International Trade Commission accusing TSMC and TSMC North America of infringing one U.S. patent. In January 2014, TSMC filed a lawsuit in the U.S. District Court for the Northern District of California against Tela for trade secret misappropriation and breach of contract. In September 2014, all pending litigations between the parties in the U.S. District Court for the District of Delaware, the ITC and the U.S. District Court for the Northern District of California were dismissed.

In March 2014, DSS Technology Management, Inc. filed a complaint in the U.S. District Court for the Eastern District of Texas alleging that TSMC, TSMC North America, TSMC Development, Inc., and several other companies infringe one U.S. patent. TSMC Development, Inc. has subsequently been dismissed. The outcome cannot be determined at this time.

Other than the matters described above, we were not involved in any other material litigation in 2014 and are not currently involved in any material litigation.

Table of Contents**Dividends and Dividend Policy**

The following table sets forth the dividends per share paid during each of the years indicated in respect of common shares outstanding on the record date eligible to the payment of those dividends. During 2012, 2013 and 2014, we paid cash dividends in the amounts of NT\$77,748,667,725, NT\$77,773,307,004 and NT\$77,785,851,420 (US\$2,461,577,577), respectively.

	Cash Dividends Per Share NT\$	Stock dividends Per 100 shares	Total shares issued as stock dividends	Outstanding common shares at year end
2012	2.9995			25,924,435,668
2013	2.9995			25,928,617,140
2014	2.9999			25,929,662,436

Our dividend policy is set forth in our articles of incorporation. Except as otherwise specified in the articles of incorporation or under Taiwan law, we will not pay dividends when there is no profit or retained earnings. Our profits may be distributed by way of cash dividend, stock dividend, or a combination of cash and stock. On December 21, 2004, our shareholders approved amendments to our articles of incorporations pursuant to which distributions of profits shall be made preferably by way of cash dividend. In addition, pursuant to the amendments, the ratio for stock dividends shall not exceed 50% of the total distribution.

Holders of outstanding common shares on a dividend record date will be entitled to the full dividend declared without regard to any subsequent transfer of the common shares. Payment of dividends (including in cash and in common shares) in respect of the prior year is made following approval by our shareholders at the annual general meeting of shareholders. Distribution of stock dividends is subject to approval by the R.O.C. FSC.

Except as otherwise specified in the articles of incorporation or under Taiwan law, we are not permitted to distribute dividends or make other distributions to shareholders in respect of any year in which we have no current or retained earnings. The R.O.C. Company Law also requires that 10% of annual net income (less prior years' losses and outstanding taxes) be set aside as legal reserves until the accumulated legal reserves equal our paid-in capital. Our articles of incorporation provide that at least one percent of annual net earnings (after recovering any losses incurred in prior years and deducting the legal reserve and special reserve provisions, if any) may be distributed as a bonus to employees and that not more than 0.3 percent of our annual net earnings (after recovering any losses incurred in prior years and deducting the legal reserve and special reserve provisions, if any) may be distributed as a bonus to directors. Under our articles of incorporation, directors who also serve as executive officers are not entitled to any director bonuses.

Holders of ADRs evidencing ADSs are entitled to receive dividends, subject to the terms of the deposit agreement, to the same extent as the holders of common shares. Cash dividends will be paid to the depositary and, after deduction of any applicable R.O.C. taxes and except as otherwise provided in the deposit agreement, will be paid to holders. Stock dividends will be distributed to the depositary and, except as otherwise provided in the deposit agreement, will be distributed to holders by the depositary in the form of additional ADSs.

For information relating to R.O.C. withholding taxes payable on cash and stock dividends, see Item 10. Additional Information Taxation R.O.C. Taxation Dividends .

ITEM 9. THE OFFER AND LISTING

The principal trading market for our common shares is the Taiwan Stock Exchange. Our common shares have been listed on the Taiwan Stock Exchange under the symbol 2330 since September 5, 1994, and the ADSs have been listed on the New York Stock Exchange under the symbol TSM since October 8, 1997. The outstanding ADSs are identified by the CUSIP number 874039100. The table below sets forth, for the periods indicated, the high and low closing prices and the average daily volume of trading activity on the Taiwan Stock Exchange for the common shares and the high and low closing prices and the average daily volume of trading activity on the New York Stock Exchange for the common shares represented by ADSs.

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	Taiwan Stock Exchange Closing price per common share ⁽²⁾		Average daily trading volume (in thousands of shares)	New York Stock Exchange ⁽¹⁾ Closing price per ADS ⁽²⁾		Average daily trading volume (in thousands of ADSs)
	High (NT\$)	Low (NT\$)		High (US\$)	Low (US\$)	
2010	64.12	47.85	46,661	11.19	7.92	14,140
2011	70.28	58.08	50,131	12.24	10.05	14,704
2012	94.37	68.81	39,620	16.43	11.96	10,581
2013	109.88	92.33	34,841	19.23	15.41	10,372
First Quarter	103.70	93.23	37,186	18.22	16.07	9,717
Second Quarter	109.88	92.76	34,520	19.23	15.92	10,900
Third Quarter	107.58	92.33	39,847	18.13	15.41	10,974
Fourth Quarter	109.05	97.80	28,192	18.74	16.62	9,855
2014	141.50	98.29	36,510	23.47	16.10	11,066
First Quarter	115.90	98.29	41,001	19.58	16.10	11,392
Second Quarter	123.72	114.43	31,400	21.22	19.19	10,151
Third Quarter	133.50	119.50	37,411	22.66	19.79	11,126
Fourth Quarter	141.50	120.50	36,626	23.47	19.44	11,595
October	130.50	120.50	42,971	22.02	19.44	15,991
November	141.50	131.00	33,171	23.47	21.80	9,780
December	141.00	130.50	33,688	22.94	21.44	8,567
2015						
January	147.00	130.00	52,773	24.19	20.79	17,403
February	154.50	142.00	41,621	25.04	22.67	11,614
March	154.00	142.50	53,210	24.80	22.94	13,423
April (through April 10, 2015)	147.00	143.00	42,793	23.69	23.20	11,722

Source: Bloomberg

- (1) Trading in ADSs commenced on October 8, 1997 on the New York Stock Exchange. Each ADS represents the right to receive five common shares.
- (2) As adjusted for a NT\$2.9997 cash dividend per share in July 2010, a NT\$2.9995 cash dividend per share in July 2011, a NT\$2.9995 cash dividend per share in July 2012, a NT\$2.9995 cash dividend per share in July 2013 and a NT\$2.9999 cash dividend per share in July 2014.

ITEM 10. ADDITIONAL INFORMATION**Description of Common Shares**

We are organized under the laws of the R.O.C. Set forth below is a description of our common shares, including summaries of the material provisions of our articles of incorporation, the R.O.C. Company Law, the R.O.C. Securities and Exchange Law and the regulations promulgated thereunder.

General

Our authorized share capital is NT\$280,500,000,000, divided into 28,050,000,000 common shares of which 500,000,000 common shares are reserved for the issuance for our employee stock options and among which 25,929,662,436 and 25,930,043,279 common shares were issued and outstanding as of December 31, 2014 and February 28, 2015, respectively.

The R.O.C. Company Law, the R.O.C. Act for Establishment and Administration of Science Parks and the R.O.C. Securities and Exchange Law provide that any change in the issued share capital of a public company, such as us, requires the approval of its board of directors, (or, for capital reduction, a resolution of its shareholders meeting), the approval of, or the registration with, the R.O.C. FSC and the Ministry of Economic Affairs or the Science Park Administration (as applicable) and/or an amendment to its articles of incorporation (if such change also involves a change in the authorized share capital).

There are no provisions under either R.O.C. law or the deposit agreement under which holders of ADSs would be required to forfeit the common shares represented by ADSs.

Table of Contents***Dividends and Distributions***

An R.O.C. company is generally not permitted to distribute dividends or to make any other distributions to shareholders in respect of any year for which it did not have either earnings or retained earnings. In addition, before distributing a dividend to shareholders following the end of a fiscal year, the company must recover any past losses, pay all outstanding taxes and set aside in a legal reserve, until such time as its legal reserve equals its paid-in capital, 10% of its net income for that fiscal year (less any past losses and outstanding tax), and may set aside a special reserve. Our articles of incorporation provide that at least one percent of the net distributable income for that fiscal year be distributed as a bonus to employees and that not more than 0.3 percent of the net distributable income for that fiscal year may be distributed as a bonus to directors. Under our articles of incorporation, directors who also serve as executive officers are not entitled to any director bonuses. In 2012, 2013 and 2014, we paid 100% of the bonus to employees and directors in the form of cash. Subject to compliance with these requirements, a company may pay dividends or make other distributions from its accumulated earnings or reserves as permitted by the R.O.C. Company Law as set forth below.

At the annual general meeting of our shareholders, the board of directors submits to the shareholders for their approval our financial statements for the preceding fiscal year and any proposal for the distribution of a dividend or the making of any other distribution to shareholders from our earnings or retained earnings (subject to compliance with the requirements described above) at the end of the preceding fiscal year. All common shares outstanding and fully paid as of the relevant record date are entitled to share equally in any dividend or other distribution so approved. Dividends may be distributed in cash, in the form of common shares or a combination thereof, as determined by the shareholders at the meeting.

In addition to permitting dividends to be paid out of earnings or retained earnings, the R.O.C. Company Law permits us to make distributions to our shareholders in cash or in the form of common shares from capital surplus and the legal reserve. However, dividend distribution out of our legal reserve can only be effected to the extent of the excessive amount of the accumulated legal reserve over 25% of our paid-in capital.

For information as to R.O.C. taxes on dividends and distributions, see [Taxation](#) [R.O.C. Taxation](#) .

Preemptive Rights and Issues of Additional Common Shares

Under the R.O.C. Company Law, when a public company such as us issues new shares of common stock for cash, 10% to 15% of the issue must be offered to its employees. The remaining new shares must be offered to existing shareholders in a preemptive rights offering, subject to a requirement under the R.O.C. Securities and Exchange Law that at least 10% of these issuances must be offered to the public. This percentage can be increased by a resolution passed at a shareholders' meeting, thereby limiting or waiving the preemptive rights of existing shareholders. The preemptive rights provisions do not apply to limited circumstances, such as:

issuance of new shares upon conversion of convertible bonds; and

offerings of new shares through a private placement approved at a shareholders' meeting.

Authorized but unissued shares of any class may be issued at such times and, subject to the above-mentioned provisions of the R.O.C. Company Law and the R.O.C. Securities and Exchange Law, upon such terms as the board of directors may determine. The shares with respect to which preemptive rights have been waived may be freely offered,

subject to compliance with applicable R.O.C. law.

Meetings of Shareholders

Meetings of our shareholders may be general meetings or special meetings. General meetings of shareholders are generally held in Hsinchu, Taiwan, within six months after the end of each fiscal year. Special meetings of shareholders may be convened by resolution of the board of directors whenever it deems necessary, or under certain circumstances, by shareholders or the audit committee. For a public company such as us, notice in writing of shareholders' meetings, stating the place, time and purpose thereof, must be sent to each shareholder at least thirty days (in the case of general meetings) and fifteen days (in the case of special meetings) prior to the date set for each meeting.

Voting Rights

A holder of common shares has one vote for each common share. Except as otherwise provided by law, a resolution may be adopted by the holders of a simple majority of the total issued and outstanding common shares represented at a shareholders' meeting at which a majority of the holders of the total issued and outstanding common shares are present. The election of directors at a shareholders' meeting is by cumulative voting. As authorized under the R.O.C. Company Law, we have adopted a nomination procedure for election of our directors in our articles of incorporation. According to our articles of incorporation, ballots for the election of directors and independent directors are cast separately.

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The R.O.C. Company Law also provides that in order to approve certain major corporate actions, including (i) any amendment to the articles of incorporation (which is required for, among other actions, any increase in authorized share capital), (ii) execution, modification or termination of any contracts regarding leasing of all business or joint operations or mandate of the company's business to other persons, (iii) the dissolution, amalgamation or spin-off of a company or the transfer of the whole or an important part of its business or its properties or the taking over of the whole of the business or properties of any other company which would have a significant impact on the acquiring company's operations or (iv) the removal of directors or supervisors or (v) the distribution of any stock dividend, a meeting of the shareholders must be convened with a quorum of holders of at least two-thirds of all issued and outstanding shares of common stock at which the holders of at least a majority of the common stock represented at the meeting vote in favor thereof. However, in the case of a publicly held company such as us, such a resolution may be adopted by the holders of at least two-thirds of the shares of common stock represented at a meeting of shareholders at which holders of at least a majority of the issued and outstanding shares of common stock are present.

A shareholder may be represented at a shareholders' meeting by proxy. A valid proxy must be delivered to us at least five days prior to the commencement of the shareholders' meeting.

Holders of ADSs will not have the right to exercise voting rights with respect to the common shares represented thereby, except as described in "Voting of Deposited Securities".

Other Rights of Shareholders

Under the R.O.C. Company Law, dissenting shareholders are entitled to appraisal rights in the event of amalgamation, spin-off or certain other major corporate actions. A dissenting shareholder may request us to redeem all of the shares owned by that shareholder at a fair price to be determined by mutual agreement or a court order if agreement cannot be reached. A shareholder may exercise these appraisal rights by serving a written notice on us prior to the related shareholders' meeting and by raising an objection at the shareholders' meeting. In addition to appraisal rights, any shareholder has the right to sue for the annulment of any resolution adopted at a shareholders' meeting where the procedures were legally defective within thirty days after the date of such shareholders' meeting. One or more shareholders who have held more than three percent of the issued and outstanding shares for over a year may require audit committee to bring a derivative action against a director for that director's liability to us as a result of that director's unlawful actions or failure to act. In addition, one or more shareholders who have held more than three percent of our issued and outstanding shares for over a year may require the board of directors to convene a special shareholders' meeting by sending a written request to the board of directors.

The R.O.C. Company Law allows shareholder(s) holding 1% or more of the total issued shares of a company to, during the period of time prescribed by the company, submit one proposal in writing containing no more than three hundred words (Chinese characters) for discussion at the general meeting of shareholders. In addition, if a company adopts a nomination procedure for election of directors or supervisors in its articles of incorporation, shareholders representing 1% or more of the total issued shares of such company may submit a candidate list in writing to the company along with relevant information and supporting documents.

Register of Shareholders and Record Dates

Our share registrar, Chinatrust Commercial Bank, maintains the register of our shareholders at its office in Taipei, Taiwan. Under the R.O.C. Company Law, the transfer of common shares in registered form is effected by endorsement of the transferor's and transferee's seals on the share certificates and delivery of the related share certificates. In order to assert shareholders' rights against us, however, the transferee must have his name and address registered on the register of shareholders. Shareholders are required to file their respective specimen signatures or

seals with us. The settlement of trading in the common shares is carried out on the book-entry system maintained by the Taiwan Depository & Clearing Corporation and therefore, the share transfer will follow the procedures of the Taiwan Depository & Clearing Corporation.

The R.O.C. Company Law permits us to set a record date and close the register of shareholders for a specified period in order for us to determine the shareholders or pledgees that are entitled to certain rights pertaining to common shares by giving advance public notice. Under the R.O.C. Company Law, our register of shareholders should be closed for a period of sixty days, thirty days and five days immediately before each general meeting of shareholders, special meeting of shareholders and record date of dividend distribution, respectively.

Annual Financial Statements

Under the R.O.C. Company Law, ten days before the general meeting of shareholders, our annual financial statements must be available at our principal office in Hsinchu for inspection by the shareholders.

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Acquisition of Common Shares by Us

With minor exceptions, we may not acquire our common shares under the R.O.C. Company Law. However, under the R.O.C. Securities and Exchange Law, we may, by a board resolution adopted by majority consent at a meeting with two-thirds of our directors present, purchase our common shares on the Taiwan Stock Exchange or by a tender offer, in accordance with the procedures prescribed by the R.O.C. FSC, for the following purposes: (i) to transfer shares to our employees; (ii) to satisfy our obligations to provide our common shares upon exercise or conversion of any warrants, convertible bonds or convertible preferred shares; and (iii) if necessary, to maintain our credit and our shareholders' equity (such as for the purpose of supporting the trading price of our common shares during market dislocations), provided that the common shares so purchased shall be cancelled thereafter.

We are not allowed to purchase more than ten percent of our total issued and outstanding common shares. In addition, we may not spend more than the aggregate amount of our retained earnings, premium from issuing stock and the realized portion of the capital reserve to purchase our common shares.

We may not pledge or hypothecate any purchased common shares. In addition, we may not exercise any shareholders' rights attached to such common shares. In the event that we purchase our common shares on the Taiwan Stock Exchange, our affiliates, directors, managers and their respective spouses, minor children and nominees are prohibited from selling any of our common shares during the period in which we purchase our common shares.

In addition, effective from November 14, 2001 under the revised R.O.C. Company Law, our subsidiaries may not acquire our shares. This restriction does not, however, affect any of our shares acquired by our subsidiaries prior to November 14, 2001.

Liquidation Rights

In the event of our liquidation, the assets remaining after payment of all debts, liquidation expenses, taxes and distributions to holders of preferred shares, if any, will be distributed pro rata to our shareholders in accordance with the R.O.C. Company Law.

Transaction Restrictions

The R.O.C. Securities and Exchange Law (i) requires each director, supervisor, manager or shareholder holding more than ten percent of the shares of a public company to report the amount of that person's shareholding to that company and (ii) limits the number of shares that can be sold or transferred on the Taiwan Stock Exchange or on the R.O.C. Over-the-Counter (Taipei Exchange) by that person per day.

Material Contracts

We joined the Customer Co-Investment Program of ASML Holding N.V. (ASML) and entered into an investment agreement in August 2012. The agreement includes an investment of EUR838 million to acquire 5% of ASML's equity with a lock-up period of 2.5 years. Both parties also signed a research and development funding agreement under which we will provide EUR276 million to ASML's research and development programs from 2013 to 2017.

Foreign Investment in the R.O.C.

Since 1983, the R.O.C. government has periodically enacted legislation and adopted regulations to permit foreign investment in the R.O.C. securities market.

On September 30, 2003, the R.O.C. Executive Yuan approved an amendment to Regulations Governing Investment in Securities by Overseas Chinese and Foreign National, or the Regulations, which took effect on October 2, 2003. According to the Regulations, the R.O.C. FSC abolished the mechanism of the so-called qualified foreign institutional investors and general foreign investors as stipulated in the Regulations before the amendment.

Under the Regulations, foreign investors are classified as either onshore foreign investors or offshore foreign investors according to their respective geographical location. Both onshore and offshore foreign investors are allowed to invest in R.O.C. securities after they register with the Taiwan Stock Exchange. The Regulations further classify foreign investors into foreign institutional investors and foreign individual investors. Foreign institutional investors refer to those investors incorporated and registered in accordance with foreign laws outside of the R.O.C. (i.e., offshore foreign institutional investors) or their branches set up and recognized within the R.O.C. (i.e., onshore foreign institutional investors). Offshore overseas Chinese and foreign individual investors may be subject to a maximum investment ceiling that will be separately determined by the R.O.C. FSC after consultation with the Central Bank of the Republic of China (Taiwan). Currently, there is no maximum investment ceiling for offshore overseas Chinese and foreign individual investors. On the other hand, foreign institutional investors are not subject to any ceiling for investment in the R.O.C. securities market.

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Except for certain specified industries, such as telecommunications, investments in R.O.C.-listed companies by foreign investors are not subject to individual or aggregate foreign ownership limits. Custodians for foreign investors are required to submit to the Central Bank of the Republic of China (Taiwan) and the Taiwan Stock Exchange a monthly report of trading activities and status of assets under custody and other matters. Capital remitted to the R.O.C. under these guidelines may be remitted out of the R.O.C. at any time after the date the capital is remitted to the R.O.C. Capital gains and income on investments may be remitted out of the R.O.C. at any time.

Foreign investors (other than foreign investors who have registered with the Taiwan Stock Exchange for making investments in the R.O.C. securities market) who wish to make direct investments in the shares of R.O.C. companies are required to submit a foreign investment approval application to the Investment Commission of the R.O.C. Ministry of Economic Affairs or other applicable government authority. The Investment Commission or such other government authority reviews each foreign investment approval application and approves or disapproves each application after consultation with other governmental agencies (such as the Central Bank of the Republic of China (Taiwan) and the R.O.C. FSC).

Under current R.O.C. law, any non-R.O.C. person possessing a foreign investment approval may repatriate annual net profits, interest and cash dividends attributable to the approved investment. Stock dividends attributable to this investment, investment capital and capital gains attributable to this investment may be repatriated by the non-R.O.C. person possessing a foreign investment approval after approvals of the Investment Commission or other government authorities have been obtained.

In addition to the general restriction against direct investment by non-R.O.C. persons in securities of R.O.C. companies, non-R.O.C. persons (except in certain limited cases) are currently prohibited from investing in certain industries in the R.O.C. pursuant to a negative list, as amended by the R.O.C. Executive Yuan. The prohibition on foreign investment in the prohibited industries specified in the negative list is absolute in the absence of a specific exemption from the application of the negative list. Pursuant to the negative list, certain other industries are restricted so that non-R.O.C. persons (except in limited cases) may invest in these industries only up to a specified level and with the specific approval of the relevant competent authority that is responsible for enforcing the relevant legislation that the negative list is intended to implement.

The R.O.C. FSC announced on April 30, 2009 the Regulations Governing Mainland Chinese Investors' Securities Investments (P.R.C. Regulations). According to the P.R.C. Regulations, a P.R.C. qualified domestic institutional investor (QDII) is allowed to invest in R.O.C. securities (including less than 10% shareholding of an R.O.C. company listed on Taiwan Stock Exchange or R.O.C. Over-the-Counter (Taipei Exchange)). Nevertheless, the total investment amount of QDIIs cannot exceed US\$500 million. For each QDII, the custodians of such QDIIs must apply with the Taiwan Stock Exchange for the remittance amount for each QDII, which cannot exceed US\$100 million, and QDII can only invest in the R.O.C. securities market with the amount approved by the Taiwan Stock Exchange. In addition, QDIIs are currently prohibited from investing in certain industries, and their investment of certain other industries in a given company is restricted to a certain percentage pursuant to a list promulgated by the FSC and amended from time to time. P.R.C. investors other than QDII, however, are prohibited from making investments in an R.O.C. company listed on the Taiwan Stock Exchange or the R.O.C. Over-the-Counter (Taipei Exchange), unless with approval from the Investment Commission of the R.O.C. Ministry of Economic Affairs for its investment of 10% or more (or other percentage applicable to certain restricted industries) of the equity interest of such R.O.C. company.

In addition to investments permitted under the P.R.C. Regulations, P.R.C. investors who wish to make (i) direct investment in the shares of R.O.C. private companies or (ii) investments, individually or aggregately, in 10% or more (or other percentage applicable to certain restricted industries) of the equity interest of an R.O.C. company listed on the Taiwan Stock Exchange or R.O.C. Over-the-Counter (Taipei Exchange) are required to submit an investment

approval application to the Investment Commission of the R.O.C. Ministry of Economic Affairs or other government authority. The Investment Commission of the R.O.C. Ministry of Economic Affairs or such other government authority reviews Investment Approval application and approves or disapproves each application after consultation with other governmental agencies. Furthermore, P.R.C. investor who wishes to be elected as an R.O.C. company's director or supervisor shall also submit an investment approval application to the Investment Commission of the R.O.C. Ministry of Economic Affairs or other government authority for approval.

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Depository Receipts

In April 1992, the R.O.C. FSC enacted regulations permitting R.O.C. companies with securities listed on the Taiwan Stock Exchange, with the prior approval of the R.O.C. Financial Supervisory Commission, to sponsor the issuance and sale to foreign investors of depository receipts. Depository receipts represent deposited shares of R.O.C. companies. In December 1994, the R.O.C. FSC allowed companies whose shares are traded on the R.O.C. Over-the-Counter (Taipei Exchange) or listed on the Taiwan Stock Exchange, upon approval of the R.O.C. FSC, to sponsor the issuance and sale of depository receipts.

Our deposit agreement has been amended and restated on November 16, 2007 to: (i) make our ADSs eligible for the direct registration system, as required by the New York Stock Exchange, by providing that ADSs may be certificated or uncertificated securities, (ii) enable the distribution of our reports by electronic means and (iii) reflect changes in R.O.C. laws in connection with the nomination of candidates for independent directors, for voting at the meeting of the shareholders. A copy of our amended and restated deposit agreement has been filed under the cover of Form F-6 on November 16, 2007.

A holder of depository receipts (other than citizens of the P.R.C. and entities organized under the laws of the P.R.C. save for QDII or those which otherwise obtain the approval of the Investment Commission of the R.O.C. Ministry of Economic Affairs) may request the depository to either cause the underlying shares to be sold in the R.O.C. and to distribute the sale proceeds to the holder or to withdraw from the depository receipt facility the shares represented by the depository receipts to the extent permitted under the deposit agreement (for depository receipts representing existing shares, immediately after the issuance of the depository receipts; and for depository receipts representing new shares, in practice four to seven business days after the issuance of the depository receipts) and transfer the shares to the holder.

We, or the foreign depository bank, may not increase the number of depository receipts by depositing shares in a depository receipt facility or issuing additional depository receipts against these deposits without specific R.O.C. FSC approval, except in limited circumstances. These circumstances include issuances of additional depository receipts in connection with:

dividends or free distributions of shares;

the exercise by holders of existing depository receipts of their pre-emptive rights in connection with capital increases for cash; or

if permitted under the deposit agreement and custody agreement, the deposit of common shares purchased by any person directly or through a depository bank on the Taiwan Stock Exchange or the R.O.C.

Over-the-Counter (Taipei Exchange) (as applicable) or held by such person for deposit in the depository receipt facility.

However, the total number of deposited shares outstanding after an issuance under the circumstances described in the third clause above may not exceed the number of deposited shares previously approved by the R.O.C. FSC plus any depository receipts created under the circumstances described in the first two clauses above. Issuances of additional depository receipts under the circumstances described in the third clause above will be permitted to the extent that previously issued depository receipts have been canceled and the underlying shares have been withdrawn from the

depository receipt facility.

Under current R.O.C. law, a non-R.O.C. holder of ADSs who withdraws and holds the underlying shares must register with the Taiwan Stock Exchange and appoint an eligible local agent to:

open a securities trading account with a local securities brokerage firm;

remit funds; and

exercise rights on securities and perform other matters as may be designated by the holder.

Under existing R.O.C. laws and regulations, without this account, holders of ADSs that withdraw and hold the common shares represented by the ADSs would not be able to hold or subsequently transfer the common shares, whether on the Taiwan Stock Exchange or otherwise. In addition, a withdrawing non-R.O.C. holder must appoint a local bank to act as custodian for handling confirmation and settlement of trades, safekeeping of securities and cash proceeds and reporting of information.

Holders of ADSs who are non-R.O.C. persons withdrawing common shares represented by ADSs are required under current R.O.C. law and regulations to appoint an agent in the R.O.C. for filing tax returns and making tax payments. This agent, a tax guarantor, must meet certain qualifications set by the R.O.C. Ministry of Finance and, upon appointment, becomes a guarantor of the withdrawing holder's R.O.C. tax payment obligations. In addition, under current R.O.C. law, repatriation of profits by a non-R.O.C. withdrawing holder is subject to the submission of evidence of the appointment of a tax guarantor to, and approval thereof by, the tax authority, or submission of tax clearance certificates or submission of evidencing documents issued by such agent (so long as the capital gains from securities transactions are exempt from R.O.C. income tax).

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Under existing R.O.C. laws and regulations relating to foreign exchange control, a depositary may, without obtaining further approvals from the Central Bank of the Republic of China (Taiwan) or any other governmental authority or agency of the R.O.C., convert NT dollars into other currencies, including U.S. dollars, in respect of the following: proceeds of the sale of shares represented by depositary receipts, proceeds of the sale of shares received as stock dividends and deposited into the depositary receipt facility and any cash dividends or cash distributions received. In addition, a depositary, also without any of these approvals, may convert inward remittances of payments into NT dollars for purchases of underlying shares for deposit into the depositary receipt facility against the creation of additional depositary receipts. A depositary may be required to obtain foreign exchange approval from the Central Bank of the Republic of China (Taiwan) on a payment-by-payment basis for conversion from NT dollars into other currencies relating to the sale of subscription rights for new shares. Proceeds from the sale of any underlying shares by holders of depositary receipts withdrawn from the depositary receipt facility may be converted into other currencies without obtaining Central Bank of the Republic of China (Taiwan) approval. Proceeds from the sale of the underlying shares withdrawn from the depositary receipt facility may be used for reinvestment in the Taiwan Stock Exchange or the R.O.C. Over-the-Counter (Taipei Exchange), subject to compliance with applicable laws and regulations.

Direct Share Offerings

Since 1997, the R.O.C. government has amended regulations to permit R.O.C. companies listed on the Taiwan Stock Exchange or R.O.C. Over-the-Counter (Taipei Exchange) to issue shares directly (not through depositary receipt facility) overseas.

Overseas Corporate Bonds

Since 1989, the R.O.C. FSC has approved a series of overseas bonds issued by R.O.C. companies listed on the Taiwan Stock Exchange or the R.O.C. Over-the-Counter (Taipei Exchange) in offerings outside the R.O.C. Under current R.O.C. law, these overseas corporate bonds can be:

converted by bondholders, other than citizens of the P.R.C. and entities organized under the laws of the P.R.C. save for QDII or those that have obtained the approval of the Investment Commission of the R.O.C. Ministry of Economic Affairs, into shares of R.O.C. companies; or

subject to R.O.C. FSC approval, converted into depositary receipts issued by the same R.O.C. company or by the issuing company of the exchange shares, in the case of exchangeable bonds.

The relevant regulations also permit public companies to issue corporate debt in offerings outside the R.O.C. Proceeds from the sale of the shares converted from overseas convertible bonds may be used for reinvestment in securities listed on the Taiwan Stock Exchange or traded on the R.O.C. Over-the-Counter (Taipei Exchange), subject to compliance with applicable laws and regulations.

Exchange Controls in the R.O.C.

The R.O.C. Foreign Exchange Control Statute and regulations provide that all foreign exchange transactions must be executed by banks designated to handle such business by the R.O.C. FSC and by the Central Bank of the Republic of China (Taiwan). Current regulations favor trade-related foreign exchange transactions. Consequently, foreign currency earned from exports of merchandise and services may now be retained and used freely by exporters, and all foreign currency needed for the importation of merchandise and services may be purchased freely from the designated foreign

exchange banks.

Trade aside, R.O.C. companies and resident individuals may, without foreign exchange approval, remit to and from the R.O.C. foreign currency of up to US\$50 million (or its equivalent) and US\$5 million (or its equivalent), respectively, in each calendar year. Furthermore, any remittance of foreign currency into the R.O.C. by a R.O.C. company or resident individual in a year will be offset by the amount remitted out of R.O.C. by such company or individual (as applicable) within its annual quota and will not use up its annual inward remittance quota to the extent of such offset. The above limits apply to remittances involving a conversion of NT dollars to a foreign currency and vice versa. A requirement is also imposed on all enterprises to register medium- and long-term foreign debt with the Central Bank of the Republic of China (Taiwan).

In addition, foreign persons may, subject to certain requirements, but without foreign exchange approval of the Central Bank of the Republic of China (Taiwan), remit outside and into the R.O.C. foreign currencies of up to US\$100,000 (or its equivalent) for each remittance. The above limit applies to remittances involving a conversion of NT dollars to a foreign currency and vice versa. The above limit does not, however, apply to the conversion of NT dollars into other currencies, including U.S. dollars, in respect of the proceeds of sale of any underlying shares withdrawn from a depositary receipt facility.

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Voting of Deposited Securities

Holders may direct the exercise of voting rights with respect to the common shares represented by the ADSs only in accordance with the provisions of the deposit agreement as described below and applicable R.O.C. law. See Item 3. Key Information Risk Factors Risks Relating to Ownership of ADSs Your voting rights as a holder of ADSs will be limited .

Except as described below, the holders will not be able to exercise the voting rights attaching to the common shares represented by the ADSs on an individual basis. According to provisions of the deposit agreement, the voting rights attaching to the common shares represented by ADSs must be exercised as to all matters subject to a vote of shareholders by the depositary bank or its nominee, who represents all holders of ADSs, collectively in the same manner, except in the case of an election of directors. Directors are elected by cumulative voting unless our articles of incorporation stipulate otherwise.

In the deposit agreement, the holders will appoint the depositary bank as their representative to exercise the voting rights with respect to the common shares represented by the ADSs.

We will provide the depositary bank with copies (including English translations) of notices of meetings of our shareholders and the agenda of these meetings, including a list of the director candidates, if an election of directors is to be held at the meeting. The depositary bank will mail these materials, together with a voting instruction form to holders as soon as practicable after the depositary bank receives the materials from us. In order to validly exercise its voting rights, the holder of ADSs must complete, sign and return to the depositary bank the voting instruction form by a date specified by the depositary bank.

Subject to the provisions described in the second succeeding paragraph, which will apply to the election of directors done by means of cumulative voting, if persons together holding at least 51% of the ADSs outstanding at the relevant record date instruct the depositary bank to vote in the same manner in respect of one or more resolutions to be proposed at the meeting (other than the election of directors), the depositary bank will notify the instructions to the chairman of our board of directors or a person he may designate. The depositary bank will appoint the chairman or his designated person to serve as the voting representative of the depositary bank or its nominee and the holders. The voting representative will attend such meeting and vote all the common shares represented by ADSs to be voted in the manner so instructed by such holders in relation to such resolution or resolutions.

If, for any reason, the depositary bank has not by the date specified by it received instructions from persons together holding at least 51% of all the ADSs outstanding at the relevant record date to vote in the same manner in respect of any resolution specified in the agenda for the meeting (other than the election of directors), then the holders will be deemed to have instructed the depositary bank or its nominee to authorize and appoint the voting representative as the representative of the depositary bank and the holders to attend such meeting and vote all the common shares represented by all ADSs as the voting representative deems appropriate with respect to such resolution or resolutions, which may not be in your interests; provided, however, that the depositary bank or its nominee will not give any such authorization and appointment unless it has received an opinion of R.O.C. counsel addressed to the depositary bank and in form and substance satisfactory to the depositary bank, at its sole expense, to the effect that, under R.O.C. law (i) the deposit agreement is valid, binding and enforceable against us and the holders and (ii) the depositary bank will not be deemed to be authorized to exercise any discretion when voting in accordance with the deposit agreement and will not be subject to any potential liability for losses arising from such voting. We and the depositary bank will take such actions, including amendment of the provisions of the deposit agreement relating to voting of common shares, as we deem appropriate to endeavor to provide for the exercise of voting rights attached to the common shares represented by all ADSs at shareholders meetings in a manner consistent with applicable R.O.C. law.

The depositary bank will notify the voting representative of the instructions for the election of directors received from holders and appoint the voting representative as the representative of the depositary bank and the holders to attend such meeting and vote the common shares represented by ADSs as to which the depositary bank has received instructions from holders for the election of directors, subject to any restrictions imposed by R.O.C. law and our articles of incorporation. Holders who by the date specified by the depositary bank have not delivered instructions to the depositary bank will be deemed to have instructed the depositary bank to authorize and appoint the voting representative as the representative of the depositary bank or its nominee and the holders to attend such meeting and vote all the common shares represented by ADSs as to which the depositary bank has not received instructions from the holders for the election of directors as the voting representative deems appropriate, which may not be in your best interests. Candidates standing for election as representatives of a shareholder may be replaced by such shareholder prior to the meeting of the shareholders, and the votes cast by the holders for such candidates shall be counted as votes for their replacements.

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By accepting and continuing to hold ADSs or any interest therein, the holders will be deemed to have agreed to the voting provisions set forth in the deposit agreement, as such provisions may be amended from time to time to comply with applicable R.O.C. law.

There can be no assurance that the holders will receive notice of shareholders' meetings sufficiently prior to the date established by the depositary bank for receipt of instructions to enable you to give voting instructions before the cutoff date.

Moreover, in accordance with the deposit agreement, as further amended and restated as of November 16, 2007 and pursuant to R.O.C. Company Law, holders that individually or together with other holders hold at least 51% of the ADSs outstanding at the relevant record date are entitled to submit each year one written proposal for voting at the general meeting of shareholders; provided, that (i) such proposal is in Chinese language and does not exceed 300 Chinese characters, (ii) such proposal is submitted to the depositary bank at least two business days prior to the expiry of the relevant submission period, which shall be publicly announced by us each year in a report on Form 6-K filed with the Securities Exchange Commission prior to the commencement of the 60 days closed period for general meetings of shareholders, (iii) such proposal is accompanied by a written certificate to the depositary bank, in the form required by the depositary bank, certifying that such proposal is being submitted by holders that individually or together with other holders hold at least 51% of the ADSs outstanding at the date of the submission and, if the date of the submission is on or after the relevant record date, also certifying that the holders who submitted the proposal held at least 51% of the ADSs outstanding as of the relevant record date, (iv) if the date of the submission is prior to the relevant record date, the holders who submitted the proposal must also provide, within five business days after the relevant record date, a second written certificate to the depositary bank, in the form required by the depositary bank, certifying that the holders who submitted the proposal continued to hold at least 51% of the ADSs outstanding at the relevant record date, (v) such proposal is accompanied by a joint and several irrevocable undertaking of all submitting holders to pay all fees and expenses incurred in relation to the submission (including the costs and expenses of the depositary bank or its agent to attend the general meeting of the shareholders) as such fees and expenses may be reasonably determined and documented by the depositary bank or us, and (vi) such proposal shall only be voted upon at the general meeting of shareholders if such proposal is accepted by our board of directors as eligible in accordance with applicable law for consideration at a shareholders meeting.

Taxation

R.O.C. Taxation

The following is a general summary of the principal R.O.C. tax consequences of the ownership and disposition of ADSs representing common shares to a non-resident individual or entity. It applies only to a holder that is:

an individual who is not an R.O.C. citizen, who owns ADSs and who is not physically present in the R.O.C. for 183 days or more during any calendar year (a Non-ROC Individual Holder); or

a corporation or a non-corporate body that is organized under the laws of a jurisdiction other than the R.O.C. for profit-making purposes and has no fixed place of business or business agent in the R.O.C. (a Non-ROC Entity Holder).

Holders of ADSs are urged to consult their own tax advisors as to the particular R.O.C. tax consequences of owning the ADSs which may affect them.

Dividends. Dividends declared by us out of our retained earnings and distributed to the holders are subject to R.O.C. withholding tax, currently at the rate of 20%, on the amount of the distribution in the case of cash dividends or on the par value of the common shares in the case of stock dividends. However, a 10% R.O.C. retained earnings tax paid by us on our undistributed after-tax earnings, if any, would provide a credit of up to 5% of the gross amount of any dividends declared out of those earnings that would reduce the 20% R.O.C. tax imposed on those distributions.

Distribution of common shares declared by us out of our capital reserves is not subject to R.O.C. withholding tax, except under limited circumstances.

Capital Gains. Capital gains realized from the sale or disposal of the common shares on or before December 31, 2012 are exempt from R.O.C. income tax under Article 4-1 of the R.O.C. Income Tax Act. Starting from January 1, 2013, Non-R.O.C. Entity Holders remain exempt from income tax on capital gains from the sale or disposal of the common shares. However, Non-R.O.C. Individual Holders are now subject to R.O.C. income tax on capital gains from the sale or disposal of the common shares. Capital loss incurred therefrom can be deducted from capital gains in calculating the net capital gain and income tax liability, but cannot be carried forward to subsequent years. Capital gains are taxed at a flat rate of 15%. In addition, only 50% of the net capital gains are subject to income tax if the Non-R.O.C. Individual Holder has held the common shares for one year or longer. As a result, the tax agent of each Non-R.O.C. Individual Holder should pay the income tax payable, if any, and file an income tax return in May each year for the capital gains that the Non-R.O.C. Individual Holder generates in the prior year.

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Subscription Rights. Distributions of statutory subscription rights for common shares in compliance with R.O.C. law are not subject to any R.O.C. tax. Proceeds derived from sales of statutory subscription rights evidenced by securities are subject to securities transaction tax at the rate of 0.3% of the gross amount received. Non-R.O.C. Entity Holders are exempt from income tax on capital gains from the sale of statutory subscription rights evidenced by securities. However, Non-R.O.C. Individual Holders are now subject to R.O.C. income tax at a flat rate of 15% on capital gains from such sale. Proceeds derived from sales of statutory subscription rights that are not evidenced by securities are subject to capital gains tax at the rate of 20%.

Subject to compliance with R.O.C. law, we, at our sole discretion, can determine whether statutory subscription rights shall be evidenced by issuance of securities.

Securities Transaction Tax. A securities transaction tax, at the rate of 0.3% of the sales proceeds, will be withheld upon a sale of common shares in the R.O.C. Transfers of ADSs are not subject to R.O.C. securities transaction tax. Withdrawal of common shares from the deposit facility is not subject to R.O.C. securities transaction tax.

Estate and Gift Tax. R.O.C. estate tax is payable on any property within the R.O.C. left by a deceased, and R.O.C. gift tax is payable on any property within the R.O.C. donated by an individual. Estate tax and Gift tax are currently payable at the rate of 10%. Under R.O.C. estate and gift tax laws, common shares issued by R.O.C. companies are deemed located in the R.O.C. regardless of the location of the holder. It is unclear whether a holder of ADSs will be considered to hold common shares for this purpose.

Tax Treaty. The R.O.C. does not have a double taxation treaty with the United States. On the other hand, the R.O.C. has double taxation treaties with Indonesia, Singapore, South Africa, Australia, Vietnam, New Zealand, Malaysia, Macedonia, Israel, Gambia, The Netherlands, the United Kingdom, Senegal, Sweden, Belgium, Denmark, Paraguay, Hungary, France, Swaziland, India, Slovakia, Switzerland, Germany, Thailand, Luxembourg, Kiribati and Austria which may limit the rate of R.O.C. withholding tax on dividends paid with respect to common shares in R.O.C. companies. The ADS holders may or may not be considered to hold common shares for the purposes of these treaties. The holders should consult their tax advisors concerning their eligibility for the benefits with respect to the ADSs.

United States Federal Income Taxation

This section discusses the material United States federal income tax consequences to U.S. holders (as defined below) of owning and disposing of our common shares or ADSs. It applies to you only if you hold your common shares or ADSs as capital assets for United States federal tax purposes. This section does not apply to you if you are a member of a special class of holders subject to special rules, including:

dealers or traders in securities or foreign currencies;

banks and certain other financial institutions;

brokers;

traders in securities that elect to use a mark-to-market method of accounting for their securities holdings;

tax-exempt organizations, retirement plans, individual retirement accounts and other tax-deferred accounts;

life insurance companies;

persons liable for alternative minimum tax;

persons that actually or constructively own 10% or more of our voting stock;

persons that hold common shares or ADSs as part of a straddle or a hedging or conversion or integrated transaction for United States federal income tax purposes;

persons who are former citizens or former long-term residents of the United States, or

persons whose functional currency is not the U.S. dollar.

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This section is based on the Internal Revenue Code of 1986, as amended, its legislative history, existing and proposed regulations, and published rulings and court decisions, all as currently in effect. These laws are subject to change, possibly on a retroactive basis. In addition, this section is based in part upon the representations of the depositary and the assumption that each obligation in the Deposit Agreement and any related agreement will be performed in accordance with its terms. In general, for United States federal income tax purposes, if you hold ADRs evidencing ADSs, you will be treated as the owner of the shares represented by those ADSs. Exchanges of shares for ADRs, and ADRs for shares, generally will not be subject to United States federal income tax.

Further, this section is based on the depositary's representation that it will not, by reason of existing Taiwanese legal and regulatory limitations applicable to depositary receipt programs, engage in the issuance of ADRs prior to the receipt of shares or the release of shares prior to the cancellation of ADRs (pre-release transactions). The depositary has not represented that it will not engage in pre-release transactions if such Taiwanese legal and regulatory limitations change. If the depositary engages in such pre-release transactions, there may be material adverse United States federal income tax consequences to holders of ADRs.

You are a U.S. holder if you are a beneficial owner of common shares or ADSs and you are:

a citizen or resident of the United States;

a United States domestic corporation, or other entity subject to United States federal income tax as a domestic corporation;

an estate whose income is subject to United States federal income tax regardless of its source; or

a trust if a United States court can exercise primary supervision over the trust's administration and one or more United States persons are authorized to control all substantial decisions of the trust.

If a partnership (including for this purpose any entity treated as a partnership for United States federal income tax purposes) is a beneficial owner of the common shares or ADSs, the United States tax treatment of a partner in the partnership generally will depend on the status of the partner and the activities of the partnership. A holder of the common shares or ADSs that is a partnership and partners in such a partnership should consult their own tax advisors concerning the United States federal income tax consequences of purchasing, owning and disposing of common shares or ADSs.

We urge you to consult your own tax advisor regarding the United States federal, state, local income tax and other tax consequences of owning and disposing of common shares or ADSs in your particular circumstances.

Taxation of Dividends

Subject to the passive foreign investment company, or PFIC, rules discussed below, if you are a U.S. holder, the gross amount of any dividend we pay in respect of your common shares or ADSs out of our current or accumulated earnings and profits (as determined for United States federal income tax purposes) including the amount of any R.O.C. tax withheld reduced by any credit against such withholding tax on account of the 10% retained earnings tax imposed on us, is subject to United States federal income taxation. Because we do not intend to calculate our earnings and profits

under U.S. federal income tax principles, a U.S. Holder should expect that any distribution made by us to such holder will generally be treated as a dividend. If you are a noncorporate U.S. holder, under existing law any dividends paid to you that constitute qualified dividend income will be taxable to you at a maximum tax rate of 20% (plus, if applicable, the Medicare Tax discussed below) provided that you hold the common shares or ADSs for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date and meet other holding period requirements. Dividends we pay with respect to the common shares or ADSs will be qualified dividend income provided that, in the year that you receive the dividend, the common shares or ADSs are readily tradable on an established securities market in the United States. The dividend is taxable to you when you, in the case of common shares, or the Depository, in the case of ADSs, receive the dividend actually or constructively. The dividend will not be eligible for the dividends-received deduction generally allowed to United States corporations in respect of dividends received from other United States corporations. The amount of the dividend distribution that you must include in your income as a U.S. holder will be the U.S. dollar value of the NT Dollar payments made, determined at the spot NT Dollar/U.S. dollar rate on the date the dividend distribution is includible in your income, regardless of whether the payment is in fact converted into U.S. dollars. Generally, any gain or loss resulting from currency exchange fluctuations during the period from the date you include the dividend payment in income to the date you convert the payment into U.S. dollars will be treated as ordinary income or loss and will not be eligible for the special tax rate applicable to qualified dividend income. The gain or loss generally will be income or loss from sources within the United States for foreign tax credit limitation purposes. Distributions in excess of current and accumulated earnings and profits, as determined for United States federal income tax purposes, will be treated as a non-taxable return of capital to the extent of your basis in the common shares or ADSs and thereafter as capital gain.

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Subject to generally applicable limitations and restrictions, the R.O.C. taxes withheld from dividend distributions and paid over to the R.O.C. (reduced by any credit against such withholding tax on account of the 10% retained earnings tax) will be eligible for credit against your U.S. federal income tax liabilities. Special rules apply in determining the foreign tax credit limitation with respect to dividends that are subject to the maximum 20% tax rate. Dividends will be income from sources outside the United States. Dividends will, depending on your circumstances, be passive or general income which, in either case, is treated separately from other types of income for purposes of computing the foreign tax credit allowable to you. The rules applicable to the United States foreign tax credit are complex, and we urge you to consult your own tax adviser concerning the availability of the credit in your particular circumstances.

Pro rata distributions of common shares by us to holders of common shares or ADSs will generally not be subject to U.S. federal income tax. Accordingly, such distributions will generally not give rise to U.S. federal income tax against which the R.O.C. tax imposed on such distributions may be credited. Any such R.O.C. tax will generally only be creditable against a U.S. holder's U.S. federal income tax liability with respect to general limitation income and not with respect to passive income.

In the event that the ex-dividend date on The New York Stock Exchange or other securities exchange or market for a dividend or distribution that gives rise to R.O.C. withholding tax is after the record date for such dividend or distribution (during which period such ADSs may trade with due bills), a purchaser of ADSs during the period from the record date to the ex-dividend date likely would not be entitled to a foreign tax credit for R.O.C. taxes paid in respect of such ADSs even if (i) the purchaser receives the equivalent of such dividend or distribution on the relevant distribution date, and (ii) an amount equivalent to the applicable R.O.C. withholding tax is withheld therefrom or otherwise charged to the account of such purchaser.

Taxation of Capital Gains

Subject to the PFIC rules discussed below, if you are a U.S. holder and you sell or otherwise dispose of your common shares or ADSs, you will recognize capital gain or loss for United States federal income tax purposes equal to the difference between the U.S. dollar value of the amount that you realize and your tax basis, determined in U.S. dollars, in your common shares or ADSs. Capital gain of a noncorporate U.S. holder is generally taxed under existing law at a maximum rate of 15% where the property is held more than one year. The gain or loss will generally be income or loss from sources within the United States for foreign tax credit limitation purposes.

Medicare Tax

A United States person that is an individual or estate, or a trust that does not fall into a special class of trusts that is exempt from such tax, is subject to a 3.8% tax on the lesser of (1) the United States person's net investment income for the relevant taxable year and (2) the excess of the United States person's modified adjusted gross income for the taxable year over a certain threshold (which in the case of individuals is between \$125,000 and \$250,000, depending on the individual's circumstances). A holder's net investment income will generally include its gross dividend income and its net gains from the disposition of ADSs, unless such dividends or net gains are derived in the ordinary course of the conduct of a trade or business (other than a trade or business that consists of certain passive or trading activities). If you are a United States person that is an individual, estate or trust, you are urged to consult your tax advisors regarding the applicability of the Medicare tax to your income and gains in respect of your investment in the ADSs.

Passive Foreign Investment Company Rules

We believe that common shares and ADSs should not be treated as stock of a PFIC for United States federal income tax purposes for the current taxable year and for future taxable years, but this conclusion is a factual determination that

is made annually, based on the categories and amounts of income that we earn and the categories and valuation of our assets (including goodwill) for each taxable year, and thus may be subject to change. Accordingly, no assurance can be given that the Company will not be considered by the U.S. Internal Revenue Service to be a PFIC in the current or future years.

In general, if you are a U.S. holder, we will be a PFIC with respect to you if for any taxable year in which you held our common shares or ADSs:

at least 75% of our gross income for the taxable year is passive income; or

at least 50% of the value, determined on the basis of a quarterly average, of our assets is attributable to assets that produce or are held for the production of passive income.

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Passive income generally includes dividends, interest, royalties, rents (other than certain rents and royalties derived in the active conduct of a trade or business), annuities and gains from assets that produce passive income. If a foreign corporation owns directly or indirectly at least 25% by value of the stock of another corporation, the foreign corporation is treated for purposes of the PFIC tests as owning its proportionate share of the assets of the other corporation, and as receiving directly its proportionate share of the other corporation's income.

If we are treated as a PFIC, and you are a U.S. holder that does not make a mark-to-market election, as described below, you will be subject to special rules with respect to:

any gain you realize on the sale or other disposition of your common shares or ADSs; and

any excess distribution that we make to you (generally, any distributions to you during a single taxable year that are greater than 125% of the average annual distributions received by you in respect of the common shares or ADSs during the three preceding taxable years or, if shorter, your holding period for the common shares or ADSs).

Under these rules:

the gain or excess distribution will be allocated ratably over your holding period for the common shares or ADSs,

the amount allocated to the taxable year in which you realized the gain or excess distribution will be taxed as ordinary income,

the amount allocated to each prior year, with certain exceptions, will be taxed at the highest tax rate in effect for that year, and

the interest charge generally applicable to underpayments of tax will be imposed in respect of the tax attributable to each such year.

Special rules apply for calculating the amount of the foreign tax credit with respect to excess distributions by a PFIC.

If you own common shares or ADSs in a PFIC that are treated as marketable stock, you may make a mark-to-market election. If you make this election, you will not be subject to the PFIC rules described above. Instead, in general, you will include as ordinary income each year the excess, if any, of the fair market value of your common shares or ADSs at the end of the taxable year over your adjusted basis in your common shares or ADSs. These amounts of ordinary income will not be eligible for the favorable tax rates applicable to qualified dividend income or long-term capital gains. You will also be allowed to take an ordinary loss in respect of the excess, if any, of the adjusted basis of your common shares or ADSs over their fair market value at the end of the taxable year (but only to the extent of the net amount of previously included income as a result of the mark-to-market election). Your basis in the common shares or ADSs will be adjusted to reflect any such income or loss amounts. Your gain, if any, recognized upon the sale of your common shares or ADSs will be taxed as ordinary income.

Also, where a company that is a PFIC meets certain reporting requirements, a U.S. holder could avoid certain adverse PFIC consequences described herein by making a qualified electing fund (QEF) election to be taxed currently on its proportionate share of the PFIC's ordinary income and net capital gains. U.S. holders will not be able to treat the Company as a QEF if the Company does not prepare the information that U.S. holders would need to make a QEF election. We do not intend to prepare or provide the information that would enable U.S. Holders to make a QEF election.

In addition, notwithstanding any election you make with regard to the common shares or ADSs, dividends that you receive from us will not constitute qualified dividend income to you if we are a PFIC either in the taxable year of the distribution or the preceding taxable year. Moreover, your common shares or ADSs will be treated as stock in a PFIC if we were a PFIC at any time during your holding period in your shares or ADSs, even if we are not currently a PFIC. For purposes of this rule, if you make a mark-to-market election with respect to your shares or ADSs, you will be treated as having a new holding period in your shares or ADSs beginning on the first day of the first taxable year beginning after the last taxable year for which the mark-to-market election applies. Dividends that you receive that do not constitute qualified dividend income are not eligible for taxation at the 20% maximum rate applicable to qualified dividend income. Instead, you must include the gross amount of any such dividend paid by us out of our accumulated earnings and profits (as determined for United States federal income tax purposes) in your gross income, and it will be subject to tax at rates applicable to ordinary income as well as the special rules provided with respect to excess distributions, if applicable, as described above.

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If you own common shares or ADSs during any year that we are a PFIC with respect to you, you must file Internal Revenue Service Form 8621.

The rules dealing with PFICs and with the QEF and mark-to-market elections are very complex and are affected by various factors in addition to those described above, including the Company's ownership of any non-U.S. subsidiaries. As a result, U.S. holders are urged to consult their own tax advisors concerning the PFIC rules.

Non-U.S. Holders

Except as described in the section titled "Information reporting and backup withholding" below, a non-U.S. holder will not be subject to U.S. federal income or withholding tax on the payment of dividends and the proceeds from the disposition of shares or ADSs unless: such item is effectively connected with the conduct by the non-U.S. holder of a trade or business in the United States and, in the case of a resident of a country which has a treaty with the United States and is eligible for the benefits of the treaty with the United States, such item is attributable to a permanent establishment or, in the case of an individual, a fixed place of business, in the United States; or the non-U.S. holder is an individual who holds the shares or ADSs as a capital asset and is present in the United States for 183 days or more in the taxable year of the disposition, certain other conditions are met, and such non-U.S. holder does not qualify for an exemption. If the first exception applies, the non-U.S. holder generally will be subject to U.S. federal income tax with respect to such item in the same manner as a U.S. holder unless otherwise provided in an applicable income tax treaty; a non-U.S. holder that is a corporation for U.S. federal income tax purposes may also be subject to a branch profits tax with respect to such item at a rate of 30% (or at a reduced rate under an applicable income tax treaty). If the second exception applies, the non-U.S. holder generally will be subject to U.S. federal income tax at a rate of 30% (or at a reduced rate under an applicable income tax treaty) on the amount by which such non-U.S. holder's capital gains allocable to U.S. sources exceed capital losses allocable to U.S. sources during the taxable year of disposition of the shares or ADSs.

Information reporting and backup withholding

U.S. holders generally are subject to information reporting requirements with respect to dividends paid on shares or ADSs and on the proceeds from the sale, exchange or disposition of shares or ADSs unless the holder is a corporation or otherwise establishes a basis for exemption. In addition, U.S. holders are subject to back-up withholding (currently at 28%) on dividends paid on shares or ADSs, and on the sale, exchange or other disposition of shares or ADSs, unless each such U.S. holder provides a taxpayer identification number and a duly executed IRS Form W-9 or otherwise establishes an exemption. Non-U.S. holders generally are not subject to information reporting or backup withholding with respect to dividends, or the proceeds from the sale, exchange or other disposition of shares or ADSs, provided that each such non-U.S. holder certifies as to its foreign status on the applicable duly executed IRS Form W-8 or otherwise establishes an exemption. Backup withholding is not an additional tax and the amount of any backup withholding will be allowed as a credit against a U.S. holder's or non-U.S. holder's U.S. federal income tax liability and may entitle such holder to a refund, provided that certain required information is timely furnished to the IRS.

Information with Respect to Foreign Financial Assets

Individuals that own "specified foreign financial assets" with an aggregate value in excess of \$50,000 will generally be required to file an information report with respect to such assets with their tax returns. "Specified foreign financial assets" include any financial accounts maintained by foreign financial institutions, as well as any of the following, but only if they are not held in accounts maintained by financial institutions: (i) stocks and securities issued by non-U.S. persons, (ii) financial instruments and contracts held for investment that have non-U.S. issuers or counterparties and

(iii) interests in foreign entities. U.S. holders that are individuals are urged to consult their tax advisors regarding the application of these rules to their ownership of ADSs.

Documents on Display

We are subject to the information requirements of the Securities Exchange Act of 1934, as amended. In accordance with these requirements, we file reports and other information with the Securities and Exchange Commission. These materials, including this annual report and the exhibits thereto, may be inspected and copied at the Commission's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. The public may obtain information on the operation of the Commission's Public Reference Room by calling the Commission in the United States at 1-800-SEC-0330. The Commission also maintains a web site at <http://www.sec.gov> that contains reports, proxy statements and other information regarding registrants that file electronically with the Commission. In addition, material filed by us can be inspected at the offices of the New York Stock Exchange at 20 Broad Street, New York, New York 10005.

Table of Contents**ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS**

Our exposure to financial market risks derives primarily from changes in interest rates, foreign exchange rates and equity investment prices. To mitigate these risks, we utilize derivative financial instruments, the application of which, pursuant to our internal guidelines, is for hedging purposes and not for trading or speculative purposes. Our policy is to account for the unrealized gains or losses of these hedging contracts on a mark-to-market rate basis through profit or loss.

Interest Rate Risks: We are exposed to interest rate risks, primarily related to borrowings for general corporate purposes. As of December 31, 2014, we also had investment in held-to-maturity, fixed-rate commercial papers in the amount of NT\$4,486 million, which had maturity dates of not more than 6 months.

The table below presents annual principal amounts due and related weighted average forward interest rates by year of maturity for our debt obligations outstanding as of December 31, 2014.

	As of December 31, 2014 Expected Maturity Dates					Total	Aggregate Fair Value ⁽¹⁾	As of December 31, 2013	
	2015	2016	2017	2018	2019 and thereafter			Total	Aggregate Fair Value
Long-term debt (in millions) NT\$									
Denominated debt									
Variable rate		NT\$8	NT\$10	NT\$10	NT\$12	NT\$40	NT\$40	NT\$40	NT\$40
Weighted average interest rate		3.93%	4.11%	4.19%	4.19%	4.12% ⁽²⁾		4.44%	
Fixed rate		NT\$12,000	NT\$38,100	NT\$24,300	NT\$91,800	NT\$166,200	NT\$166,357	NT\$166,200	NT\$165,476
Weighted average interest rate		1.39%	1.30%	1.35%	1.52%	1.43%		1.43%	
US\$ denominated debt									
Fixed rate		US\$350		US\$1,150		US\$1,500	US\$1,476	US\$1,500	US\$1,449
Weighted average interest rate		0.95%		1.63%		1.47%		1.47%	

Represents the then quoted market price.

Weighted average implied forward interest rates

Foreign Currency Risk: Substantial portions of our revenues and expenses are denominated in currencies other than NT dollar. As a result, as of December 31, 2014, the majority of our receivables and payables were denominated in currencies other than NT dollar,

primarily in U.S. dollar, Euro and Japanese Yen. To protect against reductions in value and the volatility of future cash flows caused by changes in foreign exchange rates, we utilize foreign currency denominated debts and offsetting derivatives, including currency forward contracts and cross currency swaps, to hedge our currency exposure. These hedging transactions help to reduce partially, but do not eliminate, the impact of foreign currency exchange rate movements. Based on a sensitivity analysis performed on our financial position as of December 31, 2014, a hypothetical, unfavorable 10% movement in the levels of foreign currency exchange rates relative to the NT dollar, after taking into account hedging and offsetting positions, would have increased our net unrealized losses by NT\$332 million (US\$10 million).

The table below presents our outstanding foreign currency derivative transactions as of December 31, 2014. These contracts all had a maturity date of not more than 12 months.

Forward

Exchange

Agreements

	As of December 31, 2014					Total	Aggregate Fair Value ⁽¹⁾	As of December 31,	
	Expected Maturity Dates							2013	
(in millions)	2015	2016	2017	2018	2019 and thereafter			Total	Aggregate Fair Value
sell US\$/Buy JPY)									
Contract Amount	US\$29.5					US\$29.5	NT\$(4.3)	US\$340.1	NT\$46.7
Average Contractual Change Rate (against US\$ dollars)	1.22					1.22		1.37	
sell US\$/Buy Y)									
Contract Amount	US\$226.0					US\$226.0	NT\$39.9	US\$341.0	NT\$(17.4)
Average Contractual Change Rate (against Japanese Yen)	120.14					120.14		104.85	
sell NT\$/Buy JPY)									
Contract Amount								NT\$4,514.3	NT\$9.4
Average Contractual Change Rate (against NT dollar)								41.04	

(\$ dollars)					
Sell					
NT\$/Buy					
(\$)					
Contract					
Amount	NT\$1,632.4	NT\$1,632.4	NT\$10.5	NT\$683.7	NT\$3.6

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	As of December 31, 2014 Expected Maturity Dates					Total	Aggregate Fair Value ⁽¹⁾	As of December 2013	
	2015	2016	2017	2018	2019 and thereafter			Total	Aggregate Fair Value
Annual interest rate (NT\$)	31.45					31.45		29.99	
\$/Buy Contract	US\$181.0					US\$181.0	NT\$15.0	US\$138.0	NT\$
Annual interest rate (RMB)	6.24					6.24		6.10	
\$/Buy Contract	US\$170.0					US\$170.0	NT\$(115.4)		
Annual interest rate (NT\$)	31.04					31.04			
\$/Buy Contract	EUR4.6					EUR4.6	NT\$0.8		
Annual interest rate (US\$)	1.22					1.22			
Currency									
	As of December 31, 2014 Expected Maturity Dates					Total	Aggregate Fair Value ⁽¹⁾	As of December 2013	
	2015	2016	2017	2018	2019 and thereafter			Total	Aggregate Fair Value
\$/Buy Contract	NT\$2,511.9					NT\$2,511.9	NT\$21.9	NT\$1,639.2	NT\$
of interest	0%					0%		0%	
of interest received	0.05%~0.13%					0.05%~0.13%		1.03%~2.00%	

\$/Buy contract	US\$1,460.0	US\$1,460.0
of interest 1	0.16%~1.92%	0.16%~1.92% NT\$(262.6)
of interest divided	0%	0%

fair value represents the amount of the receivable from or payable to the counter-parties if the contracts had been terminated at the end of the reporting period.

Table 3. Key Information Exchange Rates for a summary of the movements between the NT dollar and the U.S. dollar during recent years.

Market Risk: As of December 31, 2014, we had available-for-sale equity investments in the amount of NT\$75,598 million (US\$2,392 million). These investments predominantly consisted of our investment in ASML shares with a carrying value of NT\$72,473 million (US\$2,293 million). In 2013 and 2014, we entered into equity derivative transactions to fully hedge the market risk of our investment in ASML shares. The weighted average hedge price was EUR62.59 per share, resulting in a lock-in profit of approximately US\$695 million. We also had investments in private equity securities through a number of investment funds with a carrying value of NT\$1,801 million (US\$57 million). The carrying value of these investments in private equity securities and in the investment funds are subject to fluctuations and their fair market value may be significantly different from the carrying value. We recorded declines in the value of certain publicly traded securities and privately held investments and recorded impairment losses of NT\$3,000 million, NT\$1,540 million and NT\$211 million (US\$7 million), respectively, in 2012, 2013 and 2014.

The table below presents our outstanding equity derivative transactions as of December 31, 2014.

Contract	As of December 31, 2014 Expected Maturity Dates					Total	Aggregate Fair Value ⁽¹⁾	As of December 2013	
	2015	2016	2017	2018	2019 onward			Total	Aggregate Fair Value
Contract amount	NT\$56,173					NT\$56,173	NT\$(16,364)	NT\$37,432	NT\$
Contract Price	EUR62.59					EUR62.59		Footnote ⁽²⁾	

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- (1) Fair value represents the amount of the receivable from or payable to the counter-parties if the contracts had been terminated at the end of the reporting period.
- (2) Determined by a specific percentage of the spot price on the respective trade date.

ITEM 12D. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**Depository Fees and Charges**

Under the terms of the Depository Agreement for the TSMC American Depositary Shares (ADSs), an ADS holder may have to pay the following service fees to the depository bank:

Service	Fees
Issuance of ADS	Up to US\$0.05 (or fractions thereof) per ADS issued
Cancellation of ADS	Up to US\$0.05 (or fractions thereof) per ADS cancelled
Distribution of cash proceeds (i.e. upon sale of rights and other entitlements)	Up to US\$0.02 per ADS held
Distribution of ADS rights or other free distributions of Stock (excluding stock dividends)	Up to US\$0.05 (or fractions thereof) per ADS issued

Depository fees payable upon the issuance and cancellation of ADSs are typically paid to the depository bank by the brokers (on behalf of their clients) receiving the newly-issued ADSs from the depository bank and by the brokers (on behalf of their clients) delivering the ADSs to the depository bank for cancellation. The brokers in turn charge these transaction fees to their clients.

Depository Payment

In 2014, we received reimbursement of proxy related expenses (printing, postage and distribution) of US\$415,680.2 from Citibank, N.A., the Depository Bank for our ADR program.

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PART II

ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

None.

ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

None.

ITEM 15. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures. Pursuant to Rule 13a-15(b) of the Securities Exchange Act of 1934, an evaluation was carried out under the supervision and with the participation of our principal executive and principal financial officers of the effectiveness of our disclosure controls and procedures. Based upon that evaluation, the Co-Chief Executive Officers and Chief Financial Officer concluded that these disclosure controls and procedures were effective as of December 31, 2014.

Management's Annual Report on Internal Control over Financial Reporting. Management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is a process designed under the supervision of our principal executive and principal financial officers to provide reasonable assurance regarding the reliability of financial reporting and the preparation of our financial statements for external reporting purposes in accordance with IFRSs as issued by the IASB. Our internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with IFRSs as issued by the IASB, and that receipts and expenditures are being made only in accordance with authorizations of our management and directors; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

As of the end of 2014, management conducted an assessment of the effectiveness of our internal control over financial reporting based on the framework established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has determined that our internal control over financial reporting as of December 31, 2014 is effective.

Our independent registered public accounting firm, Deloitte & Touche, independently assessed the effectiveness of our company's internal control over financial reporting. Deloitte & Touche has issued an attestation report, which is included at the end of this Item 15.

Changes in Internal Control over Financial Reporting. During 2014, there was no material change to our internal control over financial reporting.

Attestation Report of the Independent Registered Public Accounting Firm.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Taiwan Semiconductor Manufacturing Company Limited

We have audited the internal control over financial reporting of Taiwan Semiconductor Manufacturing Company Limited and subsidiaries (the Company) as of December 31, 2014, based on the criteria established in *Internal Control Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on the criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2014 of the Company and our report dated April 13, 2015 expressed an unqualified opinion on those financial statements and included an explanatory paragraph regarding the convenience translation of New Taiwan dollar amounts into U.S. dollar amounts.

/s/ Deloitte & Touche
Taipei, Taiwan
The Republic of China
April 13, 2015

ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our Audit Committee is currently comprised of five independent directors. Since June 1, 2005, no Audit Committee member has served as audit committee financial expert. Instead, our Audit Committee has engaged a financial expert consultant who our board of directors determined has the attributes required of an audit committee financial expert as defined under the applicable rules of the U.S. SEC issued pursuant to Section 407 of the Sarbanes-Oxley Act of 2002. In particular, our board of directors appointed Mr. J.C. Lobbezoo to serve as an independent financial expert consultant to our Audit Committee from February 14, 2006 onwards. Our board of directors believes that the Audit Committee members along with the advisors of the Audit Committee, including the financial expert consultant, possess sufficient financial knowledge and experience.

ITEM 16B. CODE OF ETHICS

We have adopted a Policy of Ethics and Business Conduct for employees, officers and directors, which also applies to our Chief Executive Officer, Chief Financial Officer, Controller, and any other persons performing similar functions.

We will provide to any person without charge, upon request, a copy of our Policy of Ethics and Business Conduct . Any request should be made per email to our Investor Relations Division at invest@tsmc.com.

Table of Contents**ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The table below summarizes the fees that we paid for services provided by Deloitte & Touche and its affiliated firms (the Deloitte Entities) for the years ended December 31, 2013 and 2014.

	2013	2014
	NT\$	NT\$
	(In thousands)	
Audit Fees	69,369	65,065
Audit-Related Fees	789	180
All Other Fees	2,800	
Total	72,958	65,245

Audit Fees. This category includes the audit of our annual financial statements and internal control over financial reporting, review of quarterly financial statements and services that are normally provided by the independent auditors in connection with statutory and regulatory filings or engagements for those fiscal years. This category also includes advice on audit and accounting matters that arose during, or as a result of, the audit or the review of quarterly financial statements and statutory audits required by non-U.S. jurisdictions, including statutory audits required by the Tax Bureau of the R.O.C., Customs Bureau of the R.O.C., and the FSC of the R.O.C.

Audit-Related Fees. This category consists of assurance and related services by the Deloitte Entities that are reasonably related to the performance of the audit or review of our financial statements and are not reported above under Audit Fees. The services for the fees disclosed under this category include review of certain regulatory filings with the FSC of the R.O.C.

All Other Fees. This category consists of professional services rendered by the Deloitte Entities for IFRSs adoption.

We have not established any pre-approval policies and procedures, and, accordingly, all non-audit services need to be pre-approved by the Audit Committee on a case-by-case basis. In its meeting of May 5, 2006, the Audit Committee agreed to delegate to the Chairman of the Audit Committee authority to pre-approve non-material unanticipated non-audit services and to report any such actions to the Audit Committee for ratification at its next scheduled meeting. All audit and non-audit services performed by Deloitte & Touche after May 6, 2003, the effective date of revised Rule 2-01(c) (7) of Regulation S-X entitled Audit Committee Administration of the Engagement on strengthening requirements regarding auditor independence, were pre-approved by the Audit Committee.

ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES

Not applicable.

ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS

Not applicable.

ITEM 16F. CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT

Not applicable.

ITEM 16G. CORPORATE GOVERNANCE

TSMC's corporate governance practices are governed by applicable Taiwan law, specifically, the R.O.C. Company Law and R.O.C. Securities and Exchange Law, and also TSMC's Articles of Incorporation. Also, because TSMC securities are registered with the U.S. Securities and Exchange Commission (U.S. SEC) and are listed on the New York Stock Exchange (NYSE), TSMC is subject to corporate governance requirements applicable to NYSE-listed foreign private issuers.

Under Section 303A of the NYSE Listed Company Manual, NYSE-listed non-US companies may, in general, follow their home country corporate governance practices in lieu of most of the new NYSE corporate governance requirements. However, all NYSE-listed foreign private issuers must comply with NYSE Sections 303A.06, 303A.11, 303A.12(b) and 303A.12(c).

Item 16G as well as NYSE Section 303A.11 requires that foreign private issuers disclose any significant ways in which their corporate governance practices differ from US companies under NYSE listing standards. A NYSE-listed foreign private issuer is required to provide to its US investors, a brief, general summary of the significant differences, either: (a) on the company website in English, or (b) in its annual report distributed to its US investors. To comply with NYSE Section 303A.11, TSMC has prepared the comparison in the table below.

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The most relevant differences between TSMC corporate governance practices and NYSE standards for listed companies are as follows:

NYSE Standards for US Companies

under Listed Company Manual

Section 303A

NYSE Section 303A.01 requires a NYSE-listed company to have a majority of independent directors on its board of directors.

NYSE Section 303A.02 establishes general standards to evaluate directors' independence (no director qualifies as independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company either directly or as a partner, shareholder or officer of an organization that has a relationship with the listed company).

NYSE Section 303A.03 requires non-management directors to meet at regularly scheduled executive meetings that are not attended by management.

NYSE Section 303A.04 requires listed companies to have a nominating/corporate governance committee comprised entirely of independent directors which committee shall have a written charter establishing certain minimum responsibilities as set forth in NYSE Section 303A.04(b)(i) and providing for an annual evaluation of the committee's performance.

TSMC Corporate Practices

Taiwan law does not require a board of directors of publicly traded companies to consist of a majority of independent directors. Taiwan law requires public companies meeting certain criteria to have at least two independent directors but no less than one fifth of the total number of directors on its board of directors. In addition, Taiwan law requires public companies to disclose information pertaining to their directors, including their independence status. Please see TSMC's annual report for the relevant year filed with the Taiwan authorities and the U.S. SEC (both of which are available online at www.tsmc.com) for information on the total number of TSMC directors and directors who would be considered independent under NYSE Section 303A.02 and Taiwan law.

Taiwan law establishes comparable standards to evaluate director independence. For further information, please consult TSMC's Taiwan Annual Report for the relevant year.

Taiwan law does not contain such a requirement. Except for meetings of sub-committees of the board of directors and those held by managing directors, Taiwan law does not allow separate board meetings of part but not all of the board of directors.

Taiwan law does not contain such a requirement. Taiwan law requires directors to be nominated (if nomination is provided in its articles of incorporation) either by the shareholders or by the entire board of directors.

NYSE Section 303A.05(a) requires listed companies to have a compensation committee comprised entirely of independent directors.

Taiwan law requires certain public companies, such as us, to establish a compensation committee by September 30, 2011. TSMC, however, has established its compensation committee since 2003, which has met the requirements under the Taiwan law. Please see TSMC's annual report for the relevant year filed with the Taiwan authorities and the U.S. SEC (both of which are available online at www.tsmc.com) for further information regarding the composition and functions of its compensation committee.

NYSE Section 303A.05(b) requires a compensation committee's charter to establish certain minimum responsibilities and to provide for an annual evaluation of the committee's performance.

Taiwan law requires certain public companies, such as us, to establish a compensation committee by September 30, 2011. TSMC, however, has established its compensation committee since 2003, which has met the requirements under the Taiwan law, and TSMC's compensation committee charter contains the same responsibilities as those provided under NYSE Section 303A.05(b)(i) and mandates the committee to review the adequacy of its charter annually.

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NYSE Section 303A.06 requires listed companies to have an audit committee that satisfies the requirements of Rule 10A-3 under the Securities Exchange Act of 1934 (the Exchange Act). Foreign private issuers must satisfy the requirements of Rule 10A-3 under the Exchange Act by July 31, 2005.

NYSE Section 303A.07(a) requires an audit committee to consist of at least three board members. All of its members shall be financially literate or must acquire such financial knowledge within a reasonable period and at least one of its members shall have experience in accounting or financial administration.

NYSE Section 303A.07(a) requires that if an audit committee member is simultaneously a member of the audit committee of more than three public companies, and the listed company does not limit the number of audit committees on which its members may serve, then, in each case the board of that company shall determine whether the simultaneous service would prevent such member from effectively serving on the listed company's audit committee, and shall report its decision in the annual proxy statement of the company or in the company's annual report on Form 10-K filed with the SEC.

NYSE Section 303A.07(a) All members of the audit committee are required to be independent.

NYSE Section 303A.07(b) requires an audit committee to have a written charter establishing the duties and responsibilities of its members, including the duties and responsibilities required, at a minimum, by Rule 10A-3(b)(2), (3), (4) & (5) of the Exchange Act.

Taiwan law requires public companies meeting certain criteria to have an audit committee that satisfies comparable standards or public companies may voluntarily elect to establish an audit committee. TSMC has voluntarily elected to establish an audit committee. Please see TSMC's annual report for the relevant year filed with the Taiwan authorities and the U.S. SEC (both of which are available online at www.tsmc.com) for further information regarding the composition of its audit committee. TSMC's audit committee members are all financially literate and are assisted by a financial expert consultant.

Taiwan law requires all independent directors of a public company to be members of the audit committee if the company has established such a committee of which at least one shall have accounting or financial expertise. Please see TSMC's annual report for the relevant year filed with the Taiwan authorities and the U.S. SEC (both of which are available online at www.tsmc.com) for further information regarding the composition of its audit committee. TSMC's audit committee members are all financially literate and are assisted by a financial expert consultant.

Taiwan law does not contain such requirement. Taiwan law requires all independent directors of a public company to be members of the audit committee if the company has established such a committee. Taiwan law forbids an independent director from serving as an independent director on a total of more than four Taiwan public companies.

Taiwan law requires all independent directors of a public company to be members of the audit committee if the company has established such a committee.

Taiwan law requires comparable standards. TSMC currently has a written audit committee charter containing the same duties and responsibilities as those provided under Section 10A-3(b)(1) of the Exchange Act.

NYSE Section 303A.07(b)(iii)(B) and (C) establishes audit committee objectives: (i) to discuss the annual audited financial statements and the quarterly financial statements of the company with management and the independent auditor, including the information disclosed under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations"; and (ii) to discuss the company's press releases relating to its earnings as well as the financial information and guidelines relating to its earnings that are supplied to analysts and rating agencies.

TSMC's written audit committee charter establishes the same audit committee objectives.

NYSE Section 303A.07(b)(iii)(G) requires an audit committee to establish clear policies for hiring external auditor's employees.

Taiwan law does not contain such requirement.

NYSE Section 303A.07(c) requires each company to have an internal audit function that provides to the management and to the audit committee ongoing assessments on the company's risk management processes and internal control system.

Taiwan law requires public companies to establish an internal audit department. Internal auditors are subject to strict qualification standards under Taiwan law, which require the board of directors to approve the head of a company's internal audit department. TSMC's internal audit department has substantially the same responsibilities as provided under NYSE Section 303A.07(d).

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NYSE Section 303A.08 requires each company to give to shareholders the opportunity to vote on all equity based compensation plans and material revisions thereto with certain exceptions.

Taiwan law imposes a similar requirement. TSMC currently has in place an equity based compensation plan. TSMC's employee stock option plans (ESOPs) are required to be approved by the board of directors. Shareholders' approval is not required if the number of options granted under the relevant ESOP does not exceed the reservation made in TSMC's Articles of Incorporation and if the exercise price is not below the price as determined by relevant regulations. Otherwise, any change to such reservation in the Articles requires shareholders' approval.

NYSE Section 303A.09 requires public companies to adopt and disclose corporate governance guidelines, including several issues for which such reporting is mandatory, and to include such information on the company's website (which website should also include the charters of the audit committee, the nominating committee, and the compensation committee.)

Under Taiwan law, if a listed company has adopted corporate governance guidelines, it must inform investors how to access such guidelines.

NYSE Section 303A.09 requires the board of directors to make a self-assessment of its performance at least once a year to determine if it or its committees function effectively and report thereon.

Taiwan law does not contain such requirement.

NYSE Section 303A.10 provides for the adoption of a Code of Business Conduct and Ethics and sets out the topics that such code must contain.

Taiwan law does not contain such requirement. But, because of sound corporate governance principles, TSMC has adopted a Policy of Ethics and Business Conduct, which complies with the Sarbanes-Oxley Act's requirements concerning financial officers and CEO accountability.

NYSE Section 303A.12(a) requires the CEO, on a yearly basis, to certify to the NYSE that he or she knows of no violation by the company of NYSE rules relating to corporate governance.

Taiwan law does not contain such a requirement. But, in order to comply with relevant SEC regulations, each of TSMC's Co-CEOs is required to certify in TSMC's 20-F annual report that, to his or her knowledge the information contained therein fairly represents in all material respects the financial condition and results of operation of TSMC.

NYSE Section 303A.12(b) requires the CEO to notify the NYSE in writing whenever any executive officer of the company becomes aware of any substantial non-fulfillment of any applicable provision under NYSE Section 303A.

Taiwan law does not contain such requirement. But, in order to be consistent with the corporate governance principles established under the Sarbanes-Oxley Act of 2002, TSMC's Co-CEOs comply with the notice provision as set forth under NYSE Section 303A.12(b).

NYSE Section 303A.12(c) requires each listed company to submit an executed Written Affirmation annually to the NYSE and Interim Written Affirmation each time a specified change occurs in the board or any of the committees subject to Section 303A.

Taiwan law does not contain such requirement. But, in order to comply with the corporate governance principles established under the Sarbanes-Oxley Act of 2002, TSMC complies with NYSE Section 303A.12(c).

ITEM 16H. MINE SAFETY DISCLOSURE

Not applicable.

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PART III

ITEM 17. FINANCIAL STATEMENTS

The Company has elected to provide the financial statements and related information specified in Item 18 in lieu of Item 17.

ITEM 18. FINANCIAL STATEMENTS

Refer to the consolidated financial statements on page F-1.

ITEM 19. EXHIBITS

- (a) See page F-1 for an index of the financial statements filed as part of this annual report.
- (b) Exhibits to this Annual Report:
 - 1.1⁽¹¹⁾ Articles of Incorporation of Taiwan Semiconductor Manufacturing Company Limited, as amended and restated on June 12, 2012.
 - 2b.1 The Company hereby agrees to furnish to the Securities and Exchange Commission, upon request, copies of instruments defining the rights of holders of long-term debt of the Company and its subsidiaries.
 - 3.1⁽¹¹⁾ Rules for Election of Directors, as amended and restated on June 12, 2012.
 - 3.2⁽¹¹⁾ Rules and Procedures of Board of Directors Meetings, as amended and restated on November 13, 2012.
 - 3.3⁽³⁾ Rules and Procedures of Shareholders Meetings, as amended and restated on May 7, 2002.
 - 4.1⁽²⁾ Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective August 1, 1997 to July 31, 2017) (in Chinese with English summary).
 - 4.2⁽³⁾ Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective May 1, 1998 to April 30, 2018) (in Chinese with English summary).
 - 4.3⁽⁴⁾ Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective November 1, 1999 to October 31, 2019) (in Chinese with English summary).
 - 4.4⁽¹²⁾ Land Lease with Hsinchu Science Park Administration relating to Fab 3 and F12 (Phase III) (effective December 4, 2009 to December 31, 2028) (English summary).
 - 4.5⁽²⁾ Land Lease with Hsinchu Science Park Administration relating to the Fab 3 and F12 (Phase III) (effective July 1, 1995 to June 30, 2015) (in Chinese with English summary).

- 4.6⁽²⁾ Land Lease with Hsinchu Science Park Administration relating to Fab 8 (effective June 14, 2001 to March 14, 2017) (in Chinese with English summary).
- 4.7⁽³⁾ Land Lease with Hsinchu Science Park Administration relating to Fab 12 (Phase I) (effective December 1, 1999 to November 30, 2019) (in Chinese with English summary).
- 4.8aaa⁽⁶⁾ Taiwan Semiconductor Manufacturing Company Limited 2004 Employee Stock Option Plan.
- 4.8aaaa⁽¹⁾ Taiwan Semiconductor Manufacturing Company Limited 2004 Employee Stock Option Plan, as revised on February 22, 2005.
- 4.8ccc⁽⁶⁾ WaferTech, LLC 2004 Employee Stock Option Plan.
- 4.8cccc⁽¹⁾ WaferTech, LLC 2004 Employee Stock Option Plan, as revised on February 22, 2005.
- 4.9⁽⁷⁾ Shareholders Agreement, dated as of March 15, 1999, by and among EDB Investments Pte. Ltd., Koninklijke Philips Electronics N.V. and Taiwan Semiconductor Manufacturing Company Ltd.
- 4.10⁽¹²⁾ Land Lease with Hsinchu Science Park Administration relating to Fabs 2 and 5 and Corporate Headquarters (effective April 1, 2008 to December 31,2027) (English summary)
- 4.11⁽¹²⁾ Land Lease with Hsinchu Science Park Administration relating to Fabs 3 (effective May 16, 2013 to December 31, 2032) (English summary)

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- 4.12⁽⁸⁾ Land Lease with Hsinchu Science Park Administration relating to Fab 12 (Phase II) (effective May 1, 2001 to December 31, 2020) (English summary).
- 4.13⁽¹¹⁾ Land Lease with Central Science Industrial Park Administration relating to fabs located in Taichung Science Park (effective September 1, 2009 to September 1, 2029) (English summary).
- 4.14⁽¹²⁾ Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective May 14, 2005 to December 31, 2024) (English summary)
- 4.15⁽¹²⁾ Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective April 15, 2006 to December 31, 2024) (English summary)
- 4.16⁽¹²⁾ Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective December 1, 2009 to November 30, 2029) (English summary)
- 4.17⁽¹²⁾ Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective December 15, 2006 to December 31, 2024) (English summary)
- 4.18⁽¹²⁾ Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective October 1, 2011 to September 30, 2030) (English summary)
- 4.19⁽¹²⁾ Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective August 1, 2012 to July 31, 2032) (English summary)
- 4.20 Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective January 22, 2014 to July 31, 2032) (in Chinese with English summary)
- 4.21⁽¹²⁾ Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective February 1, 2012 to January 31, 2032) (English summary)
- 4.22⁽¹²⁾ Land Lease with Hsinchu Science Park Administration relating to Fab 12 (Phase IV and Phase V) (effective November 10, 2007 to December 31, 2026) (English summary)
- 4.23⁽¹²⁾ Land Lease with Hsinchu Science Park Administration relating to Fab 12 (Phase VI) (effective August 20, 2010 to December 31, 2028) (English summary)
- 4.24⁽¹²⁾ Land Lease with Hsinchu Science Park Administration relating to Fab 12 (Phase VII) (effective March 17, 2011 to December 31, 2027) (English summary)
- 4.25⁽¹²⁾ Land Lease with Hsinchu Science Park Administration relating to Fabs 2 and 5 and Corporate Headquarters (effective April 1, 2010 to December 31, 2029) (English summary)
- 4.26⁽¹²⁾ Land Lease with Hsinchu Science Park Administration relating to Fab 12 (Phase IV and Phase VI bridge) (effective July 21, 2008 to December 31, 2027) (English summary)
- 4.27⁽¹²⁾ Land Lease with Hsinchu Science Park Administration relating to Fab 8 (effective June 14, 2001 to March 14, 2017) (English summary)

- 4.28 Land Lease with Hsinchu Science Park Administration relating to Fab 12 (effective December 1, 2014 to December 31, 2033) (in Chinese with English summary)
- 4.29 Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective March 1, 2014 to February 28, 2034) (in Chinese with English summary)
- 4.30 Land Lease with Southern Taiwan Science Park Administration (formerly Tainan Science Park Administration) relating to the fabs located in Southern Taiwan Science Park (effective August 1, 2014 to July 31, 2034) (in Chinese with English summary)
- 12.1 Certification of Co-Chief Executive Officer required by Rule 13a-14(a) under the Exchange Act.

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12.2 Certification of Co-Chief Executive Officer required by Rule 13a-14(a) under the Exchange Act.
 12.3 Certification of Chief Financial Officer required by Rule 13a-14(a) under the Exchange Act.
 13.1 Certification of Co-Chief Executive Officer required by Rule 13a-14(b) under the Exchange Act.
 13.2 Certification of Co-Chief Executive Officer required by Rule 13a-14(b) under the Exchange Act.
 13.3 Certification of Chief Financial Officer required by Rule 13a-14(b) under the Exchange Act.
 99.1 Consent of Deloitte & Touche.

- (1) Previously filed in TSMC s annual report on Form 20-F for the fiscal year ended December 31, 2004, filed by TSMC on May 16, 2005.
 (2) Previously filed in TSMC s annual report on Form 20-F for the fiscal year ended December 31, 2001, filed by TSMC on May 9, 2002.
 (3) Previously filed in TSMC s annual report on Form 20-F for the fiscal year ended December 31, 1999, filed by TSMC on June 29, 2000.
 (4) Previously filed in TSMC s annual report on Form 20-F for the fiscal year ended December 31, 2002, filed by TSMC on June 23, 2003.
 (5) Previously filed in TSMC s registration statement on Form S-8, filed by TSMC on October 20, 2003.
 (6) Previously filed in TSMC s registration statement on Form S-8, filed by TSMC on January 6, 2005.
 (7) Previously filed in TSMC s annual report on Form 20-F for the fiscal year ended December 31, 1998, filed by TSMC on April 30, 1999.
 (8) Previously filed in TSMC s annual report on Form 20-F for the fiscal year ended December 31, 2003, filed by TSMC on May 28, 2004.
 (9) Previously filed in TSMC s registration statement on Form F-1, filed by TSMC on September 15, 1997.
 (10) Previously filed in TSMC s annual report on Form 20-F for the fiscal year ended December 31, 2008, filed by TSMC on April 17, 2009.
 (11) Previously filed in TSMC s annual report on Form 20-F for the fiscal year ended December 31, 2012, filed by TSMC on April 2, 2013.
 (12) Previously filed in TSMC s annual report on Form 20-F for the fiscal year ended December 31, 2013, filed by TSMC on April 14, 2014.
 + Contains portions for which confidential treatment has been requested.

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SIGNATURE

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant certifies that it meets all the requirements for filing on Form 20-F and has duly caused this annual report to be signed on its behalf by the undersigned.

Date: April 13, 2015

TAIWAN SEMICONDUCTOR MANUFACTURING

COMPANY LIMITED

By: /s/ Lora Ho

Name: Lora Ho

Title: Senior Vice President, Chief Financial Officer &

Spokesperson

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of

Taiwan Semiconductor Manufacturing Company Limited

We have audited the accompanying consolidated statements of financial position of Taiwan Semiconductor Manufacturing Company Limited (a Republic of China corporation) and subsidiaries (the Company) as of December 31, 2013 and 2014, and the related consolidated statements of profit or loss and other comprehensive income, changes in equity, and cash flows for each of the three years in the period ended December 31, 2014 (all expressed in New Taiwan dollars). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Taiwan Semiconductor Manufacturing Company Limited and subsidiaries as of December 31, 2013 and 2014, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2014, in conformity with International Financial Reporting Standards as issued by the International Accounting Standards Board.

Our audits also comprehended the translation of New Taiwan dollar amounts into U.S. dollar amounts and, in our opinion, such translation has been made in conformity with the basis stated in Note 3. Such U.S. dollar amounts are presented solely for the convenience of the readers in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2014, based on the criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated April 13, 2015 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche

Taipei, Taiwan

The Republic of China

April 13, 2015

Table of Contents**Taiwan Semiconductor Manufacturing Company Limited and Subsidiaries****CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**

(In Millions of New Taiwan Dollars or U.S. Dollars)

ASSETS	Notes	December 31, 2013		December 31, 2014			
			NT\$	NT\$	US\$ (Note 3)		
CURRENT ASSETS							
Cash and cash equivalents	7	\$	242,695.4	\$	358,449.0	\$	11,343.3
Financial assets at fair value through profit or loss	8		90.4		192.0		6.1
Available-for-sale financial assets	9		760.8		73,797.5		2,335.4
Held-to-maturity financial assets	10		1,796.0		4,485.6		141.9
Notes and accounts receivable, net	12		71,649.9		114,734.7		3,630.8
Receivables from related parties	37		291.7		313.0		9.9
Other receivables from related parties	37		221.6		178.6		5.7
Inventories	6, 13		37,494.9		66,338.0		2,099.3
Noncurrent assets held for sale	14		-		944.2		29.9
Other financial assets	38		501.8		3,476.9		110.0
Other current assets	18		2,984.2		3,656.1		115.7
Total current assets			358,486.7		626,565.6		19,828.0
NONCURRENT ASSETS							
Available-for-sale financial assets	9		60,867.6		1,800.5		57.0
Investments accounted for using equity method	6, 15		28,156.5		28,059.7		888.0
Property, plant and equipment	6, 16		792,665.9		818,198.8		25,892.4
Intangible assets	6, 17		11,490.4		13,531.5		428.2
Deferred income tax assets	6, 31		7,145.0		5,138.8		162.6
Refundable deposits	37		2,519.0		356.1		11.3
Other noncurrent assets	18		1,469.6		1,202.0		38.0
Total noncurrent assets			904,314.0		868,287.4		27,477.5
TOTAL		\$	1,262,800.7	\$	1,494,853.0	\$	47,305.5

(Continued)

Table of Contents**Taiwan Semiconductor Manufacturing Company Limited and Subsidiaries****CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**

(In Millions of New Taiwan Dollars or U.S. Dollars)

LIABILITIES AND EQUITY	Notes	December 31, 2013	December 31, 2014	
		NT\$	NT\$	US\$
				(Note 3)
CURRENT LIABILITIES				
Short-term loans	19	\$ 15,645.0	\$ 36,158.5	\$ 1,144.3
Financial liabilities at fair value through profit or loss	8	33.7	486.2	15.4
Hedging derivative financial liabilities	11		16,364.3	517.9
Accounts payable		14,670.3	21,878.9	692.4
Payables to related parties	37	1,688.4	1,491.5	47.2
Salary and bonus payable		8,330.9	10,573.9	334.6
Accrued profit sharing to employees and bonus to directors and supervisors	24	12,738.8	18,052.8	571.3
Payables to contractors and equipment suppliers		89,810.2	26,980.4	853.8
Income tax payable	31	36,759.4	52,388.1	1,657.9
Provisions	6, 20	7,603.8	10,445.5	330.5
Liabilities directly associated with noncurrent assets held for sale	14		219.1	6.9
Accrued expenses and other current liabilities	16, 23	16,693.5	29,746.0	941.3
Total current liabilities		203,974.0	224,785.2	7,113.5
NONCURRENT LIABILITIES				
Hedging derivative financial liabilities	11	5,481.6		
Bonds payable	21	210,767.6	213,673.8	6,761.8
Long-term bank loans		40.0	40.0	1.3
Deferred income tax liabilities	31		199.7	6.3
Obligations under finance leases	16	776.2	802.1	25.4
Accrued pension cost	6, 22	6,801.7	6,567.8	207.8
Guarantee deposits	23	151.7	25,538.5	808.2
Others	20	694.9	885.2	28.0
Total noncurrent liabilities		224,713.7	247,707.1	7,838.8
Total liabilities		428,687.7	472,492.3	14,952.3

EQUITY ATTRIBUTABLE TO
SHAREHOLDERS OF THE PARENT

Capital stock	24	259,286.2	259,296.6	8,205.6
Capital surplus	24	55,858.6	55,963.4	1,771.0
Retained earnings	24			
Appropriated as legal capital reserve		132,436.0	151,250.7	4,786.4
Appropriated as special capital reserve		2,785.8		
Unappropriated earnings		369,309.4	529,973.5	16,771.3
		504,531.2	681,224.2	21,557.7
Others	24	14,170.3	25,749.3	814.9
Equity attributable to shareholders of the parent		833,846.3	1,022,233.5	32,349.2
NONCONTROLLING INTERESTS	24	266.7	127.2	4.0
Total equity		834,113.0	1,022,360.7	32,353.2
TOTAL		\$ 1,262,800.7	\$ 1,494,853.0	\$ 47,305.5

The accompanying notes are an integral part of the consolidated financial statements.

(Concluded)

Table of Contents**Taiwan Semiconductor Manufacturing Company Limited and Subsidiaries****CONSOLIDATED STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME**

(In Millions of New Taiwan Dollars or U.S. Dollars, Except Earnings Per Share that are in New Taiwan or U.S. Dollars)

	Notes	2012 NT\$	2013 NT\$	2014 NT\$	US\$ (Note 3)
NET REVENUE	6, 26, 37, 41	\$ 506,745.3	\$ 597,024.2	\$ 762,806.5	\$ 24,139.4
COST OF REVENUE	13, 33, 37	262,592.5	315,642.5	385,113.0	12,187.1
GROSS PROFIT BEFORE UNREALIZED GROSS PROFIT ON SALES TO ASSOCIATES					
		244,152.8	281,381.7	377,693.5	11,952.3
REALIZED (UNREALIZED) GROSS PROFIT ON SALES TO ASSOCIATES		(25.0)	(20.9)	28.5	0.9
GROSS PROFIT		244,127.8	281,360.8	377,722.0	11,953.2
OPERATING EXPENSES					
	6, 33, 37				
Research and development		40,387.1	47,952.0	56,828.8	1,798.4
General and administrative		17,633.0	18,881.8	18,933.4	599.1
Marketing		4,496.2	4,505.2	5,087.4	161.0
Total operating expenses		62,516.3	71,339.0	80,849.6	2,558.5
OTHER OPERATING INCOME AND EXPENSES, NET					
	14, 27, 33	(449.4)	47.1	(1,002.1)	(31.7)
INCOME FROM OPERATIONS	41	181,162.1	210,068.9	295,870.3	9,363.0
NON-OPERATING INCOME AND EXPENSES					
Share of profits of associates and joint venture	15, 41	2,073.1	3,806.8	3,919.8	124.0
Other income	28	1,716.1	2,342.1	3,380.4	107.0
Foreign exchange gain , net		582.5	285.5	2,111.3	66.8
Finance costs	29	(1,020.4)	(2,646.8)	(3,236.3)	(102.4)

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Other gains and losses	30, 37	(2,852.3)	2,105.0	28.0	0.9
Total non-operating income and expenses		499.0	5,892.6	6,203.2	196.3
INCOME BEFORE INCOME TAX		181,661.1	215,961.5	302,073.5	9,559.3
INCOME TAX EXPENSE	31, 41	22,374.7	32,111.8	47,889.9	1,515.5
NET INCOME		159,286.4	183,849.7	254,183.6	8,043.8
OTHER COMPREHENSIVE INCOME (LOSS)	15, 24, 31				
Items that will not be reclassified subsequently to profit or loss					
Remeasurement of defined benefit obligation		(678.2)	(653.7)	258.5	8.2
Share of other comprehensive loss of associate and joint venture				(15.7)	(0.5)
Income tax benefit (expense) related to items that will not be reclassified subsequently		81.4	77.7	(31.9)	(1.0)
Items that may be reclassified subsequently to profit or loss					
Exchange differences arising on translation of foreign operations		(4,322.7)	3,668.5	11,771.1	372.5
Changes in fair value of available-for-sale financial assets		9,534.3	13,290.4	(36.6)	(1.1)
Cash flow hedges		0.2			

(Continued)

Table of Contents**Taiwan Semiconductor Manufacturing Company Limited and Subsidiaries****CONSOLIDATED STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME**

(In Millions of New Taiwan Dollars or U.S. Dollars, Except Earnings Per Share that are in New Taiwan or U.S. Dollars)

	Notes	2012 NT\$	2013 NT\$	2014 NT\$	US\$ (Note 3)
Share of other comprehensive income (loss) of associates and joint venture		\$ 54.9	\$ (60.3)	\$ (135.3)	\$ (4.3)
Income tax benefit (expense) related to items that may be reclassified subsequently		(409.3)	36.5	(5.1)	(0.2)
Other comprehensive income for the year, net of income tax		4,260.6	16,359.1	11,805.0	373.6
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		\$ 163,547.0	\$ 200,208.8	\$ 265,988.6	\$ 8,417.4
NET INCOME (LOSS) ATTRIBUTABLE TO:					
Shareholders of the parent		\$ 159,480.8	\$ 183,977.6	\$ 254,301.4	\$ 8,047.5
Noncontrolling interests		(194.4)	(127.9)	(117.8)	(3.7)
		\$ 159,286.4	\$ 183,849.7	\$ 254,183.6	\$ 8,043.8
TOTAL COMPREHENSIVE INCOME (LOSS) ATTRIBUTABLE TO:					
Shareholders of the parent		\$ 163,692.0	\$ 200,343.4	\$ 266,090.6	\$ 8,420.6
Noncontrolling interests		(145.0)	(134.6)	(102.0)	(3.2)
		\$ 163,547.0	\$ 200,208.8	\$ 265,988.6	\$ 8,417.4
		2012 Income Attributable to Shareholders of the Parent	2013 Income Attributable to Shareholders of the Parent	2014 Income Attributable to Shareholders of the Parent	

		NT\$		NT\$		NT\$		US\$ (Note 3)
EARNINGS PER SHARE								
Basic earnings per share	32	\$	6.15	\$	7.10	\$	9.81	\$ 0.31
Diluted earnings per share	32	\$	6.15	\$	7.10	\$	9.81	\$ 0.31
EARNINGS PER EQUIVALENT ADS								
Basic earnings per share		\$	30.76	\$	35.48	\$	49.04	\$ 1.55
Diluted earnings per share		\$	30.75	\$	35.48	\$	49.04	\$ 1.55

The accompanying notes are an integral part of the consolidated financial statements.

(Concluded)

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Table of Contents**Taiwan Semiconductor Manufacturing Company Limited and Subsidiaries****CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY****(In Millions of New Taiwan Dollars, Except Dividends Per Share)****Equity Attributable to Shareholders of the Parent**

	Legal	Retained Earnings		Total	Foreign Currency Translation Reserve	Others Unrealized Gain/Loss		Total	Total
		Capital Reserve	Special Reserve			Un- appropriated Earnings	Available- for-sale Financial Assets		
Capital surplus	Capital Reserve	Capital Reserve	Un- appropriated Earnings	Total	Foreign Currency Translation Reserve	Available- for-sale Financial Assets	Cash Flow Hedges Reserve	Total	Total
5,471.7	\$ 102,400.0	\$ 6,433.9	\$ 208,960.5	\$ 317,794.4	\$ (6,433.4)	\$ (1,172.8)	\$ (0.1)	\$ (7,606.3)	\$ 624,822.2
-	13,420.1	-	(13,420.1)	-	-	-	-	-	-
-	-	1,172.4	(1,172.4)	-	-	-	-	-	-
-	-	-	(77,748.7)	(77,748.7)	-	-	-	-	(77,748.7)
-	13,420.1	1,172.4	(92,341.2)	(77,748.7)	-	-	-	-	(77,748.7)
Performance Based	Long-Term								
Performance Based	Long-Term								

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Compensation Discussion and Analysis

In order to encourage profitable growth while protecting shareholders' interests, the Company's compensation programs include the following risk mitigating features:

Robust Goal Setting

Balanced Performance Measures

Claw back Policies

Stock Ownership Requirements

N/A

Performance Payouts Capped

No Dividend Equivalents Paid on PRSUs

N/A

N/A

Compensation Committee Oversight

Internal and Independent External Risk Review

Restrictions on Hedging and Pledging

N/A

Target total compensation for the Company's employees is generally set to approximate the market median. The weighting of the individual compensation components varies by level, with more senior level executives having a greater emphasis on performance-based long-term compensation which aligns management to shareholders. As shown in the table below, NEO compensation is structured so that the largest component is long-term equity (stock options and PRSUs), followed by base salary and the performance-based annual incentives. Each NEO's compensation is compared to equivalent positions in a comparator group selected by the Compensation Committee (with assistance from the Committee's independent compensation consultant). NEO base salaries and long-term incentive grants are determined based on many factors including individual performance, responsibilities, and the overall relation to market levels of compensation.

These components and the use of performance-based pay are consistent with the compensation mix of the comparator group. The tables below show compensation components as a percentage of the total target compensation package.

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Compensation Discussion and Analysis

"2018 Adjusted ROIC" means the Company's Return on Invested Capital calculated using operating earnings, adjusted (as reconciled to its most directly comparable GAAP measure in Part II, Item 7 (p. 20) of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2018), divided by net working assets (a 5-point average for the year-to-date). Net working assets are working assets minus working liabilities defined as follows: working assets equal Total assets less cash equivalents (part of Cash and cash equivalents; 5-point average of \$173.6 million), LIFO reserves (part of Inventories - net; 5-point average of \$386.7 million), Deferred income taxes, and investments in unconsolidated entities (part of Other assets). Working liabilities equal Total current liabilities less Short-term debt, Current maturities of long-term debt and Income taxes payable. For purposes of the 2018 MIP payout, the Compensation Committee has accepted the Company's calculation of 2018 Adjusted ROIC.

"Annual Compensation" consists of base salary and the annual incentive plan as described further under "*Annual Incentives*."

"Fixed/Individual Based Compensation" consists of base salary as described further under "*Base Salaries*."

"Long-term Compensation" consists of stock options, PRSUs, and retirement profit sharing. Annual retirement profit sharing contributions are based on the Company's short-term performance; distributions are restricted, with full vesting of contributions once a participant has achieved five years of service with the Company as described further under "*Long-Term Incentives*" and "*Other Benefits*."

"Peers" are the comparator group in the 2018 Deloitte Consulting Compensation Study as described further under "*Compensation Comparator Group*."

"Performance Based Compensation" consists of the annual incentive plan, long-term incentives, and retirement profit sharing as described further under "*Annual Incentives*" and "*Long-Term Incentives*."

The Company's compensation structure links pay with Company performance. Our 2018 financial results exceeded expectations and therefore the annual bonus payment was above target. The Company's long-term plan, established in 2016, met the target results for three year ROIC and therefore payout approximated target for this program.

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Compensation Discussion and Analysis

The Company is focused on profitable daily sales growth over the short- and long-term. The Company believes that using capital efficiency (ROIC) and revenue (sales growth) is appropriate because the metrics are tied to shareholder values in both the short-term and long-term:

Different Performance Goals. The short-term incentive program focuses on one-year sales growth compared to the prior year and a pre-determined ROIC, with both measures linked to the Company's one-year plan. The long-term incentive program focuses on three-year average ROIC performance.

Different Time Periods. The short-term incentive program focuses on the achievement of sales growth and ROIC over one year. The long-term incentive program focuses on three-year average ROIC performance above 18%.

Company-Wide Performance Measures. Performance is measured at the Company- wide level as opposed to specific business unit or regional levels.

Maximum Payout is Capped. Short-term incentive plans are capped at 200% of the target award and long-term incentives are capped at 100% of the target shares.

As a result, the Company believes that ROIC and sales growth are appropriate metrics and do not create unreasonable risk.

Compensation Philosophy, Plans, and Practices

As part of the Company's pay for performance philosophy, the Company's compensation program includes several features that maintain alignment with shareholders:

Emphasis on Variable Performance-Based Compensation. Between 40% and 88% of the NEOs' target compensation is tied to Company performance.

Performance Thresholds and Caps. Both the annual incentive and performance share programs require a threshold level of performance in order to achieve any payment, and the maximum payments are capped.

Stock Ownership Requirements. The Chairman and CEO is required to hold equity in the Company worth at least 6x his base salary, and all other NEOs are required to hold at least 3x base salary. Those who fail to achieve ownership requirements will not receive future equity-based awards.

Double-Trigger Change in Control Requirements. Both the existing Change in Control Agreements and awards under the W.W. Grainger, Inc. 2015 Incentive Plan, as amended and restated as of October 31, 2018 (the 2015 Incentive Plan), have double-trigger change in control provisions.

Prohibition on Hedging and Pledging. NEOs and Directors are prohibited from hedging their ownership in Company shares, and from pledging Company shares as collateral for a loan or a margin account.

Claw back Provisions. The Company has established recoupment policies with respect to executive compensation in the event of fraud, criminal misconduct, materially inaccurate financial statements, conduct that violates Company policy, misconduct that causes or is discovered to have caused damage or injury to the Company's property or reputation or violations of non-competition or non-solicitation agreements, or in the event an Executive receives any amount in excess of what the Executive should have received for any reason.

Executive Physicals. In order to ensure the stability of the leadership team, the Company requires that the NEOs and certain other Company officers have periodic physical examinations.

Annual Risk Reviews. The Company conducts an annual risk review based on a process recommended by the Compensation Committee of the Board's independent compensation consultant.

The Company's compensation programs also maintain alignment with shareholders by not including certain features:

No Cash Buyouts of Underwater Stock Options, Repricing, or Stock Options issued at a discount. Stock options issued will not be repriced, replaced, or regranted through cancellation or by lowering the exercise price of a previously granted stock option.

No Excessive Change in Control Agreements. The maximum cash benefit is equal to 2x salary and target bonus.

No Change in Control Agreements with Excise Tax Gross-ups.

No Tax Gross-ups on Perquisites.

No Employment Agreements. The Company does not maintain any employment agreements with its NEOs.

No Dividend Equivalents Paid on Unearned Performance-Based Awards

Overall, the Company's compensation program is designed to be straightforward and understandable to its employees and shareholders, and to drive long-term shareholder value creation by aligning compensation with both individual and Company performance.

Compensation Committee of the Board

The Compensation Committee of the Board is responsible for the Company's compensation programs.

The Compensation Committee oversees the Company's compensation and benefit programs for all officers and employees. The Committee is responsible for ensuring that the Company's compensation practices provide appropriate incentives to increase long-term shareholder value, reflect the highest level of integrity, and protect the interests of shareholders. One of its responsibilities is to make certain that a competitive compensation structure is in place that will attract, reward, and retain employees and to motivate them to grow the business profitably. The Committee is also charged with ensuring that compensation, especially for executives, is linked to both individual and Company performance, and ensuring that compensation policies and practices for all employees do not include incentives to take inappropriate risk.

In setting individual compensation levels, the Compensation Committee selects a compensation comparator group of companies and reviews studies of total compensation paid to executives in those comparator group companies with similar duties and responsibilities. The Committee

then considers a variety of reference points, including competitive compensation data at the 25th, 50th, and 75th percentiles, individual and Company performance, the executive's overall experience, replaceability, internal equity, unique skills, and management's recommendation to determine appropriate compensation for each executive. All elements of compensation are valued and reviewed in

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Compensation Discussion and Analysis

evaluating the relative competitiveness of the Company's compensation practices against the comparator group. Target total compensation for the Company's employees and executives as a whole (including the NEOs) is generally set to approximate the market median.

The Compensation Committee reviews at least annually a tally sheet for each NEO to evaluate the potential value of all compensation. The tally sheet includes each NEO's current base salary, annual incentive award, and the value of all outstanding equity-based awards (both vested and unvested), deferrals, benefits, and perquisites, as well as potential payments under retirement and certain change in control situations. Since no NEO has an employment agreement with the Company that guarantees continued employment, the tally sheets also facilitate the Committee's evaluation of vested and unvested awards and the retention value of these awards.

Under its charter, the Compensation Committee makes executive compensation decisions and recommends actions to the Board of Directors and to shareholders (for example, related to the advisory Say on Pay vote or equity plan proposals), as appropriate.

In discharging its responsibilities, the Committee regularly consults with independent advisors, compensation consultants, and the Company's management. After a review of the factors prescribed by the SEC and the NYSE, the Compensation Committee determined that its compensation consultant, Deloitte Consulting, is an independent advisor under the applicable rules and regulations. *The Compensation Committee's charter is available in the Governance section of Grainger's website at <http://www.grainger.com/investor>.*

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Compensation Discussion and Analysis

The following steps are performed each year to review, recommend, and approve NEO compensation. These steps are described further under "*Role of Management*," "*Compensation Comparator Group*," and "*Base Salaries*."

Purpose	A review of the comparators is performed to maintain a group of companies that are relatively similar in complexity and size to Grainger	An analysis of NEO compensation versus the comparator group is performed to ensure compensation is market competitive	Recommendations for base salaries, performance shares and stock options, and any changes to the structure and targets of short-term and long-term incentive programs are made to update compensation based on market data.	
Timing of Analysis	Annual	Annual	Annual	Annual
Recommendation	Recommended by the independent compensation consultant to the Compensation Committee	Recommended by the independent compensation consultant to the Compensation Committee	Reviewed and recommended by the Compensation	Recommended by Management
Approval	Reviewed and approved by the Compensation Committee	Reviewed by the Compensation Committee	Committee and approved by Independent Directors in Executive Session	Reviewed and recommended by the Compensation Committee and approved by the Board
Planned Timing of Approval	July	October	February	February

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Compensation Discussion and Analysis

Risk Assessment

The Compensation Committee's oversight responsibility includes assessing the relationship between potential risk created by the Company's compensation programs and their impact on long-term shareholder value. The Company's compensation programs are designed to include risk-mitigating features, and the Committee also engaged its independent compensation consultant (Deloitte Consulting) to assist with the process of an annual internal risk assessment of all incentive-based compensation, including short-term and long-term incentive programs.

The incentive compensation programs include risk-mitigating components, such as:

balanced performance measures sales growth combined with profitability;

robust performance measure selection and rigorous targets;

balanced mix of short-term and long-term incentives;

balanced mix of equity vehicles stock options are combined with performance shares;

claw back provisions to recoup incentive compensation;

stock ownership, retention, and holding requirements; and

clear business conduct guidelines.

Since 2009, the Committee has engaged its independent compensation consultant, Deloitte Consulting, to conduct a risk assessment that is completed every three years. Deloitte Consulting conducted the Company's most recent triennial risk assessment in 2018 and the results were discussed with the Committee. For the interim years, the Company will conduct an annual internal risk review based on practices and methodologies recommended by the Committee's independent compensation consultant.

Based on the risk review and the Committee's discussions, the Committee does not believe that the Company's compensation policies and practices are reasonably likely to have a material adverse effect on the Company.

Say on Pay

At the 2018 annual meeting of shareholders, the annual advisory vote to approve the compensation of the Company's NEOs received the support of 97% of the shareholders voting on the proposal. The Compensation Committee has considered these results and believes that they confirm the appropriateness of the Company's current executive compensation policies and practices. The Company routinely discusses its compensation philosophy with its shareholders as part of investor relations activities.

The Company is required to seek shareholder vote on the frequency of the advisory Say on Pay vote every six years. In 2011 and 2017, management recommended an annual advisory Say on Pay vote. The next advisory frequency vote is scheduled for 2023.

Role of Management

Management assists the Compensation Committee in the design, recommendation, and implementation of compensation programs.

Members of management assist the Compensation Committee by routinely recommending programs that management believes will provide the appropriate level of compensation and incentives consistent with the Company's compensation philosophy. Consistent with this process, management works with advisors from Deloitte Consulting to develop market information and recommends adjustments in base salaries, annual incentive targets, and long-term incentive awards to be reviewed by the Compensation Committee and approved by the Board. For NEOs other than Mr. Macpherson, the recommendations also include the structure and targets of short-term and long-term incentive programs, as well as changes to programs required for regulatory compliance. These recommendations are reviewed and approved by the Chairman of the Board and CEO before they are presented to the Compensation Committee. Mr. Macpherson's compensation is reviewed by the Compensation Committee in conjunction with its independent compensation consultant, together with other independent Directors (as directed by the Board), in executive session without members of management present.

Compensation Comparator Group

The Company's compensation program is regularly benchmarked against a Compensation Committee-approved comparator group of companies that are similar to the Company in size and complexity. The Company performs these studies to understand current market practices and to provide a reference point for compensation discussions.

Every year, the Compensation Committee determines a compensation comparator group of companies and undertakes a study of total compensation paid to executives occupying similar positions with similar duties and responsibilities in the comparator companies. All elements of compensation are valued and considered when determining the relative competitiveness of the Company's compensation practices. A comparator group compensation study was conducted in 2018 (2018 Compensation Study).

The 2018 comparator group consists of 19 businesses that are relatively similar in complexity and size to the Company and represent the types of major companies with which the Company historically competes for executive talent. The companies that were selected for the 2018 Compensation Study are generally within a range of 0.5 to 2.0 times Grainger's annual revenue. The competitive market for executive talent includes companies both within and outside the same industry or sector as the Company. Most of the Company's publicly traded direct competitors tend to be too small in sales or scope of operations for direct compensation comparisons with the Company. Including a broader range of companies provides a more representative depiction of the Company's competitive market for talent. Therefore, companies used for compensation comparison purposes differ from those in the industry indices used in the Company Performance Graph in Part II, Item 5 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2018.

The Committee relied on its independent compensation consultant, Deloitte Consulting, for survey and market data. The role of management in selecting the comparator group was limited to providing general comments on the relevance of each industry represented by the comparator companies.

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Compensation Discussion and Analysis

Listed below are the 2018 Compensation Study comparator group and the 2017 revenues and enterprise values for each company.

Anixter International Inc.	\$7,927	\$3,722
Avnet, Inc.	\$17,440	\$5,744
CDW Corporation	\$15,192	\$14,510
Eaton Corporation plc	\$20,404	\$41,998
eBay Inc.	\$9,567	\$43,390
Fastenal Company	\$4,391	\$16,024
Genuine Parts Company	\$16,309	\$14,877
HD Supply Holdings, Inc.	\$4,819	\$9,070
Henry Schein, Inc.	\$12,462	\$13,191
Illinois Tool Works Inc.	\$14,314	\$62,518
Ingersoll-Rand Plc	\$14,198	\$25,158
Insight Enterprises, Inc.	\$6,704	\$1,908
LKQ Corporation	\$9,737	\$15,494
Parker-Hannifin Corporation	\$12,029	\$31,553
Sanmina Corporation	\$6,869	\$2,450
Tech Data Corporation	\$26,235	\$5,095
The Sherwin-Williams Company	\$14,984	\$48,884

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Univar Inc.	\$8,254	\$7,045
WESCO International, Inc.	\$7,679	\$4,541
25th Percentile	\$7,803	\$5,420
50th Percentile	\$12,029	\$14,510
75th Percentile	\$15,088	\$28,355
W.W. Grainger, Inc.	\$10,425	\$15,634
Percent Rank	46%	63%

*

Revenue is for Fiscal Year 2017.

**

Enterprise Value is calculated as market capitalization plus debt, minority interest and preferred shares, minus total cash and cash equivalents, as of 12/31/2017.

The Compensation Committee reviewed and approved the comparator group and considered the findings of the 2018 Compensation Study in conjunction with a tally sheet listing the potential value of all compensation available for the NEOs. The Compensation Committee concluded that the NEOs' earned and potential awards for 2018 were consistent with the Company's pay philosophy, Company and individual performance, and market practices (as reflected in the 2018 Compensation Study). Based on this review and the strong support from shareholders on the Say on Pay proposal, the Committee

did not make material adjustments to the design of the Company's compensation programs. The next Compensation Study and comparator group validation is scheduled to take place in 2019.

Base Salaries

Base salaries are intended to provide an appropriate level of fixed compensation to attract and retain executives. Base salaries are determined after a detailed evaluation of individual performance, competitive market levels, and executive experience.

Annual base salary adjustments are considered and implemented to reflect individual performance, contribution and experience, and to maintain market competitiveness. The 2018 Compensation Study showed that, on average, the Company's base salaries for NEOs were approximately 14% above the market median.

Base salary increases for the NEOs, with the exception of Mr. Macpherson, are reviewed and approved by the Chairman of the Board and CEO before they are presented to the Compensation Committee for review and recommendation to the Board. The Committee reviews these recommendations in conjunction with its independent compensation consultant.

The compensation awarded to Mr. Macpherson was determined by the Board with assistance from the Compensation Committee and its independent compensation consultant. The Compensation Committee reviews and approves the corporate goals and objectives relevant to Mr. Macpherson's compensation and evaluates each individual's performance in light of those goals and objectives. Together with the other independent Directors (as directed by the Board), the Compensation Committee determined and approved Mr. Macpherson's compensation level based on this evaluation, in executive session without members of management present.

Following the annual performance management review process (which is similar to the process in which all employees participate), base salaries are reviewed and adjusted (if appropriate) to reflect individual and Company performance, base salaries for comparable positions from market studies, experience, tenure, fairness and internal equity.

Based on the process outlined above, on April 1, 2018, Mr. Macpherson's base salary remained flat at \$1,030,000 (+0.0%).

The following base salary adjustments were made for the other NEOs effective April 1, 2018:

Mr. Okray's base salary was set at \$700,000 upon his appointment as Grainger's Senior Vice President and Chief Financial Officer effective May 2, 2018;

Mr. Howard's base salary was increased to \$705,000 (+0.8%);

Ms. Robbins' base salary was increased to \$510,000 (+1.2%); and

Ms. Merriwether's base salary was increased to \$452,962 (+3.7%).

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Compensation Discussion and Analysis

Annual Incentives

Annual incentives are intended to provide an appropriate level of variable compensation to encourage executives to achieve annual results that create shareholder value without encouraging excessive risk taking.

NEOs are eligible to receive short-term cash-based incentives on the achievement of specified annual Company-wide financial performance measures set forth in the Company Management Incentive Program (MIP). The Company structures the MIP to motivate performance that balances short-term and long-term results and aligns the interests of management with shareholders.

Each NEO's target incentive award under the annual incentive program is based on a review of competitive market practice and is designed to approximate a market value that is generally at the median of the comparator group. The following table displays the 2018 MIP target payment, which is paid based on total Company results, applicable to each NEO.

D.G. Macpherson	135%(1)	135%
Thomas B. Okray	90%(2)	135%
John L. Howard	80%(3)	135%
Paige K. Robbins	80%(4)	135%
Deidra C. Merriwether	50%	135%
Ronald L. Jadin	85%(5)	135%
Joseph C. High	75%(6)	135%

(1) Mr. Macpherson's 2018 target incentive was increased from 125% to 135% of target effective April 1, 2018. Accordingly, his 2018 incentive amount is pro-rated at 125% of target for 3 months and 135% of target for 9 months.

(2) Mr. Okray was appointed as Grainger's Senior Vice President & Chief Financial Officer effective May 2, 2018. Accordingly, his 2018 incentive amount is pro-rated for his 8 months of service in 2018.

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- (3) Mr. Howard's 2018 target incentive was increased from 75% to 80% of target effective April 1, 2018. Accordingly, his 2018 incentive amount is pro-rated at 75% of target for 3 months and 80% of target for 9 months.
- (4) Ms. Robbins' 2018 target incentive was increased from 60% to 80% of target effective April 1, 2018. Accordingly, her 2018 incentive amount is pro-rated at 60% for 3 months and 80% for 9 months.
- (5) Mr. Jadin retired effective May 2, 2018. Accordingly, his 2018 incentive amount is pro-rated for his 4 months of service in 2018.
- (6) Mr. High retired effective August 31, 2018. Accordingly, his 2018 incentive amount is pro-rated for his 8 months of service in 2018.

The Compensation Committee and management perform a thorough analysis in setting financial measures and goals for the Company MIP to ensure the program appropriately balances the Company's objectives, is aligned with long-term shareholder interest, and has appropriate and effective risk-mitigating components. While the measures and goals are clearly aligned with the Company's strategy, they also account for current economic conditions. The combination of sales growth and

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ROIC performance, as well as threshold, target, and maximum payment levels, serves to mitigate risk to the Company's shareholders.

The Company believes the design of the annual incentive program creates shareholder value and encourages performance by focusing on profitable sales growth and ROIC. The basic framework of the MIP has been in place for more than ten years, although specific objectives and performance target levels have been modified on a year-by-year basis in light of the current economic and competitive environment. This framework was selected to align with Company strategy and to balance sales growth with profitability, efficiency, expense management, and asset management. ROIC reflects how effectively management uses Company assets and is generally defined by the Company as pre-tax operating earnings divided by net working assets. Year-over-year daily sales growth is determined by year-over-year results. Acquisitions and divestitures that occur during the year are not included in the calculation of daily sales growth or ROIC. These measures are consistent with the Company's objective of growing profitably over time, which it believes is closely linked with shareholder value creation.

The 2018 Company MIP was based on the Company's 2018 Adjusted ROIC and year-over-year daily sales growth. The Company determined the payment earned for ROIC and the payment earned for sales growth, and the two amounts were added together:

$$\text{MIP Payment} = (\text{Sales Growth Performance} + \text{ROIC Performance})$$

The following table shows various payout scenarios that were established at the beginning of the year for 2018:

<20.6%	0%
20.6%	25%
25.1%	50%
29.6%	75%
34.1%	100%
< 3.4%	0%
0.5%	25%
4.4%	50%
8.3%	75%

12.2%

100%

*

Payouts are interpolated on a straight-line basis.

**

For the year 2018, reported sales growth was 7.2% and 2018 Adjusted ROIC was 28.5%. This resulted in a final Company MIP payout of 135% of target.

The Company believes that it establishes sales growth and ROIC targets that are rigorous and provide an appropriate level of motivation. Under the Terms and Conditions of the MIP, the Committee has the discretion to adjust the reported financial results for incentive plan purposes to correct for any unusual circumstances, both positive and negative, that might affect ROIC or sales growth.

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Incentive amounts paid to Mr. Macpherson, Mr. Howard, Ms. Robbins, Mr. Jadin, and Mr. High were based on the performance targets established for the 2018 MIP and were made under a separate annual incentive program described in the 2015 Incentive Plan. Prior to the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA), this program was intended to qualify annual incentives for tax deductibility under Section 162(m) of the Internal Revenue Code (Section 162(m)). After the enactment of the TCJA, these annual incentives are no longer deductible under Section 162(m). Under the program, the Committee allocates a portion of an incentive pool to each participant.

Consistent with current practice, the 2019 MIP will continue to utilize daily sales growth along with ROIC as performance measures and all NEOs will be aligned to the Company MIP.

Long-Term Incentives

The Company annually provides long-term incentives to NEOs and other key managers in order to align with the following elements of the Company's strategy to improve shareholder value:

achieve long-term business goals and objectives that increase shareholder value (including achieving financial performance that balances growth, profitability, and asset management);

reward management for taking prudent action and achieving results that create shareholder value;

attract qualified leaders to join the Company; and

retain management through business cycles.

In 2018, in response to market practice, the Company changed the long term incentive mix from 50% stock options and 50% performance shares to 50% stock options and 50% PRSUs. Providing a mix of different types of equity awards is consistent with market practice for senior executives. Using both stock options and PRSUs provides incentives to drive shareholder value creation and the three-year vesting schedule aids in executive retention. The Company's long-term incentives for NEOs are provided under shareholder-approved incentive plans.

The target number of shares provided for stock options and PRSUs is designed to approximate an economic value that targets the median of the compensation comparator group for comparable jobs. The Compensation Committee annually establishes the target value of the award based on the executive's position. The actual award may be adjusted up or down to reflect individual performance. In 2018, the value was converted to shares using the 200-day average stock price as of January 31, 2018. Beginning with the 2019 equity grants, Grainger will adjust this methodology for both Directors and grant-eligible employees from a 200-day average to a 20-day average to better reflect market practice.

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NEO Long-Term Incentives

Stock Options	50%	3-year vesting; 10 year term	Grant allocated based on individual performance; long-term value based on appreciation in stock price.
PRsUs	50%	3-year vesting contingent on performance	3-year average ROIC.

Stock Options

The Company's stock options provide the right to purchase Company stock at a specified price over a ten-year term with three-year vesting. They are intended to directly link management's and shareholders' interests by tying a substantial portion of long-term incentives to stock price appreciation. The ten-year term is designed to focus the NEOs on long-term value creation. Three-year vesting encourages meaningful retention before an executive can realize any value created by stock price appreciation. Stock option repricing is not permitted under any of the Company's equity incentive plans. Stock options are awarded at an exercise price equal to the closing price of the Company's common stock reported on the business day of the grant.

Performance Restricted Stock Units (PRsUs)

The Company's PRsU program provides the NEOs and other executives with a potential share payout depending on ROIC achievement over a three-year cycle. The actual number of shares paid to an NEO will be either 0% or 100% of the target number of PRsUs awarded. The Compensation Committee (with the assistance of its independent compensation consultant) and management perform a thorough analysis in setting the financial measures and goals for a three-year performance cycle that begins January 1 of the first year. The ROIC component is measured at the end of the third year based on the three-year average. These measurement dates reinforce a long term focus. No dividend equivalents are paid on PRsUs.

The Compensation Committee selected these performance measures because they balance sales growth with long-term profitability, expense management, and asset management and align with objectives established in the annual incentive program. The Committee may use different sales growth and ROIC objectives and targets from year to year to maximize alignment with then-current business objectives and to reflect economic conditions.

2016-2018 Performance Share Cycle

For the 2016-2018 performance share cycle, the program was designed to reward for achievement based on a three-year average ROIC and 2018 sales. The sales goal was established when 2015 sales were \$10.0 billion. The Company's average ROIC performance over the three-year period ending in 2018

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and net sales in 2018 will determine the number of shares earned. The payout of the target performance share awards for this program cycle was made according to the following table:

≤21.6%	0%
23.8%	50%
≥26.0%	100%
<\$11.2B	0%
\$11.7B	50%
≥\$12.2B	100%

*

Payouts are interpolated on a straight-line basis.

In 2018, sales were \$11.2 billion, and 3-year average ROIC for the performance period 2016 - 2018 was 25.8%. Accordingly, the participants earned 97% of their target. The Compensation Committee has accepted the Company's calculation of the 3-year average ROIC for purposes of the 2016 - 2018 performance share cycle.

2017-2019 Performance Share Cycle

The structure of the 2017 Performance Share Program is similar to the 2016 program. It is driven by total Company sales achieved in 2019 and 3-year average ROIC. The adjustment to the Target will be made by adding the results of the following two tables:

<\$11.4B	0%
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\$11.9B	50%
≥\$12.4B	100%
≤19.1%	0%
21.6%	50%
≥24.0%	100%

Three-year average ROIC at or above 24% or sales at or above \$12.24 billion in 2019 can independently achieve 100% of the target award. Achieving both will yield 200% of the target award. This award will remain at risk through 2019.

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2018-2020 PRSU Cycle

The 2018 PRSU Program focuses on maintaining profitability over a three-year period. It is driven by total Company 3-year average ROIC. The adjustment to the Target will be based on the results of the following table:

<18%	0%
≥18%	100%

This award will remain at risk through 2020.

The Company will continue to evaluate equity vehicles for the 2019 program to remain responsive to market practice while continuing to provide appropriate incentives to drive shareholder value creation.

Stock Ownership Guidelines

As of December 31, 2018, all officers subject to stock ownership guidelines, including the NEOs, are in compliance with the guidelines.

The Company continues to believe that requiring executive ownership of Company stock creates alignment between executives and shareholders and encourages executives to act to increase shareholder value. In 1996, the Company established stock ownership guidelines for its NEOs and other officers. In 2011, the Company increased the minimum ownership requirement for the CEO from 5x base salary to 6x and established a retention ratio for equity awards. The stock ownership guidelines for the current NEOs are as follows:

D.G. Macpherson	6x	Yes
Thomas B. Okray	3x	Yes
John L. Howard	3x	Yes
Paige K. Robbins	3x	Yes
Deidra C. Merriwether	3x	Yes

These stock ownership guidelines must be met within three years of being appointed an officer or assuming a new position and are reviewed annually by the Board. NEOs are required to hold exercised option shares and other stock awards until ownership requirements are met. Officers who fail to achieve these ownership levels will not be allowed to sell shares received from the vesting of equity awards until they comply with the guidelines. Shares owned directly by the officer (including those held as a joint tenant or as a tenant in common), shares owned in a self-directed IRA, shares owned or held for the benefit of a spouse or minor children, PRSUs, and RSUs are counted toward meeting the

guidelines. Stock options (whether vested or unvested) and performance share awards are not counted toward meeting the ownership guidelines.

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Compensation Discussion and Analysis

Hedging and Pledging Prohibition

The Company's Business Conduct Guidelines (which are available in the Governance section of Grainger's website at <http://www.grainger.com/investor>) prohibit employees and the Board of Directors from engaging in any financial arrangement (including, without limitation, short sales, put and call options) that establish a short position in Company stock and are designed to hedge or offset, any decrease in market value of the Company's (or its subsidiaries') equity securities. Company officers and Directors are also prohibited from pledging any Company stock as collateral for a loan or for a margin account. No Directors or executive officers have hedged or pledged any of the shares beneficially owned by them

Other Benefits

The other components of the Company's compensation program for NEOs are substantially similar to those available for most of the Company's other employees, other than the benefits discussed in this section. This includes the same health and welfare benefits and the same performance-based retirement profit sharing contribution methodology that is applied to the U.S.-based employees who are retirement profit sharing participants. The Company provides Supplemental Profit Sharing Plans solely to maintain an equal percentage of retirement profit sharing compensation contribution to approximately 160 employees, including NEOs, who would be subject to contribution or compensation limitations imposed on qualified plans by the Internal Revenue Code. The Company does not provide any other supplemental retirement benefits to its NEOs or other employees based in the United States.

Retirement profit sharing is the primary Company-sponsored retirement vehicle for U.S.-based employees. Retirement profit sharing aligns the interests of the Company's employees, management, and shareholders as the Company's annual contribution to retirement profit sharing is based on ROIC. The Company contributes a minimum of 8% of payroll to the plan and provides employees the opportunity to share in the success of the Company beyond this amount only if a threshold return on capital is achieved. The Company's Profit Sharing Plan includes a 401(k) feature for all U.S.-based employees, including the NEOs. Of the 8% Company contribution, the first 3% (which is funded from the retirement profit sharing pool) will go into the 401(k).

Effective April 2011, the Company requires that the NEOs and certain other Company officers have periodic physical examinations that are paid for by the Company. The Company believes that periodic physical exams are helpful in maintaining the effectiveness of its executive talent. There are currently 11 participants in the program.

Messrs. Macpherson and Howard and certain other Company officers have grandfathered participation in the Company's Executive Death Benefit Plan that was discontinued effective December 31, 2009. The beneficiary of a participant who dies while employed by the Company is entitled to a taxable benefit of 120 monthly payments of 50% of the participant's monthly compensation, calculated on the basis of salary and target annual incentive. The Company's policy is that, unless offered to other employees, it will not make payments, grants, or awards following the death of an executive in the form of unearned salary or unearned bonuses, accelerated vesting or the continuation in force of unvested equity grants, awards or un-granted equity, perquisites, and other payments or awards made in lieu of compensation.

Officers are allowed the business use of corporate aircraft, which is chartered by the Company from a third party provider on an as needed basis. Officers also are allowed the business use of a car and driver, while Mr. Macpherson is allowed personal use of a car and driver, subject to reimbursement of the incremental cost of use. These benefits represent a cost-effective method of allowing the Company's top executives to more effectively use their time. All other benefits, including the retirement profit sharing contribution percentages and various welfare benefits provided to U.S. NEOs and other executive officers, are comparable to those provided to the majority of salaried and hourly U.S.-based Company employees.

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Compensation Discussion and Analysis

Summary Compensation Table

(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
D.G. Macpherson Chairman of the Board & Chief Executive Officer	2018	\$1,030,000	\$0	\$4,086,887	\$3,100,501	\$1,842,464	\$0	\$395,992	\$10,455,844
	2017	\$1,022,500	\$0	\$2,634,042	\$1,643,409	\$1,210,250	\$0	\$456,158	\$6,966,359
	2016	\$875,000	\$0	\$2,511,744	\$1,070,785	\$796,875	\$0	\$284,128	\$5,538,532
Thomas B. Okray Sr. Vice President & Chief Financial Officer	2018	\$498,630	\$0	\$2,450,059	\$0	\$567,000	\$0	\$795,845	\$4,311,534
John. L. Howard Sr. Vice President & General Counsel	2018	\$703,533	\$0	\$796,617	\$604,376	\$749,486	\$0	\$185,994	\$3,040,006
	2017	\$694,042	\$0	\$622,544	\$388,434	\$492,889	\$0	\$261,308	\$2,459,217
	2016	\$673,828	\$0	\$332,937	\$556,807	\$381,808	\$0	\$93,599	\$2,038,979
Paige K. Robbins Sr. Vice President, Grainger Chief Digital Officer	2018	\$508,500	\$0	\$846,722	\$262,778	\$516,375	\$0	\$118,944	\$2,253,319
	2017	\$484,185	\$0	\$203,537	\$126,996	\$268,464	\$0	\$94,921	\$1,178,103
	2016	\$441,769	\$0	\$202,621	\$171,356	\$191,813	\$0	\$51,835	\$1,059,394
Deidra C. Merriwether Sr. Vice President & President, US Direct Sales & Strategic Initiatives	2018	\$448,922	\$0	\$293,843	\$210,209	\$305,749	\$0	\$100,035	\$1,358,758
Ronald L. Jadin Former Sr. Vice President & Chief Financial Officer	2018	\$570,663	\$0	\$0	\$0	\$286,491	\$0	\$189,655	\$1,046,809
	2017	\$743,541	\$0	\$910,056	\$567,735	\$598,447	\$0	\$158,779	\$2,978,558
	2016	\$721,885	\$0	\$486,615	\$813,818	\$463,577	\$0	\$99,328	\$2,585,223
Joseph C. High Former Sr. Vice President & Chief People Officer	2018	\$476,667	\$0	\$692,814	\$525,556	\$365,612	\$0	\$130,034	\$2,190,683
	2017	\$511,250	\$0	\$478,897	\$298,806	\$363,075	\$0	\$105,031	\$1,757,059
	2016	\$495,250	\$0	\$256,192	\$428,323	\$281,250	\$0	\$68,099	\$1,529,114

(1)

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Mr. Jadin retired effective as of May 2, 2018. As part of his separation agreement, assuming continued compliance with all terms of the agreement, including its non-competition and non-solicitation provisions, he will receive base salary continuation for 18 months plus the continued vesting of outstanding equity.

Mr. High retired effective as of August 31, 2018. As part of his separation agreement, assuming continued compliance with all terms of the agreement, including its non-competition and non-solicitation provisions, he will receive base salary continuation for 18 months plus the continued vesting of outstanding equity.

(2)

Represents the grant date fair value of stock awards computed in accordance with FASB ASC Topic 718. As these amounts represent stock-based grants, the maximum value of the awards is the same as disclosed above. Further details with respect to these awards are included in Note 12 (Stock Incentive Plans) to the Company's audited financial statements included in the Annual Report on Form 10-K for the fiscal year ended December 31, 2018.

(3)

Represents the grant date fair value of option awards computed in accordance with FASB ASC Topic 718. Further details with respect to these awards are included in Note 12 (Stock Incentive Plans) to the Company's audited financial statements included in the Annual Report on Form 10-K for the fiscal year ended December 31, 2018.

(4)

For 2018, includes contributions accrued under the Company's profit sharing plan and the related supplemental profit sharing plan (\$345,710, \$153,092, \$180,749, \$114,474, \$94,790, \$184,710, and \$125,089 for Mr. Macpherson, Mr. Okray, Mr. Howard, Ms. Robbins, Ms. Merriwether, Mr. Jadin and Mr. High respectively).

It also includes the incremental cost of the frozen Executive Death Benefit Program (\$45,812 and \$0 for Macpherson and Howard, respectively) and the cost of executive physicals (\$4,470, \$0, \$5,245, \$4,470, \$5,245, \$4,945 and \$4,945 for Mr. Macpherson, Mr. Okray, Mr. Howard, Ms. Robbins, Ms. Merriwether, Mr. Jadin and Mr. High respectively).

It also includes a cash sign-on award for Mr. Okray subject to a two year re-payment provision in the amount of \$550,000 and cost of relocation in the amount of \$92,753.

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Grants of Plan-Based Awards

G. Macpherson	4/2/18	2/21/18	\$0	\$1,364,750	\$2,729,500	0	15,355	15,355	46,063	\$276.64	\$4,086,88	
	4/2/18	2/21/18									\$3,100,50	
Thomas B. Kray	5/2/18	4/2/18	\$0	\$420,000	\$840,000			8,690			\$2,450,05	
John. L. Howard	4/2/18	2/21/18	\$0	\$555,188	\$1,110,375	0	2,993	2,993	8,979	\$276.64	\$796,61	
	4/2/18	2/21/18									\$604,37	
Maige K. Robbins	4/2/18	2/21/18	\$0	\$382,500	\$765,000	0	1,302	1,302	1,772	3,904	\$276.64	\$346,54
	4/2/18	2/21/18										\$500,18
	4/2/18	2/21/18										\$262,77
Heidra C. Merriwether	4/2/18	2/21/18	\$0	\$226,481	\$452,962	0	0	0	1,041	3,123	\$276.64	\$
	4/2/18	2/21/18										\$293,84
	4/2/18	2/21/18										\$210,20
Donald L. Adin	4/2/18	2/21/18	\$0	\$212,190	\$424,381	0	0	0		0		\$
	4/2/18	2/21/18										\$
			\$0	\$260,000	\$520,000							

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Joseph C.
High

4/2/18	2/21/18	0	2,603	2,603					\$692,81
4/2/18	2/21/18				7,808	\$276.64			\$525,55

- (1) Represents potential amounts under the 2018 Company Management Incentive Program. Actual payout amounts under the 2018 Company Management Incentive Program are included in the "Non-Equity Incentive Plan Comp." column of the Summary Compensation Table.
- (2) The number of shares that may be earned for the 2018 grant of performance restricted stock units is either 0% or 100% of the target award and will be determined based on the Company's three-year average ROIC in 2020. The awards were made under the 2015 Incentive Plan.
- (3) Mr. Okray received a sign-on restricted stock unit award granted on May 2, 2018 with three-year graded vesting. Ms. Robbins received a one-time restricted stock unit award associated with expanded responsibilities granted on April 2, 2018 with 7-year cliff vesting. Ms. Merriwether received a restricted stock unit award as part of the regular equity program on April 2, 2018 with three-year cliff vesting.
- (4) Represents stock option awards with a ten-year term and three-year cliff vesting. The awards were made under the 2015 Incentive Plan.
- (5) Awards were issued at fair market value, which is the closing stock price on the grant date.
- (6) Represents the full grant date fair value of awards as calculated under FASB ASC Topic 718 without allocating over the vesting period.

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Outstanding Equity Awards at Fiscal Year-End

D.G. Macpherson	16,923 (7)	\$204.01	4/24/2022	0	\$0	48,301 (15)	\$13,638,270
	15,741 (8)	\$245.86	4/23/2023				
	12,266 (9)	\$248.22	4/29/2024				
	14,380 (10)	\$231.88	3/31/2025				
	23,827 (11)	\$234.38	3/31/2026				
	36,415 (12)	\$231.20	4/2/2027				
	46,063 (13)	\$276.64	4/1/2028				
Thomas B. Okray				8,690 (16)	\$2,453,708	0	\$0
John. L. Howard	11,716 (7)	\$204.01	4/24/2022	0	\$0	12,443 (17)	\$3,513,405
	11,543 (8)	\$245.86	4/23/2023				
	7,360 (9)	\$248.22	4/29/2024				
	9,728 (10)	\$231.88	3/31/2025				
	12,390 (11)	\$234.38	3/31/2026				
	8,607 (12)	\$231.20	4/2/2027				
	8,979 (13)	\$276.64	4/1/2028				
Paige K. Robbins	3,840 (14)	\$149.02	4/26/2021	4,519 (18)	\$1,275,985	2,785 (19)	\$786,373
	2,790 (7)	\$204.01	4/24/2022				
	2,330 (8)	\$245.86	4/23/2023				
	2,127 (9)	\$248.22	4/29/2024				
	3,122 (10)	\$231.88	3/31/2025				
	3,813 (11)	\$234.38	3/31/2026				
	2,814 (12)	\$231.20	4/2/2027				
	3,904 (13)	\$276.64	4/1/2028				
Deidra C. Merriwether	2,127 (9)	\$248.22	4/29/2024	5,092 (20)	\$1,437,777	1,182 (21)	\$333,750

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	2,496 (10)		\$231.88	3/31/2025				
		2,860 (11)	\$234.38	3/31/2026				
		2,318 (12)	\$231.20	4/2/2027				
		3,123 (13)	\$276.64	4/1/2028				
Ronald L. Jadin	19,527 (7)		\$204.01	4/24/2022	0	\$0	14,219 (22)	\$4,014,877
	16,790 (8)		\$245.86	4/23/2023				
	13,084 (9)		\$248.22	4/29/2024				
	15,226 (10)		\$231.88	3/31/2025				
		18,109 (11)	\$234.38	3/31/2026				
		12,580 (12)	\$231.20	4/2/2027				
Joseph C. High	8,920 (8)		\$245.86	4/23/2023	0	\$0	6,172 (23)	\$1,742,726
	7,360 (9)		\$248.22	4/29/2024				
	8,459 (10)		\$231.88	3/31/2025				
		9,531 (11)	\$234.38	3/31/2026				
		6,621 (12)	\$231.20	4/2/2027				
		7,808 (13)	\$276.64	4/1/2028				

- (1) Represents stock option awards with a ten-year term and three-year cliff vesting. Upon retirement from the Company, unvested options automatically vest and may be exercised within the lesser of six years or the remaining term of the option. Mr. Howard is currently retirement-eligible.
- (2) Awards were issued at fair market value, which is the closing stock price on the grant date.
- (3) Represents ten years after the award date.
- (4) Represents the aggregate unvested restricted stock units outstanding multiplied by the year-end closing price (\$282.36).
- (5) Represents the target number of shares that may be issued following the end of the performance period in connection with performance awards.
- (6) Represents the aggregate performance awards outstanding multiplied by the year-end closing price (\$282.36).
- (7) 100% of these options vested on April 25, 2015.
- (8) 100% of these options vested on April 24, 2016.
- (9) 100% of these options vested on April 30, 2017.
- (10) 100% of these options vested on April 1, 2018.

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- (11) 100% of these options will vest on April 1, 2019.
- (12) 100% of these options will vest on April 3, 2020.
- (13) 100% of these options will vest on April 2, 2021.
- (14) 100% of these options vested on April 27, 2014.
- (15) 3,404 of these performance shares vested on December 31, 2018, 12,139 of these performance shares will vest on December 31, 2019, 15,355 of these PRSUs will vest on April 2, 2021, 8,507 of these performance shares will vest on August 1, 2022, and 8,896 of these performance shares will vest on October 3, 2023.
- (16) 33.33% of these restricted shares will vest on May 2, 2019, May 2, 2020 and May 2, 2021, respectively.
- (17) 1,770 of these performance shares vested on December 31, 2018, 2,869 of these performance shares will vest on December 31, 2019, 4,811 of these performance shares will vest on August 1, 2020, and 2,993 of these PRSUs will vest on April 2, 2021.
- (18) 481 of these restricted shares will vest on November 1, 2019, 1,250 of these restricted shares will vest on April 23, 2020, 1,016 of these restricted shares will vest on September 2, 2021 and 1,772 of these restricted shares will vest on April 2, 2025.
- (19) 545 of these performance shares vested on December 31, 2018, 938 of these performance shares will vest on December 31, 2019 and 1,302 of these PRSUs will vest on April 2, 2021.
- (20) 2,786 of these restricted shares will vest on October 29, 2020, 1,041 of these restricted shares will vest on April 2, 2021 and 1,265 of these restricted shares will vest on November 1, 2024.
- (21) 409 of these performance shares vested on December 31, 2018 and 773 of these performance shares will vest on December 31, 2019.
- (22) 2,587 of these performance shares vested on December 31, 2018, 4,194 of these performance shares will vest on December 31, 2019 and 7,438 of these performance shares will vest on August 1, 2020.
- (23) 1,362 of these performance shares vested on December 31, 2018, 2,207 of these performance shares will vest on December 31, 2019 and 2,603 of these PRSUs will vest on April 2, 2021.

Option Exercises and Stock Vested

D.G. Macpherson	24,876	\$4,810,220	0	\$0
Thomas B. Okray	0	\$0	0	\$0
John. L. Howard	34,490	\$6,929,112	0	\$0
Paige K. Robbins	0	\$0	466	\$166,553
Deidra C. Merriwether	0	\$0	0	\$0
Ronald L. Jadin	54,336	\$10,124,552	0	\$0
Joseph C. High	10,415	\$1,624,636	2,176	\$754,115

- (1) Represents the number of stock options exercised.
- (2) Represents the difference between the exercise price and the market price of the common stock on the date of exercise.
- (3) Represents the value of the restricted stock units and performance restricted stock unit awards on the vesting date.

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Pension Benefits

D.G. Macpherson	None	n/a	n/a	n/a
Thomas B. Okray	None	n/a	n/a	n/a
John. L. Howard	None	n/a	n/a	n/a
Paige K. Robbins	None	n/a	n/a	n/a
Deidra C. Merriwether	None	n/a	n/a	n/a
Ronald L. Jadin	None	n/a	n/a	n/a
Joseph C. High	None	n/a	n/a	n/a

Nonqualified Deferred Compensation

D.G. Macpherson	SPSP & SPSP					
	II	\$0	\$185,790	\$84,991	\$0	\$1,346,181
	Total	\$0	\$185,790	\$84,991	\$0	\$1,346,181
Thomas B. Okray	SPSP & SPSP					
	II	\$0	\$0	\$0	\$0	\$0
	Total	\$0	\$0	\$0	\$0	\$0
John. L. Howard	Frozen					
	Salary & Incentive					
	Deferral	\$0	\$0	\$114,259	\$0	\$2,912,038
	SPSP & SPSP					
	II	\$0	\$96,608	\$69,617	\$0	\$1,921,440
	Deferred RSUs	\$0	\$0	\$922,200	\$0	\$5,647,200
	Total	\$0	\$96,608	\$738,324	\$0	\$10,480,678
Paige K. Robbins	SPSP & SPSP					
	II	\$0	\$48,496	\$17,022	\$0	\$233,281
	Total	\$0	\$48,496	\$17,022	\$0	\$233,281

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Deidra C. Merriwether	SPSP & SPSP					
	II	\$0	\$36,351	\$7,242	\$0	\$90,588
	Total	\$0	\$36,351	\$7,242	\$0	\$90,588
Ronald L. Jadin	Frozen					
	Salary &					
	Incentive					
	Deferral	\$0	\$0	\$24,213	\$0	\$0
	SPSP & SPSP					
	II	\$0	\$112,354	\$14,300	\$1,110,840	\$0
	Total	\$0	\$112,354	\$38,513	\$1,110,840	\$0
Joseph C. High	SPSP & SPSP					
	II	\$0	\$62,631	\$15,880	\$0	\$353,572
	Total	\$0	\$62,631	\$15,880	\$0	\$353,572

- (1) The Company provides the supplemental profit sharing plans (SPSPs) solely to maintain an equal percentage of profit sharing contribution to employees (including all NEOs) who would be subject to contribution or compensation limits imposed on qualified plans by the Internal Revenue Code. For Mr. Macpherson, Mr. Okay, Mr. Howard, Ms. Robbins, Ms. Merriwether, Mr. Jadin and Mr. High, this represents the Company SPSP contribution. These contributions were disclosed as part of "All Other Comp." in the 2018 Summary Compensation Table.
- (2) Represents earnings on all nonqualified deferred compensation balances, including SPSP earnings, stock price appreciation and dividend equivalent payments for vested, deferred restricted stock units, and for Mr. Howard and Mr. Jadin, earnings on voluntary deferrals.
- (3) Aggregate year-end balances for the SPSPs, vested deferred restricted stock units, and for Mr. Howard and Mr. Jadin, year-end balances for their voluntary deferral accounts. Mr. Howard has 20,000 vested, deferred RSUs outstanding.

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Compensation Discussion and Analysis

EMPLOYMENT CONTRACTS, CHANGE IN CONTROL AGREEMENTS, AND TERMINATION OF EMPLOYMENT ARRANGEMENTS

The Company does not maintain any employment agreements with its Named Executive Officers.

Change in Control Equity Plans

Under the terms of the Company's 2015 Incentive Plan, which is the source for all equity awards granted after April 2015, "double trigger" vesting provisions apply to all equity awards (i.e., both a change in control occurs and a participant is involuntarily terminated within one year of the change in control).

Change in Control Agreements

The Company has 2x Change in Control Agreements (CIC Agreements) with a number of executives, including the NEOs. These CIC Agreements are intended to ensure that in the event of a pending or threatened change in control, the Company retains its management and that their full attention is focused on the best interests of the Company and its shareholders and not on the uncertainty of their future employment prospects under those circumstances.

The Company's CIC Agreements have double-trigger arrangements. Under each CIC Agreement, the executive is entitled to certain benefits which include a lump-sum payment equal to 2x the sum of (i) the executive's annual salary, (ii) the executive's target annual incentive, and (iii) in connection with the Company's non-contributory retirement profit sharing plans, a percentage of annual salary and annual incentive equal to the average percentage of covered compensation contributed by the Company under the plans for the last three fiscal years. The executive is also entitled to two years of continued health and dental benefits.

The Company has committed that no more than 10 positions will be eligible for CIC Agreements in the future. Existing agreements remain in place.

Deductibility of Executive Compensation

Section 162(m) of the Internal Revenue Code generally disallows a federal income tax deduction to a public company for compensation over \$1 million per taxable year paid to the Company's NEOs. Prior to the Tax Cuts and Jobs Act of 2017 (TCJA), compensation that qualified as "performance-based" compensation was not subject to the deductibility limit. Effective for taxable years beginning after December 31, 2017, subject to certain transition relief, the TCJA eliminated this exception. Stock Options granted to our NEOs prior to November 2, 2017 under the 2015 Incentive Plan qualify for the transition relief, and gains on exercises of such stock options are considered to be "performance-based" compensation not subject to the \$1 million deductibility limit. Any other compensation paid to our NEOs, including awards other than the grandfathered stock options, is subject to the Section 162(m) deductibility limit and all or a portion of such compensation may be nondeductible. While the tax treatment applicable to the Company's compensation programs was considered in the design of these programs, the Company intends to authorize compensation that will not be deductible under Section 162(m) when the Company believes that doing so is in the best interest of the company and its shareholders.

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Compensation Discussion and Analysis

Accounting Considerations

Upon vesting, settlement, or maturity, equity awards under the 2015 Incentive Plan and predecessor plans are distributed in the form of shares of the Company's common stock. Under the Accounting Standards Codification (ASC) 718 (formerly FAS 123R), these types of awards are considered equity awards. As a result, the total amount of compensation expense to be recorded for the awards is based on the fair value of the awards on the grant date. This fair value is then recorded over the vesting period, usually three years, and is recorded to compensation expense and as an increase in paid-in capital. The amount of compensation expense is not subsequently adjusted for changes in the Company's share price, but it is adjusted for the estimated number of shares to be distributed. If an equity award is forfeited, all previously recorded compensation expensed is reversed. While the accounting treatment described above was considered in the development of the long-term incentive program, it was not a material consideration.

Compensation Recoupment Policy (Claw backs)

The Company expanded in its equity compensation agreements the recoupment (or, claw back) provisions for equity and annual incentive payments made to officers. The Company may recover incentive compensation (cash or equity) that was awarded based on achievement of financial results that were the subject of a restatement if the officer engaged in criminal conduct or financial fraud. The Company also may recover all or a portion of any incentive compensation in the case of materially inaccurate financial statements whether or not they result in a restatement and whether or not the executive officer has engaged in wrongful conduct. Recoveries under these provisions can extend back for three years from the date of the initial filing that contained the relevant financial statements. In addition, should an executive violate his or her confidentiality or non-compete obligations, any award is automatically forfeited, and in certain circumstances, the executive must return vested shares and/or gains from disposition of shares to the Company. Finally, the Company may recoup all or a portion of any incentive compensation if the Company determines that the executive has committed fraud against the Company or has engaged in any criminal conduct, including embezzlement or theft, that involves or is related to the Company, engages in any other conduct that violates Company policy, causes or is discovered to have caused, any loss, damage, injury or other endangerment to Grainger's property or reputation, or receives any amount in excess of what the Executive should have received for any reason.

This policy applies to any incentive compensation awarded or paid to an employee at a time when he or she is an officer. Subsequent changes in status, including retirement or termination of employment, do not impact the Company's rights to recover compensation under this policy.

Termination

The Company does not have employment contracts and does not maintain severance programs for its NEOs. The executive's CIC Agreements provide the potential for a lump sum payment following a change in control. Except for a limited period of time following a change in control, the NEOs are not entitled to severance upon termination.

Retirement

The definition of retirement eligibility is the same for all U.S. employees. Under this definition, an employee is retirement-eligible upon attaining any of the following:

age 60;

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Compensation Discussion and Analysis

age 55 and 20 years of service; or

25 years of service.

Mr. Howard is retirement-eligible. Mr. Jadin retired as of May 2, 2018 and Mr. High retired as of August 31, 2018.

The Company provides the following upon retirement for all employees, including NEOs:

outstanding stock options become vested and executives have the right to exercise such stock options within six years from date of termination or for the remaining term of the stock option, whichever is less;

settlement of PRSUs occurs after the end of the performance period in common stock equal to the number of the executive's outstanding performance shares earned for the performance period; and

cash payments equal to account balances under retirement profit sharing, any supplemental retirement profit sharing program, and the Voluntary Salary and Incentive Deferral Plan will be made in installment payments for up to 15 years or in a lump-sum payment based on the election made by the executive in accordance with the terms and conditions of those plans.

The following tables illustrate the potential incremental payments and benefits that could be received by the NEOs upon a termination or change in control of the Company. The amounts shown below assume that such termination or change in control was effective as of December 31, 2018 and thus only includes amounts earned through such date. However, the actual amounts that would be paid out under each circumstance can only be determined at the time of separation.

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Compensation Discussion and Analysis

Other Potential Post-Employment Payments**Macpherson, D.G.**

Cash Compensation

Cash Severance (1)	\$0	\$0	\$0	\$0	\$0	\$0	\$5,421,920
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Management Incentive Program

Prorated Annual Bonus Guarantee	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Long-Term Incentives

Stock Options

Unvested and Accelerated Awards (2)	\$0	\$0	\$0	\$3,269,691	\$3,269,691	\$3,269,691	\$3,269,691
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Restricted Stock Units

Unvested and Accelerated Awards (3)	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Performance Shares

Unvested and Accelerated Awards (4)	\$0	\$0	\$0	\$12,495,748	\$12,495,748	\$13,638,270	\$13,638,270
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Retirement Benefits

Profit Sharing

Unvested and Accelerated Awards (5)	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Deferred Compensation

Benefits

	\$0	\$0	\$0	\$0	\$0	\$0	\$34,322
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Continuation of Health & Welfare Benefits (6)

Life Insurance and Death Benefit Payout (7)	\$0	\$0	\$0	\$8,678,615	\$0	\$0	\$1,339,404
Disability Payments	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Perquisites and Tax Payments							
Excise Tax & Gross-Up	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Outplacement (8)	\$0	\$0	\$0	\$0	\$0	\$0	\$154,500
Total	\$0	\$0	\$0	\$24,444,054	\$15,765,439	\$16,907,962	\$23,858,108

- (1) The Company does not maintain any agreements with its named executive officers that guarantee the payment of cash severance upon termination, except in the event of a change in control followed by termination without cause or with good reason.
- (2) Unvested options become immediately exercisable in the event of death, disability, retirement, or a change in control.
- (3) Mr. Macpherson does not have any unvested restricted stock units as of December 31, 2018.
- (4) In the event of death or disability, Mr. Macpherson is entitled to receive in settlement of performance-based awards, a number of shares of common stock equal to the target number of shares that vest based upon the Company's average return on invested capital, as of the date of death or disability.
- (5) Mr. Macpherson does not have any unvested profit sharing amounts as of December 31, 2018.

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Compensation Discussion and Analysis

- (6) The health and welfare benefits value upon change in control followed by termination without cause or with good reason is based upon two years of continuation of active health and welfare benefits using the Company's budget/insured rates projected forward throughout the two years using 9% health and 6% dental annual trends as well as a 5% annual discount factor.
- (7) Upon death, Mr. Macpherson's survivors shall receive, for 120 months, 50% of his monthly base salary and target bonus amount, under the frozen Executive Death Benefit Plan. The figure above reflects the present value lump-sum payment amount based upon the FAS discount rate of 7.25%.
- (8) In the event of a change in control followed by termination without cause or with good reason, the Company shall provide Mr. Macpherson with standard outplacement services provided that the cost of such services to the Company not exceed 15% of the Executive's annual base salary in effect on the date of termination. The amount above represents the maximum cost to the Company for providing such outplacement services.
- (9) Mr. Macpherson is not eligible for retirement under the Company's retirement plan as of December 31, 2018.

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Compensation Discussion and Analysis

Okray, Thomas B.Cash
Compensation

Cash Severance (1)	\$0	\$0	\$0	\$0	\$0	\$0	\$2,660,000
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Management
Incentive ProgramProrated Annual
Bonus
Guarantee

	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Long-Term
Incentives

Stock Options

Unvested and
Accelerated
Awards (2)

	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Restricted Stock
UnitsUnvested and
Accelerated
Awards (3)

	\$0	\$0	\$0	\$2,453,708	\$2,453,708	\$2,453,708	\$2,453,708
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Performance
SharesUnvested and
Accelerated
Awards

	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Retirement
Benefits

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Profit Sharing

Unvested and Accelerated Awards (4)	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Deferred Compensation	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Benefits							
Continuation of Health & Welfare Benefits (5)	\$0	\$0	\$0	\$0	\$0	\$0	\$34,322
Life Insurance and Death Benefit Payout (6)	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Disability Payments	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Perquisites and Tax Payments							
Excise Tax & Gross-Up	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Outplacement (7)	\$0	\$0	\$0	\$0	\$0	\$0	\$105,000
Total	\$0	\$0	\$0	\$2,453,708	\$2,453,708	\$2,453,708	\$5,253,030

- (1) The Company does not maintain any agreements with its named executive officers that guarantee the payment of cash severance upon termination, except in the event of a change in control followed by termination without cause or with good reason.
- (2) Unvested options become immediately exercisable in the event of death, disability, retirement, and a change in control.
- (3) Mr. Okray has one grant of unvested restricted stock as December 31, 2018.
- (4) Mr. Okray does not have any unvested profit sharing amounts as of December 31, 2018.
- (5) The health and welfare benefits value upon change in control and termination without cause or with good reason is based upon two years of continuation of active health and welfare benefits using the Company's budget/insured rates projected forward throughout the two years using 9% health and 6% dental annual trends as well as a 5% annual discount factor.
- (6) Mr. Okray is not eligible for the frozen Executive Death Benefit Plan.

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Compensation Discussion and Analysis

- (7) In the event of a change in control followed by termination without cause or with good reason, the Company shall provide Mr. Okray with standard outplacement services provided that the cost of such services to the Company not exceed 15% of the Executive's annual base salary in effect on the date of termination. The amount above represents the maximum cost to the Company for providing such outplacement services.
- (8) Mr. Okray is not eligible for retirement under the Company's retirement plan as of December 31, 2018.

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Compensation Discussion and Analysis

Howard, John L.

Cash Compensation

Cash Severance (1)	\$0	\$0	\$0	\$0	\$0	\$0	\$2,842,560
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Management Incentive Program

Prorated Annual Bonus Guarantee	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Long-Term Incentives

Stock Options

Unvested and Accelerated Awards (2)	\$0	\$0	\$1,086,166	\$1,086,166	\$1,086,166	\$1,086,166	\$1,086,166
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Restricted Stock Units

Unvested and Accelerated Awards (3)	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Performance Shares

Unvested and Accelerated Awards (4)	\$0	\$0	\$1,884,941	\$3,243,375	\$3,243,375	\$3,513,405	\$3,513,405
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Retirement Benefits

Profit Sharing

Unvested and Accelerated Awards (5)	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Deferred Compensation

Benefits

Continuation of Health & Welfare Benefits (6)	\$0	\$0	\$435,654	\$0	\$0	\$0	\$34,322
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Life Insurance and Death Benefit Payout (7)	\$0	\$0	\$467,970	\$4,549,954	\$0	\$0	\$972,505
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Disability Payments	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Perquisites and Tax Payments							
Excise Tax & Gross-Up	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Outplacement (8)	\$0	\$0	\$0	\$0	\$0	\$0	\$105,750
Total	\$0	\$0	\$3,874,731	\$8,879,495	\$4,329,541	\$4,599,572	\$8,554,709

- (1) The Company does not maintain any agreements with its named executive officers that guarantee the payment of cash severance upon termination, except in the event of a change in control followed by termination without cause or with good reason.
- (2) Unvested options become immediately exercisable in the event of death, disability, retirement, and a change in control.
- (3) Mr. Howard does not have any unvested restricted stock as of December 31, 2018.
- (4) In the event of retirement, death or disability, Mr. Howard is entitled to receive in settlement of performance-based awards, a number of shares of common stock equal to the target number of shares that vest based upon the Company's average return on invested capital, as of the end of the performance period. Mr. Howard is retirement eligible as of December 31, 2018.
- (5) Mr. Howard does not have any unvested profit sharing amounts as of December 31, 2018.
- (6) The health and welfare benefits value upon change in control and termination without cause or with good reason is based upon two years of continuation of active health and welfare benefits using the Company's

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Compensation Discussion and Analysis

budget/insured rates projected forward throughout the two years using 9% health and 6% dental annual trends as well as a 5% annual discount factor.

- (7) Upon death, Mr. Howard's survivors shall receive, for 120 months, 50% of his monthly base salary and target bonus amount, under the frozen Executive Death Benefit Plan. The figure above reflects the present value lump-sum payment amount based upon the FAS discount rate of 7.25%. Upon retirement, he has elected to receive a present value cash settlement at retirement in lieu of the post-retirement death benefit under the frozen EDBP. The amount in the table is based on a 6.0% discount rate and assumed mortality of age 80. Upon a change in control, he would receive the present value, but based on the Applicable Federal Rate of 3.3%.
- (8) In the event of a change in control followed by termination without cause or with good reason, the Company shall provide Mr. Howard with standard outplacement services provided that the cost of such services to the Company not exceed 15% of the Executive's annual base salary in effect on the date of termination. The amount above represents the maximum cost to the Company for providing such outplacement services.
- (9) Mr. Howard has met the eligibility requirements for retirement under the Company's retirement plan as of December 31, 2018.

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Compensation Discussion and Analysis

Robbins, Paige K.

Cash Compensation

Cash Severance (1)	\$0	\$0	\$0	\$0	\$0	\$0	\$2,056,320
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Management Incentive Program

Prorated Annual Bonus Guarantee	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Long-Term Incentives

Stock Options

Unvested and Accelerated Awards (2)	\$0	\$0	\$0	\$349,243	\$349,243	\$349,243	\$349,243
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Restricted Stock Units

Unvested and Accelerated Awards (3)	\$0	\$0	\$0	\$1,275,985	\$1,275,985	\$1,275,985	\$1,275,985
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Performance Shares

Unvested and Accelerated Awards (4)	\$0	\$0	\$0	\$698,088	\$698,088	\$786,373	\$786,373
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Retirement Benefits

Profit Sharing

Unvested and Accelerated Awards (5)	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Deferred Compensation

Benefits

Continuation of Health & Welfare Benefits (6)	\$0	\$0	\$0	\$0	\$0	\$0	\$34,322
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Life Insurance and Death Benefit Payout (7)	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Disability Payments	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Perquisites and Tax Payments							
Excise Tax & Gross-Up	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Outplacement (8)	\$0	\$0	\$0	\$0	\$0	\$0	\$76,500
Total	\$0	\$0	\$0	\$2,323,316	\$2,323,316	\$2,411,600	\$4,578,742

- (1) The Company does not maintain any agreements with its named executive officers that guarantee the payment of cash severance upon termination, except in the event of a change in control followed by termination without cause or with good reason.
- (2) Unvested options become immediately exercisable in the event of death, disability, retirement, and a change in control.
- (3) Ms. Robbins has four grants of unvested restricted stock grants as December 31, 2018.
- (4) In the event of death or disability, Ms. Robbins is entitled to receive in settlement of performance-based awards, a number of shares of common stock equal to the target number of shares that vest based upon the Company's average return on invested capital, as of the date of death or disability.
- (5) Ms. Robbins does not have any unvested profit sharing amounts as of December 31, 2018.
- (6) The health and welfare benefits value upon change in control and termination without cause or with good reason is based upon two years of continuation of active health and welfare benefits using the Company's budget/insured rates projected forward throughout the two years using 9% health and 6% dental annual trends as well as a 5% annual discount factor.
- (7) Ms. Robbins is not eligible for the frozen Executive Death Benefit Plan.

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Compensation Discussion and Analysis

- (8) In the event of a change in control followed by termination without cause or with good reason, the Company shall provide Ms. Robbins with standard outplacement services provided that the cost of such services to the Company not exceed 15% of the Executive's annual base salary in effect on the date of termination. The amount above represents the maximum cost to the Company for providing such outplacement services.
- (9) Ms. Robbins is not eligible for retirement under the Company's retirement plan as of December 31, 2018.

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Compensation Discussion and Analysis

Merriwether, Deidra C.

Cash Compensation

Cash Severance (1)	\$0	\$0	\$0	\$0	\$0	\$0	\$1,521,952
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Management Incentive Program

Prorated Annual Bonus Guarantee	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Long-Term Incentives

Stock Options

Unvested and Accelerated Awards (2)	\$0	\$0	\$0	\$273,675	\$273,675	\$273,675	\$273,675
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Restricted Stock Units

Unvested and Accelerated Awards (3)	\$0	\$0	\$0	\$1,437,777	\$1,437,777	\$1,437,777	\$1,437,777
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Performance Shares

Unvested and Accelerated Awards (4)	\$0	\$0	\$0	\$260,995	\$260,995	\$333,750	\$333,750
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Retirement Benefits

Profit Sharing

Unvested and Accelerated Awards (5)	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Deferred Compensation

Benefits

Continuation of Health & Welfare Benefits (6)	\$0	\$0	\$0	\$0	\$0	\$0	\$34,322
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Life Insurance and Death Benefit Payout (7)	\$0	\$0	\$0	\$0	\$0	\$0	\$0
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Disability Payments	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Perquisites and Tax Payments							
Excise Tax & Gross-Up	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Outplacement (8)	\$0	\$0	\$0	\$0	\$0	\$0	\$67,944
Total	\$0	\$0	\$0	\$1,972,447	\$1,972,447	\$2,045,202	\$3,669,420

- (1) The Company does not maintain any agreements with its named executive officers that guarantee the payment of cash severance upon termination, except in the event of a change in control followed by termination without cause or with good reason.
- (2) Unvested options become immediately exercisable in the event of death, disability, retirement, and a change in control.
- (3) Ms. Merriwether has three grants of unvested restricted stock as December 31, 2018.
- (4) In the event of death or disability, Ms. Merriwether is entitled to receive in settlement of performance-based awards, a number of shares of common stock equal to the target number of shares that vest based upon the Company's average return on invested capital, as of the date of death or disability.
- (5) Ms. Merriwether does not have any unvested profit sharing amounts as of December 31, 2018.
- (6) The health and welfare benefits value upon change in control and termination without cause or with good reason is based upon two years of continuation of active health and welfare benefits using the Company's budget/insured rates projected forward throughout the two years using 9% health and 6% dental annual trends as well as a 5% annual discount factor.

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Compensation Discussion and Analysis

- (7) Ms. Merriwether is not eligible for the frozen Executive Death Benefit Plan.
- (8) In the event of a change in control followed by termination without cause or with good reason, the Company shall provide Ms. Merriwether with standard outplacement services provided that the cost of such services to the Company not exceed 15% of the Executive's annual base salary in effect on the date of termination. The amount above represents the maximum cost to the Company for providing such outplacement services.
- (9) Ms. Merriwether is not eligible for retirement under the Company's retirement plan as of December 31, 2018.

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Compensation Discussion and Analysis

CEO PAY RATIO DISCLOSURE

Under SEC rules, we are required to calculate and disclose the ratio of the annual total compensation of Mr. Macpherson, our Chairman and CEO, to the annual total compensation of our median employee. As permitted under the SEC rules, in order to identify our median employee, we used a consistently applied compensation measure of 'base pay' earned during the period from January 1, 2017 to September 30, 2017, rather than summary compensation table (SCT) total compensation for all of 2017. We annualized base pay for those employees who commenced work during 2017. The identified median employee is a full-time, U.S.-based employee. We then determined their full year's compensation based on the compensation elements required for inclusion in the SCT, with the exception of incorporating healthcare benefits in Total Compensation as discussed later in this section. The other components of our compensation program for NEOs are substantially similar to those available for most of our other employees. This includes the same health and welfare benefits and the same performance-based retirement profit sharing contribution methodology that is applied to the U.S.-based employees who are retirement profit sharing participants.

As of December 31, 2018, Grainger had approximately 24,600 employees, of whom approximately 23,100 were full-time and 1,500 were part-time or temporary.

We utilized the *de minimis* exemption to exclude approximately 4% of our global workforce, or 920 employees, as reflected below:

Included in calculation: Canada, China, Mexico, Netherlands, Panama, United Kingdom, United States (approximately 23,000 employees)

Excluded from calculation: Belgium, Costa Rica, Czech Republic, Dominican Republic, France, Germany, Hungary, India, Indonesia, Ireland, Japan, Malaysia, Peru, Poland, Portugal, Romania, Slovakia, South Africa, Spain, Thailand, United Arab Emirates (approximately 920 employees)

The median employee's circumstances have not materially changed relative to 2017. Also, we have not had significant changes in our workforce, such as employee population size fluctuations, acquisition or divestitures, nor have we had significant changes in our pay programs that we reasonably believe would result in a significant change to this pay ratio disclosure. Therefore, we believe the previously identified median employee for 2017 remains appropriate for 2018.

In calculating Total Compensation for our median employee and CEO, we included the estimated company cost of their respective Company-provided health and wellness benefits. The CEO's Total Compensation reported in the Summary Compensation Table for 2018 is \$10,455,844. The CEO's Total Compensation for purposes of our pay ratio disclosure calculation is \$10,465,572, which differs from the Total Compensation described in the Summary Compensation Table on page 57 of this document by his health and wellness benefits amount. The median employee's estimated Total Compensation for 2018 was \$67,316 (which includes compensation of \$57,588 and estimated benefits of \$9,728). The ratio of CEO pay to median employee pay is 155:1. The reasons the ratio of CEO pay to median employee pay differs from the ratio disclosed in our 2018 proxy statement include:

The Company Management Incentive Program paid out at 135% of target in 2018, as compared to 94% of target in 2017;

Mr. Macpherson's MIP target increased from 125% to 135%; and

The value of Mr. Macpherson's equity awards granted in 2018 was higher than that granted in 2017.

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Compensation Discussion and Analysis

The Company is asking its shareholders for their non-binding advisory approval of the compensation of its Named Executive Officers (Say on Pay) as disclosed in the "Compensation Discussion and Analysis" section of this proxy statement in accordance with the SEC rules.

As described in detail under "Compensation Discussion and Analysis," the Company's compensation program is based upon a philosophy that is applied to all Company employees to attract and retain the best people and provide appropriate performance-based incentives that encourage them to achieve results that create long-term shareholder value. The Company sets target compensation for the Named Executive Officers to approximate the market median of compensation at companies of similar size and complexity. Employees at all levels of the Company, including its executives, are provided clear incentives to grow the business (Sales Growth) while achieving investment returns (Return on Invested Capital or ROIC) for the Company's shareholders. The compensation program is structured to significantly reward long-term performance while not encouraging excessive risk taking. *Please read the Compensation Discussion and Analysis/ page 39 for additional details about the compensation of the Named Executive Officers.*

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This Say on Pay vote is intended to address the compensation of the Named Executive Officers as disclosed in the "Compensation Discussion and Analysis" section of this proxy statement as a whole rather than any specific item or amount of executive compensation.

We are asking our shareholders to vote "FOR" the following advisory resolution at the Company's 2019 annual meeting:

"Resolved, that the compensation of the Company's Named Executive Officers, as disclosed in the "Compensation Discussion and Analysis" section of this proxy statement, including the related tables, notes and narrative is hereby approved by the Company's shareholders."

This advisory vote on the compensation of Grainger's Named Executive Officers is determined by the votes of a majority of the shares represented in person or by proxy at the meeting and entitled to vote. Abstentions will have the same effect as votes against the proposal. Broker non-votes will not affect the outcome of the vote.

This Say on Pay vote is advisory and non-binding on the Company, our Board of Directors and the Compensation Committee of the Board. However, the Board of Directors and the Compensation Committee of the Board, which is comprised of independent Directors, expect to take into account the outcome of this Say on Pay vote when making future compensation decisions regarding Grainger's Named Executive Officers.

Approval of the proposal requires the affirmative votes of a majority of the shares of Grainger common stock represented in person or by proxy at the meeting and entitled to vote.

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Compensation Discussion and Analysis

EQUITY COMPENSATION PLANS

This table contains information as of December 31, 2018 about Grainger's equity compensation plans, all of which have been approved by Grainger's shareholders.

Equity compensation plans approved by shareholders	1,755,520 (1)	\$229.42 (2)	2,476,129 (3)
Equity compensation plans not approved by shareholders	0	N/A	0
Total	1,755,520	\$229.42	2,476,129

(1) Includes an aggregate of 363,814 restricted stock units that are to be settled by the issuance of shares of common stock on a 1-for-1 basis. It also includes 131,231 Director's stock units to be settled upon each Director's retirement. Additionally, it includes 127,372 performance shares which will vest and settle between 2019 and 2023. The number of shares vested is dependent on the Company sales and/or the three-year average ROIC performance versus target.

(2) Weighted-average exercise price of outstanding stock options; excludes restricted stock units, performance shares, and Director's stock units.

(3) Represents shares of common stock authorized for issuance under the 2015 Incentive Plan in connection with awards of stock options, stock appreciation rights, stock units, shares of common stock, restricted shares of common stock and other stock-based awards. Under the 2015 Plan, all shares issued pursuant to "Full Value Awards" (awards other than stock options or stock appreciation rights which are settled by the issuance of shares, e.g., restricted stock, restricted stock units, Director's stock units, or other stock based awards) may be granted with the limit of no more than one million (1,000,000) shares of the Share Authorization.

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Compensation Discussion and Analysis

TRANSACTIONS WITH RELATED PERSONS

Grainger's Business Conduct Guidelines require that conflicts of interest in any form be avoided. The Board has adopted written policies and procedures, to be applied by the BANC, for the review, approval, or ratification of any transactions with related persons. Those policies and procedures apply to any proposed transaction in which Grainger is a participant, the amount involved exceeds \$120,000, and any Director, executive officer, or significant shareholder or any immediate family member of such a person has a direct or material indirect interest. The policy requires that any such proposed transaction be reviewed by the BANC to determine, among other things, the benefits of the transaction to Grainger, the availability of other sources of comparable products or services, and whether the terms of the proposed transaction are comparable to those provided to unrelated third parties. The BANC determined that the Company did not engage in any related person transactions in 2018.

In the ordinary course of its operations during 2018, Grainger engaged in various types of transactions with organizations with which Grainger Directors are associated in their principal business occupations or otherwise. Specifically, in the ordinary course of its business during 2018, Grainger bought products and/or services from, or sold products and/or services to, companies with which Ms. Perez, and Messrs. Santi, Slavik and Watson are or were associated as senior executives or otherwise as of December 31, 2018. In no instance did the total amount of the purchases from or sales to any such company during 2018 represent more than 0.176% of the consolidated gross revenues of that company for the year or more than 0.224% of the consolidated gross revenues of Grainger for the year.

In addition, as part of its overall 2018 charitable contributions program, Grainger made donations to tax-exempt organizations with which one or more Directors serve as officers, directors or trustees. In no instance did the total amount of the contributions to any charitable organization exceed \$7,500 during 2018.

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PROXY MATERIALS

What is the purpose of this proxy statement?

This proxy statement relates to the 2019 annual meeting of shareholders of Grainger, to be held on April 24, 2019, and any adjournment of that meeting to a later date. It contains information intended to help you make your voting decisions. We are sending this proxy statement to you because Grainger's Board of Directors is soliciting your proxy to vote your shares at the meeting. This proxy statement and other proxy-soliciting materials were first sent or made available to shareholders on or about March 14, 2019.

What does it mean if I receive more than one set of proxy materials?

Receiving multiple sets of proxy-soliciting materials generally means that your Grainger shares are held in different names or in different accounts. You must sign, date and return all proxy forms to ensure that all of your shares are voted.

May I revoke my proxy?

Yes. You may revoke your proxy at any time before the voting at the meeting. You can do so in one of the following ways:

Deliver to Grainger's Corporate Secretary timely written notice that you are revoking your proxy; or

Provide to Grainger another proxy with a later date (which can be done by telephone, by Internet, or by signing, dating, and returning a proxy form); or

Vote in person at the meeting.

VOTING INFORMATION

Who is entitled to vote?

Holders of shares of common stock outstanding on Grainger's books at the close of business on March 4, 2019, the record date for the meeting, may vote. There were 55,603,280 shares of common stock outstanding on that date.

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Questions and Answers

What is the difference between holding shares as "shareholder of record" and as "beneficial owner"?

If your shares are registered directly in your name with Grainger's transfer agent, Computershare Trust Company, N.A., you are the shareholder of record with respect to those shares and you have the right to instruct us directly how to vote your shares or to vote in person at the meeting.

If your shares are held in street name by a brokerage firm, bank, or other nominee, you are the beneficial owner of the shares. Your nominee is required to vote your shares according to your direction. **If you do not instruct your nominee how you want your shares voted, your shares cannot be voted for the election of Directors or on the advisory vote on the compensation of Grainger's Named Executive Officers.** Please contact your brokerage firm, bank, or other nominee with instructions to vote your shares for the election of Directors and on the advisory vote on the compensation of Grainger's Named Executive Officers, and on other matters to be considered at the meeting.

If my shares are held in "street name," can my broker vote for me?

Unless you have given specific voting instructions to your broker, your broker cannot vote your shares on the election of Directors, on the advisory vote related to executive compensation, or on any non-routine matters.

What is cumulative voting? How many votes do I have?

You have the right to cumulative voting in the election of Directors. This means that you have a number of votes in the election equal to the number of shares you own multiplied by the number of Directors being elected. You can cast those votes for the nominees as you choose. For example, you may cast all your votes for one nominee or you may apportion your votes among two or more nominees.

Cumulative voting is only available for Director elections. In any matter other than the election of Directors, each of your shares is entitled to one vote.

Does Grainger have majority voting for the election of Directors with a resignation policy for Directors failing to receive the required majority vote?

Yes. As required under Illinois law, Directors may only be elected by the votes of a majority of the shares represented in person or by proxy at the meeting and entitled to vote. Moreover, in accordance with the Company's Criteria for Membership on the Board of Directors, any Director standing for re-election (including the 11 nominees standing for election at the annual meeting) who fails to receive the required majority vote is expected to tender his or her resignation for consideration by the BANC. The BANC will consider the resignation and make a recommendation to the Board of Directors concerning the acceptance or rejection of the resignation. The Board will then take formal action on the BANC's recommendation within 90 days after the results of the Director election at the annual meeting are certified. Following the Board's decision on the BANC's recommendation, the Company will publicly disclose the Board's decision.

What voting standard applies to the ratification of the appointment of the independent auditor?

Ratification of the appointment of the independent auditor requires the affirmative votes of a majority of the shares represented in person or by proxy at the meeting and entitled to vote.

What voting standard applies to the advisory vote on the compensation of the Named Executive Officers?

Although the shareholders' vote is advisory and therefore non-binding, the vote on the compensation of the Named Executive Officers (Say on Pay) Grainger's seven highest paid officers whose compensation is discussed in the Compensation Discussion and Analysis section of this proxy statement is determined by the votes of a majority of the shares represented in person or by proxy at the meeting and entitled to vote.

How frequently does Grainger conduct an advisory vote on the compensation of its Named Executive Officers?

The Board of Directors has determined to hold an advisory vote on the compensation of the Named Executive Officers (Say on Pay) at every annual meeting of shareholders. Shareholders have the opportunity to cast an advisory vote on the frequency of Say on Pay votes at least every six years. At the 2017 annual meeting, the shareholders voted for one year as the frequency of the Say on Pay vote. The next advisory vote on the frequency of the Say on Pay vote will occur at Grainger's 2023 annual meeting.

What if I don't indicate my voting choices?

If Grainger receives your proxy in time to permit its use at the meeting, your shares will be voted in accordance with the instructions you indicate. If we have received your proxy and you have not indicated otherwise, your shares will be voted as recommended by Grainger's Board. Specifically, your shares will be voted, either individually or cumulatively:

FOR the election of the Director nominees;

FOR the proposal to ratify the appointment of the independent auditor; and

FOR the approval of the advisory vote on the compensation of Grainger's Named Executive Officers.

If you are a beneficial owner and the shares you own are held in street name by a brokerage firm, bank, or other nominee **you must specifically instruct your nominee how you want your shares voted for the election of Directors, on the advisory resolution on the compensation of Grainger's Named Executive Officers, and on the frequency of the shareholder advisory votes on the compensation of Grainger's Named Executive Officers; otherwise your nominee is not allowed to vote your shares.** Please contact your brokerage firm, bank, or other nominee with instructions to vote your shares for the election of Directors and on other matters to be considered at the meeting.

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Questions and Answers

How does discretionary voting apply?

Grainger is not aware of any matter not described in this proxy statement that will be presented for consideration at the meeting. If another matter is properly presented, your shares will be voted on the matter in accordance with the judgment of the person or persons voting the proxy unless your proxy withholds discretionary authority.

What constitutes a quorum at the meeting?

A majority of the outstanding shares entitled to vote on a matter, whether present in person or by proxy, constitutes a quorum for consideration of that matter at the meeting. A quorum is necessary for valid action to be taken on the matter. Your shares will be present by proxy and count toward the quorum if you give us your proxy by telephone, by Internet, or by signing, dating, and returning a proxy form.

Where can I find the voting results?

We will report the voting results on a Form 8-K within four business days after the end of our annual meeting.

What is the deadline for receipt of shareholder proposals for inclusion in the 2020 annual meeting proxy statement?

A shareholder who intends to present a proposal at the next annual meeting of shareholders and who wishes the proposal to be included in our proxy materials for that meeting pursuant to Rule 14a-8 under the Securities Exchange Act of 1934, as amended (Exchange Act), must submit the proposal in writing to the Corporate Secretary at the address on the notice of annual meeting accompanying this proxy statement. The proposal must be received by Grainger no later than November 15, 2019, and must comply with the applicable SEC rules and other requirements prescribed in our By-laws.

What is the procedure for nomination of Directors at the 2020 annual meeting of shareholders using Grainger's proxy access By-laws?

A qualifying shareholder, or a group of up to 20 qualifying shareholders, owning 3% or more of the Company's outstanding shares of common stock continuously for at least the previous three years may nominate and include in Grainger's proxy statement and proxy card qualifying Director nominees constituting up to the greater of two Directors or 20% of the Directors then serving on the Board, provided that the shareholder(s) and nominee(s) satisfy the requirements specified in our By-laws.

What is the procedure for other nominations of Directors or proposals to transact business at the 2020 annual meeting of shareholders?

A shareholder entitled to vote for the election of Directors at an annual meeting and who is a shareholder of record on:

the record date for that annual meeting,

the date the shareholder provides timely notice to Grainger, and

the date of the annual meeting

may directly nominate persons for Director, or make proposals of other business to be brought before the annual meeting, by providing proper timely written notice to the Corporate Secretary at the address on the notice of annual meeting accompanying this proxy statement.

Our By-laws require that written notice of proposals intended to be presented by a shareholder at the next annual meeting, but that are not intended for inclusion in our proxy statement for that meeting pursuant to Rule 14a-8 of the Exchange Act, be delivered no earlier than December 26, 2019, and no later than January 27, 2020.

Our By-laws also require that written notice of nominees for the election of Directors intended to be made by a shareholder at the next annual meeting be delivered by no later than the date with respect to submission of shareholder proposals under Rule 14a-8 of the Exchange Act as set forth in the proxy statement for the preceding annual meeting of shareholders, which in this case is November 15, 2019.

To be in proper written form, these notices must include certain information required by our By-laws, including information about the shareholder, any beneficial owner on whose behalf the nomination or proposal is being made, their respective affiliates or associates or others acting in concert with them, and any proposed Director nominee.

A copy of our By-laws is available in the Governance section of Grainger's website at <http://www.grainger.com/investor> or may be obtained free of charge on written request to the Corporate Secretary at the address on the notice of annual meeting accompanying this proxy statement.

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Appendix A Categorical Standards for Director Independence

APPENDIX A

W.W. GRAINGER, INC.

CATEGORICAL STANDARDS FOR DIRECTOR INDEPENDENCE

Business Transactions. A Director's independence will not be deemed to be impaired by reason of his or her service as an executive officer of another company that does business with Grainger if in each of the three most recent fiscal years the other company's annual sales to Grainger are less than one percent (1%) of that company's consolidated gross revenues and if in each of the three most recent fiscal years Grainger's sales to the other company are less than one percent (1%) of that company's consolidated gross revenues.

Tax-Exempt Contributions. A Director's independence will not be deemed to be impaired by reason of his or her service as an officer, Director or trustee of a tax-exempt organization that receives contributions from Grainger if Grainger's contributions to the organization are less than one percent (1%) of the organization's total annual contributions.

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