

Article

Consolidation and Reform of Financial Market Regulation in Korea: Financial Investment Services and Capital Markets Act

Joon Park*

ABSTRACT

Korea undertook a reform of its financial regulations through the enactment of new legislation – the Financial Investment Services and Capital Markets Act, which became effective on February 4, 2009. The new legislation is intended to improve the regulation of Korean capital markets by consolidating various statutes which used to govern the financial industry by type and improving their regulation. It established a system which can regulate all financial investment products traded in the capital markets and introduced regulations classifying financial investment services, financial investment products and investors based on functions. The new legislation expanded the business scope of financial investment service companies and at the same time reinforced investor protection mechanisms. It improved the structures for maintaining the market's integrity by reinforcing regulations against unlawful transactions. It also introduced new regulations on cross-border capital market transactions and business activities. Although some controversial issues remain in connection with the new concepts introduced in the legislation, it is expected to be a foundation for the development of the Korean capital markets.

Keywords: *Korean Financial Regulation, Capital Markets Regulation, Consolidation of Financial Regulation, Capital Markets Act, Financial Investment Products, Function Based Regulation*

* Professor, School of Law, Seoul National University. E-mail: joonpark@snu.ac.kr. I want to thank to the participants in the International Conference on Financial Law Reform held in June 2010 at Taiwan National University to which a preliminary version of this paper was submitted.

CONTENTS

I. INTRODUCTION	94
II. LEGISLATIVE BACKGROUND AND PURPOSE OF THE ENACTMENT OF CAPITAL MARKETS ACT	94
A. <i>Legislative Background of Capital Markets Act</i>	94
1. <i>Consolidation of Financial Regulators</i>	94
2. <i>Plan for Consolidating Financial Laws</i>	95
3. <i>Amendments to Capital Markets Act</i>	96
B. <i>Purpose and Basic Principles of Enacting Capital Markets Act</i>	96
1. <i>Legislative Purpose of the Capital Markets Act</i>	96
2. <i>Basic Principles of Enacting Capital Markets Act</i>	97
III. KEY CONTENTS OF THE CAPITAL MARKETS ACT	98
A. <i>Overview</i>	98
B. <i>Introduction of the New Definition of Financial Investment Products</i>	99
1. <i>New Definition of Financial Investment Products</i>	100
2. <i>Classification of Financial Investment Products</i>	104
C. <i>Expansion of Business Scope Available to Financial Investment Service Companies</i>	110
1. <i>Scope of Business for a Financial Investment Service Company</i>	110
2. <i>Licensing Practice under the Capital Markets Act</i>	112
3. <i>Control of Conflicts of Interest</i>	114
D. <i>Reinforcing Investor Protection</i>	117
1. <i>Overview</i>	117
2. <i>Regulations on Investment Recommendations</i>	117
3. <i>Introduction of Cooling-off</i>	122
E. <i>Reinforcing Regulation of Insider Trading and Other Fraudulent Transactions</i>	122
1. <i>Overview</i>	122
2. <i>Introduction of General Anti-fraud Provisions</i>	123
3. <i>Prohibition of Cross-Market Manipulation</i>	125
4. <i>Prohibition of Insider Trading</i>	126
F. <i>Regulation of OTC Derivatives</i>	127
1. <i>Background</i>	127
2. <i>Reinforcement of Investor Protection in OTC Derivatives Transactions</i>	127
3. <i>Reinforcement of Internal Control on OTC Derivatives Business</i>	128
4. <i>Advance Review of OTC Derivatives Products</i>	128

2011]	Consolidation and Reform of Financial Market Regulation in Korea	93
	G. <i>Regulations of Cross-border Financial Investment Services</i>	130
	1. <i>Declaration of Effects Test</i>	130
	2. <i>Regulation on Cross-border Dealing/Brokerage</i>	130
	3. <i>Regulations on Cross-border Investment Advisory Business and Discretionary Investment Management Business</i>	131
	IV. CONCLUDING REMARKS	133
	REFERENCES	135

I. INTRODUCTION

This article is to examine the legislative background and key substance of the JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul [Financial Investment Services and Capital Markets Act] (“Capital Markets Act”),¹ and the issues raised in the 16 months since it became effective on February 4, 2009. Chapter 2 of this article sets forth the background and purpose of the legislation. Chapter 3 examines the essence of the legislation and the issues raised during the last year and four months in six subtopics: definition of financial investment products, expansion of the permitted business scope of financial investment companies, enhancement of investor protection, reinforcement of regulations on insider trading and other fraudulent transactions, regulation of OTC derivatives, and the provisions on international transactions.

II. LEGISLATIVE BACKGROUND AND PURPOSE OF THE ENACTMENT OF CAPITAL MARKETS ACT

A. *Legislative Background of Capital Markets Act*

1. *Consolidation of Financial Regulators*

Korean financial regulators used to consist of the Ministry of Finance and Economy, which had the authority to determine basic policy issues and several supervisors such as the Office of Bank Supervision, the Securities Supervisory Board, the Insurance Supervisory Board. There had been discussions in past on consolidating the regulators. In the wake of the Asian financial crisis in 1997, the Act on Establishment of Financial Supervisory Organizations (Law no. 5490 of December 31, 1997) was enacted to consolidate the financial regulators. Under this Act, the Financial Services Commission was established in 1998, and the Ministry of Finance and Economy transferred control of its financial supervisory authority to the Commission. Also, the Financial Supervisory Service was established in 1999 and consolidated the four former supervisory institutions, i.e., the Office of Bank Supervision, the Securities Supervisory Board, the Insurance Supervisory Board, and the Non-Bank Supervisory Authority.

1. JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul [Financial Investment Services and Capital Markets Act], Act No. 8635, Aug. 3, 2007, last amended by Act No. 10361, June 8, 2010 [hereinafter Capital Markets Act].

2. *Plan for Consolidating Financial Laws*

Although the financial regulators were unified, the laws governing the financial industry and markets were still fragmented for each financial sector. The Korean Ministry of Finance and Economy began reviewing a plan for consolidating financial laws from 2002.² The review contemplated the consolidation of approximately forty different financial laws, and upon its request, Seoul National University Financial Law Center submitted a report on restructuring the financial laws in its entirety.³ In April 2005, the Ministry of Finance and Economy determined that consolidating laws related to capital markets first was more practicable than consolidating the entire body of financial laws into one statute. Accordingly, a task force was organized to study legislation of other countries such as the United Kingdom, Australia, the United States, Germany, France, Japan, Singapore and Hong Kong. The first draft of the new legislation was made public on February 17, 2006.⁴ After four public hearings and reviews of the draft within the government, the government's bill passed the Cabinet meeting and was submitted to the National Assembly. The bill passed through the National Assembly on July 3, 2007, was promulgated on August 3, 2007, and became effective on February 4, 2009.

6 major laws, including JeungGwonKeoRaeBeob [Securities and Exchange Act] and GanJeobTuJaJaSanUnYongEobBeob [Indirect

2. Ministry of Fin. and Econ. et al., 2003 Nyeon GyeongJeUnYongBangHyang [Economy Management Direction in 2003] 32 (2003) http://www.mosf.go.kr/_policy/policy01/policy_search_new.jsp?boardType=general&hdnBulletRunno=&cvbnPath=&sub_category=&hdnFlag=&cat=&hdnDiv=&hdnSubject=2003%EB%85%84+%EA%B2%BD%EC%A0%9C%EC%9A%B4%EC%9A%A9%EB%B0%A9%ED%96%A5&&actionType=view&runno=38800&hdnTopicDate=2003-01-08&hdnPage=1 (last visited Jan. 28, 2011). There was a split of views among scholars on this issue. Kon Sik Kim, *GeumYungSiJangUi HwanGyeongByeonHwaWa GeumYungGyuJeUi TongHap* [Changes in Financial Market Environment and Consolidation of Financial Regulation], 117 JEUNGWON [SEC.] 7-13 (2003); Kon Sik Kim & Sunseop Jung, *GeumYungBeobTongHapJagEobUi ChuJinHyeonHwang* [Current Status of the Financial Law Consolidation Project], 18 GEUMYUNGYEONGU [J. MONEY & FIN.] 103-21 (Supp. 2004) (asserting the enactment of a law consolidating the regulation of banking, securities and insurance); Yongjae Kim, *GaChing "TongHapGeumYungBeob" ChuJinE DaeHan BiPan - EunHaengUi TeukSuSeongGwa SiSeuTemGyuJeUi BunRi PilYoSeong* [Some Criticisms to the Consolidation Movement of Financial Laws in Korea — The Special Features of Banks and Systemic Regulations], 1(1) GEUMYUNGBEOBYEONGU [KOREAN J. FIN. L.] 134-71 (2004) (asserting the separate regulation of banking).

3. CTR. FIN. LAW, SEOUL NATIONAL UNIVERSITY, GEUMYUNGSIJANGHWANGYEONGUI BYEONHWAE TTAREUN GEUMYUNGGWANGYEBEOBYULUI CHEGEJEONGBIE GWANHANYEONGU [RESEARCH ON FINANCIAL LAW SYSTEM IMPROVEMENT DUE TO CHANGES IN FINANCIAL MARKET ENVIRONMENT] 55, 136-39 (2002).

4. Ministry Fin. & Econ., "GeumYungTuJaEobGwa JaBonSiJangE GwanHan BeobRyul (GaChing)" jejeong bangan ["Financial Investment Services and Capital Markets Act (tentative)" Legislative Plan] (Feb. 17, 2006) available at http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2006-02-20&sch3=2006-02-20&sword=&r_url=&menu=7210100&no=26129.

Investment Asset Management Business Act], that used to govern capital market activities were repealed by the legislation of the Capital Markets Act.⁵ As a result, Korean financial markets are now regulated by basically three laws: the Capital Markets Act, the Banking Act, and the Insurance Business Act.

3. *Amendments to Capital Markets Act*

The Capital Markets Act partially reflected some special provisions regarding corporate governance and financial management of listed corporations that were included in the Securities and Exchange Act but were scheduled to be repealed with the enactment of the Capital Markets Act. On February 3, 2009, immediately before the Act became effective, a few provisions were amended for supplementary reasons and on March 12, 2010, approximately one year after its enactment, parts were amended once again. It is noteworthy that the amendments provided for enhanced protection of non-professional investors and strengthened the regulation of OTC derivatives because of the global financial crisis.⁶

B. *Purpose and Basic Principles of Enacting Capital Markets Act*

1. *Legislative Purpose of the Capital Markets Act*

The Ministry of Finance and Economy concluded that the capital markets and the financial industry related to the capital markets were not well developed in Korea and that a financial “big bang” was necessary. It emphasized the following three aspects.⁷

(a) The capital markets were not fully performing its capital intermediation function as indicated by the lack of corporations raising funds through the capital markets.

(b) Because the financial industry related to securities, futures, asset management was not well developed, the imbalance with the indirect financing industry (i.e., commercial banks) was intensifying.

5. The following laws were repealed by the enactment of the Capital Markets Act: JeungGwonKeoRaeBeob [Securities and Exchange Act], SeonMulGeoRaeBeob [Futures Trading Act], GanJeobTuJaJaSanUnYongEobBeob [Indirect Investment Asset Management Business Act], SinTagEobBeob [Trust Business Act], JongHabGeumYungHoeSaE GwanHanBeobRyul [Merchant Banks Act], and HanGukJeungGwonSeonMulGeoRaeSoBeob [Securities and Futures Exchange Act] (the Capital Markets Act Addendum art. 2).

6. See *infra* part 3.6.

7. Fin. & Econ., *supra* note 4; MINISTRY FIN. & ECON., “JABONSIJANGGWA GEUMYUNG TUJAE OBE GWANHAN BEOBRYUL” SEOLMYEONGJARYO [“THE PROPOSED BILL ON FINANCIAL INVESTMENT SERVICES AND CAPITAL MARKETS ACT” EXPLANATORY MATERIAL] 1-3 (2006).

(c) The laws governing at that time were not able to support innovative developments of the capital markets and related financial industry.

Especially regarding the third aspect, the Ministry of Finance and Economy pointed out:

- (i) Separate law applied to each different financial industry within the capital market. Securities firms, futures trading companies, asset management companies, and trust companies were regulated by different laws. As the regulations applying to each sector were different, there were opportunities for regulatory arbitrage and loopholes in investor protection.
- (ii) The limited enumeration of the types of securities and derivatives that financial companies can handle operated as a restriction on designing, selling or brokering diverse and creative financial investment products.
- (iii) Because operating concurrent engagement in various financial services (securities business, asset management business, futures trading, and trust business) was strictly restricted, there were barriers to improving competitiveness through integration, as compared to investment banks in an advanced economy that provide various financial investment services and activities (investment banking, wealth management, securities brokerage and dealing, proprietary trading, etc.).
- (iv) Because an advanced and systematic investor protection system was not well established, it was difficult to properly cope with misselling and unfair transactions, which undermined investor confidence in the capital market.⁸

2. *Basic Principles of Enacting Capital Markets Act*

In order to resolve these problems through reforming the regulation of capital market and enhancing investor protection, the Capital Markets Act pursues four basic directions as follows.⁹

The first direction is the adopting of a “comprehensive policy” with regard to the definition of financial products regulated by the Capital Markets Act. That is, by defining financial investment products broadly and abstractly and embracing all financial investment products that may appear in the future as being subject to regulation, the scope of financial products that are available to financial investment services companies and,

8. Fin. & Econ., *supra* note 4; FIN. & ECON., *supra* note 7.

9. FIN. & ECON., *supra* note 7, at 4.

correspondingly, which are subject to investor protection regulations can be expanded.

The second direction is to adopt a functional regulation system. That is, each activity that has the same economic substance should, in principle, be regulated equally, no matter which financial institution is handling the matter, by re-classifying financial investment services, financial investment products and categories of investors based on economic substances.

The third direction is expanding the scope of businesses that financial investment service business companies could engaged in. All financial investment service business companies are able to engage in all or some of financial investment services as well as all incidental businesses.

The fourth direction is to upgrade investor protection system. This is to expressly provide the suitability principle and the duty of risk disclosure and explanation into the statute, to set up a system to prevent the conflicts of interest which may arise from expanding the business scope of financial investment service companies, and to reinforce public disclosure in the primary market.

III. KEY CONTENTS OF THE CAPITAL MARKETS ACT

A. *Overview*

The Capital Markets Act consolidated the contents of the Securities and Exchange Act, the Futures Trading Act, the Asset Management Business Act, the Trust Business Act, the Act on Merchant Banks, and the Securities and Futures Exchange Act into one law and thus a number of provisions of the Capital Markets Act are identical to those in the statutes it replaced. However, the Capital Markets Act did not simply combine old laws, but established a new regulatory framework by introducing new concepts and principles.

The most representative aspects are the introduction of new concept of financial investment products discussed in 3.2 and the expansion of business scope in which financial investment service companies could engage discussed in 3.3. These two aspects broadened the scope of products available in the capital markets and expanded the scope of business activities that financial investment service companies can perform. If more diversified financial investment products are sold to investors and traded in the market without establishing necessary devices for investor protection, investors are more likely to be exposed to risks hidden in new, innovative or complicated financial products. If investors suffer from unexpected losses, there will be negative effects on investor confidence in the market. As discussed in 3.4 below, the Capital Markets Act substantially improved protection

mechanisms for investors.

In addition, public disclosure systems of the primary market and regulations on insider trading and other fraudulent transactions were strengthened under the Capital Markets Act. And as mentioned above,¹⁰ because of the 2008 global financial crisis, Korean regulators proposed and legislators enacted amendments to the act that substantially strengthened the regulation of OTC derivatives. In addition, the Capital Markets Act provided in more detail, the regulation of cross-border transactions.¹¹

Personal information protection and privacy issues are dealt with by separate laws such as the Law concerning Real Name Financial Transaction Law¹² and the Law Concerning the Use and Protection of Credit Information¹³. The former deals with the protection of customer information with respect to financial assets (such as deposits, investment and insurance) and the latter deals with the protection of customer information in connection with the provision of credit (such as loans). Thus, the Capital Markets Act did not need general provisions addressing the protection of customer information. The Capital Markets Act does have some provisions addressing certain special circumstances such as the information provision in a business delegation situation,¹⁴ the regulation of conflicts of interest situations, the exchange of internal information among business divisions within the same entity,¹⁵ and prohibiting financial investment service companies' use of information acquired in the course of their business.¹⁶

B. *Introduction of the New Definition of Financial Investment Products*

The Capital Markets Act introduced a new concept of “financial investment products”. If a particular product falls under the category of “financial investment product”, it becomes subject to regulation under the Capital Markets Act, and determines the business scope of financial investment service companies.

10. See *supra* part II. A.3.

11. In addition to those mentioned in this article, the Capital Markets Act also changed some aspect of the regulation of collective investment schemes. The Act introduced new types of funds such as funds which may be leveraged and special purpose acquisition companies.

12. GeumYungSilMyeongGeoRae Mit BiMilBoJangE GwanHan BeobRyul [Law Concerning Real Name Financial Transaction Law], Act No. 5493, Dec. 31, 1997, last amended by Act No. 10303, May 17, 2010.

13. SinYongJeongBoUi IYong Mit BoHOE GwanHan BeobRyul [Law Concerning the Use and Protection of Credit Information], Act No. 4866, Jan. 5, 1995, last amended by Act No. 10228, Apr. 5, 2010.

14. Capital Markets Act, *supra* note 1, art. 42(6).

15. See *infra* part 3.3.3.(2).

16. Capital Markets Act, *supra* note 1, art. 54.

1. *New Definition of Financial Investment Products*

(a) Definition of Securities in Previous Securities and Exchange Act and its Problems

The previous Securities and Exchange Act enumerated the kinds of securities subject to the Act.¹⁷ If a certain financial product did not fall under any of those lists, then securities companies could not deal in it and the product was not subject to the Act. This limited enumeration system of the previous Securities and Exchange Act enhanced legal stability and foreseeability. However, a securities company was not able to deal with new financial products without amending the Act whenever a new product is developed. On the other hand, even though a person other than licensed securities companies sells such financial products, it was impossible to regulate him/her through the Securities and Exchange Act.¹⁸

(b) Definition of Financial Investment Products under Capital Markets Act

The Capital Markets Act introduced the concept of financial investment products that become a subject of the Act's regulation, which determines the scope of business that financial investment services companies can engage and the scope of application of investor protection provisions. The new definition of financial investment products would (i) serve investors' demand for new financial products, (ii) eliminate the loophole in financial regulation

17. JeungGwonKeoRaeBeob [Securities and Exchange Act], Act No. 972, Apr. 1, 1962, last amended by Act No. 8985, Mar. 21, 2008, art. 2(1): under this provision, the term "securities" in this Act means any of the following subparagraphs:

1. Government bonds;
2. Local government bonds;
3. Bonds issued by a juridical entity which is established under a special Act;
4. Corporate bonds;
5. Certificates of capital contribution issued by a juridical entity which is established under a special Act;
6. Share certificates, or instruments which represent right to subscribe shares;
7. Certificates or instruments issued by a foreign juridical entity, etc., which have the same nature as those referred to in subparagraphs 1 through 6 of this paragraph;
8. Securities depository receipts issued by a person designated by the Presidential Decree based on underlying certificates or instruments issued by a foreign juridical entity, etc.; and
9. Other certificates or instruments designated by the Presidential Decree, which are similar or related to those referred to in subparagraphs 1 through 8 of this paragraph.

Although Subparagraph 9 of the above Article refers to "other certificates and instruments", in order to fall under the definition of securities under the Securities and Exchange Act, the Presidential Decree must be amended. An amendment to the Presidential Decree of a statute is regarded as a part of the legislation and thus takes time and is, in practice, cumbersome even if it does not require the approval of the National Assembly.

(all the acts, decrees and regulations cited in this article are translated by the author.)

18. For instance, by the amendments to art. 2-3(1) of JeungGwonKeoRaeBeobSiHaengRyeong [Securities and Exchange Act Enforcement Decree], equity linked warrants, equity linked securities, beneficial certificates issued on trust type asset-backed securities, and credit linked securities were added to the list of "securities". JeungGwonKeoRaeBeobSiHaengRyeong [Securities and Exchange Act Enforcement Decree], Presidential Decree No. 618, Apr. 1, 1962, last amended by Presidential Decree No. 20653, Feb. 29, 2008.

by expanding the scope of the regulated financial investment services and (iii) serve as a criterion to distinguish deposits and insurance products from financial investment service products.^{19 20} Under Article 3(1) of the Capital Markets Act, “financial investment product” is defined as a right acquired by an agreement to pay, at the present time or a specific time in the future, money or any other valuable thing (hereinafter referred to as “money or similar”), for the purpose of earning a profit or avoiding a loss, where there is a risk that the total amount of such money or similar, paid or payable, to acquire such right (excluding any sums specified in the Presidential Decree, such as sales commissions²¹) may exceed the total amount of money or similar recovered or recoverable from the right (including any sums specified in Presidential Decree, such as termination fees²²).” Negotiability is not a criterion in determining whether a financial product falls within the category of a financial investment product.²³

19. Sunseop Jung, *GeumYungGyuJeBeobSang PoGwalGaeNyeom DoipUi GaneungSeongGwa TadangSeong JaBonSiJangTongHapBeobSang GeumYungTuJaSangPumUi GaeNeomEul JungSimEuRo* [Definition of Financial Investment Products from a Legal Perspective], 49(1) *BEOBHAK* [SEOUL L.J.] 281, 284 (2008).

20. Some commentators asserted that to keep balance with the definition of financial investment products using the concept of “investment risk” under the Capital Markets Act and to make financial industries to develop on a balanced way, similar general definitions of deposit products and insurance products are necessary. JIEUN LEE & BON-SUNG GU, *JABONSIJANG GWANRYEONBEOB TONGHAPETAREUN GEUMYUNGBEOB TONGHAPUI GIBONBANGHYANGGWA JUYOGWAJE* [THE NEW LEGISLATION ON INVESTMENT AND ITS IMPLICATIONS FOR THE INTEGRATION OF FINANCIAL SERVICES LAW] 11 (2006).

21. The term “sums specified in the Presidential Decree, such as sales commissions” in the main body of art. 3 (1) of the Capital Markets Act means the following:

- (1) The fees payable by customers, the standards of which are publicly disclosed by the financial investment services company, the sales commission for the sale of collective investment products, and other fee or commission paid by investors and customers in consideration of any services provided;
 - (2) The operating expenses and risk insurance premium under an insurance contracts; and
 - (3) Other sums specified and publicly notified by the Financial Services Commission.
- (*JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul SiHaengRyeong* [Capital Markets Act Enforcement Decree], art. 3(1), Presidential Decree No. 20947, Jul. 29, 2008, last amended by Presidential Decree No. 22637, Jan. 24, 2011 [hereinafter Capital Markets Act Enforcement Decree].)

22. The term “sums specified in the Presidential Decree, such as termination fees” means the following:

- (1) The redemption fee under collective investment products and other termination fees paid by investors and other customers for earlier termination (including fees similar thereto);
 - (2) Taxes;
 - (3) Sums that investors and other customers are unable to recover because the issuer or the counterparty to the transaction becomes unable to make the payment as originally agreed due to the bankruptcy, debt restructuring or any other similar event; and
 - (4) Other sums specified and publicly notified by the Financial Services Commission.
- (*Id.*, art. 3(2).)

23. Wonjin Choi, *JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul JejeongAnUi JuYoNaeYong Mit UiGyeonSuRyeong KeongGwa* [Main Contents and Progress of the Financial Investment Services and Capital Markets Act], 3(1) *GEUMYUNGBEOBYEONGU* [KOREAN J. FIN. L.] 127, 134 (2006).

(i) Investment Risk Requirement

The most important characteristic is the investment risk, which is the risk that the total amount recovered or recoverable under the financial investment product is less than the total amount paid or payable to acquire it. In other words, investment risk means the risk of loss on the principal of the investment. The amount that are not recovered by the investors due to a bankruptcy or debt restructuring of the issuer or the counterparty is not considered an unrecovered amount in calculating amounts recovered or recoverable.²⁴ Credit risk is not considered as an investment risk under the definition of the financial investment products. For example, even in case of deposits with a bank or insurance contracts with insurance companies, there can be a possibility of failure in collecting the deposits or insurance proceeds due to their bankruptcy. However, traditional deposits or insurance contracts do not fall within the concept of financial investment products. This definition reflects the belief that it is not reasonable to regulate financial investment products based on credit risk, because the credit risk exists in every transaction that has a counterparty. The traditional deposits and insurance products sold by banks or insurance companies are regulated by Banking Act and Insurance Business Act.²⁵ Also, when an insurance policy is terminated early, the amount that the insured can receive is often less than the insurance premiums paid, even if the insurance is a savings type insurance policy. However, the Capital Markets Act clearly provides that this type early termination does not turn an insurance contract to a financial investment product.²⁶

The investment risk in the context of the definition of financial investment products means market risk.²⁷ Government bonds are issued by the government and therefore it is hard to predict the default or the risk of loss on investment principal from the perspective of credit risk. An investor

24. Capital Markets Act Enforcement Decree, *supra* note 21, art. 3(2)(iii).

25. In case of foreign currency deposits, a question could arise as to whether it has potential profit or loss of investment because exchange risk is implied if the amount paid and the amount recovered are calculated by reference to Korean won, not the deposit currency. It cannot be considered a financial investment product when (i) a depositor makes a deposit in currency A and get paid in the same currency A, or (ii) a depositor makes a deposit and withdrawal in currency A, and, after withdrawal of the deposit, changes the withdrawn money into another currency through a spot trade. However, it is reasonable to view it as a combined transaction of deposit and currency forward transaction in cases where a depositor and a bank agree to make a deposit in currency A and also agree, either at the time of deposit or prior to maturity, to return the deposit in an amount in currency B at maturity. That is, if it is predetermined before maturity to return the deposit in a currency other than the deposit currency, it is reasonable to view it as a financial investment product due to the existence of the currency forward transaction. It is appropriate to define the characteristics of the transaction by reference to the question as to whether there was an agreement in advance between parties. Even though it may not be easy to prove the existence of such agreement, such difficulties should not justify the treatment of all the transactions such as (ii) as financial investment products.

26. Capital Markets Act Enforcement Decree, *supra* note 21, art. 3(1)(ii).

27. Jung, *supra* note 19, at 289.

in government bonds is, however, exposed to the risk of loss on his/her investment amount depending on the market interest rate, particularly when they are traded in the secondary market.²⁸

(ii) Profit Purpose Requirement

In order to qualify as a financial investment product, the product must have “the purpose of gaining profits or avoiding losses.” A product which is acquired for the purpose of consumption or use is not a financial investment product.²⁹ Would real estate or commodity purchased for the purpose of investment and not for consumption would it be regarded as a financial investment product? Some might argue that this should be the case because both tests (i.e., the risk of loss on investment and the purpose of profit) are satisfied. However, there is no necessity to regulate real estate or commodities as financial investment products on the ground that there is a purpose for profit. It must be determined whether it qualifies as one of the two subcategories of financial investment products, securities or derivatives, as discussed in 3.2.2. below. In determining the scope of financial investment products, the legislative purpose of “contributing to the development of the national economy by increasing the capital market’s fairness, reliability and efficiency by promoting financial innovations and fair competition in the capital market, protecting investors and cultivating sound finance investment businesses” should also be taken into consideration.³⁰ This issue is not free of doubt and thus may invite further controversy. Some commentators also indicated their concern over potential problems such as legal uncertainty and lower levels of predictability which may arise from the broad definition of financial investment contracts.³¹ The broad definition of financial investment products and the definition of securities (including investment contracts) implies that it would be difficult to regulate the issue of whether a particular product constitute a financial investment product or a security in advance, but that the court and *ex post* measures will play a more important role in connection with this issue.³² Thus, the potential problem on the legal uncertainty will be resolved by

28. *Id.*

29. In *United Hous. Found. Inc. v. Forman*, 421 U.S. 837 (1975), the instruments involved were not shares of stock in the ordinary sense because the instruments were not purchased to make a profit, but to acquire subsidized low-cost housing and the instruments did not constitute an investment contract because the focus was on the acquisition of a place to live.

30. Jung, *supra* note 19, at 292.

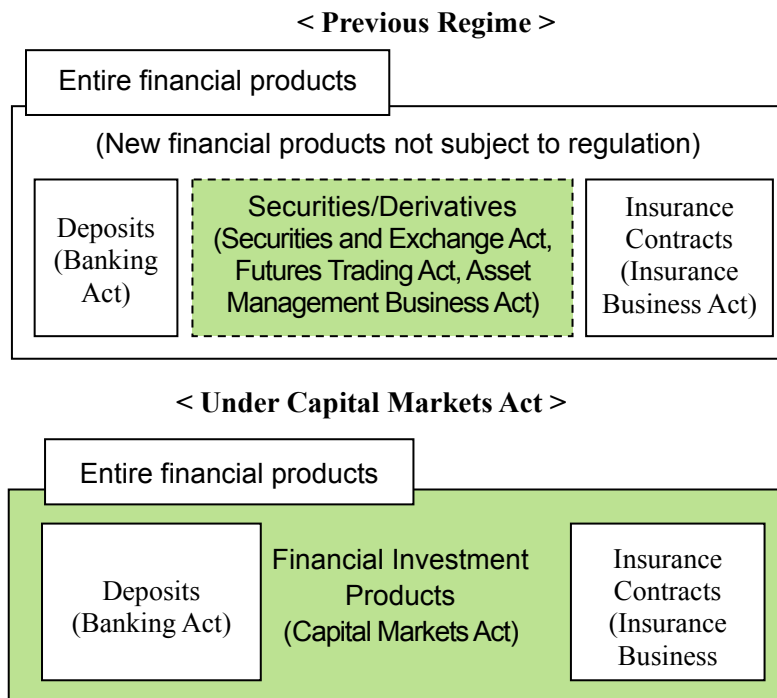
31. Sam Joo Ha, “*JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyu*” *Sang GeumYungTuJaSangPumUi GaeNyeom [The Definition of the Financial Investment Instrument under the Capital Market and Financial Investment Services Act]*, 26(2) SANGSABEOBYEONGU [COM. L. REV.] 365, 385-86 (2007) (indicating the concern and suggesting use of self control mechanism of an financial investment service company or an association of such companies and the more active use of no-action letters of Financial Supervisory Service).

32. Jung, *supra* note 19, at 308.

developing practice and accumulating court precedents.³³

(c) Structure of Financial Products Regulation in Korea's Financial Market

The enactment of the Capital Markets Act caused the financial products traded in Korea's financial market to be divided into three categories: deposit products subject to the Banking Act, insurance products subject to the Insurance Business Act, and financial investment products subject to the Capital Markets Act. That is, the vacuum of regulation under the old regime has disappeared.³⁴



2. *Classification of Financial Investment Products*

(a) Role of Subcategories of Financial Investment Products

The definition of financial investment product is intended to determine, using a functional approach, the basic characteristics of the instruments which need to be governed by the Capital Markets Act. However, there is a concern for the legal uncertainty if the concept of financial investment product is prescribed only by an abstract definition.³⁵ Therefore, the definitions of two subcategories of financial investment products, i.e.,

33. *Id.*

34. Source of diagram: MINISTRY FIN. & ECON., *supra* note 7, at 7.

35. Ha, *supra* note 31, at 385.

“securities” and “derivatives” and the types of securities and derivatives are provided in the Act to minimize uncertainty on whether a particular product is a financial investment product. That is, it is clearly indicated that a product, once qualified as a security or a derivative, would be a financial investment product and that a product, which is not a security or derivative, is not a financial product governed by the Act.³⁶ On the other hand, among products that may seem to be included in financial investment products, a product that does not need to be regulated by the Capital Markets Act is clearly excluded from the definition of financial investment products. A typical example of such exclusion is negotiable certificates of deposits.³⁷ If whether a product is a Financial Investment Products is determined solely by the tests (i.e., investment risk test and profit purpose test) under Article 3(1) of the Capital Markets Act, some products which the Capital Markets Act does not need to regulate could be included in financial investment products (for example, investment in real estate as discussed above). This issue can be solved by reviewing whether a product falls under the category of securities or derivatives, the two subcategories of financial investment products. Applying this method, greenhouse gas emission allowances or loan receivables are not considered financial investment products. Of course, derivatives based on emission allowances or loan receivables fall under the derivatives sub-category and would be financial investment products.

(b) Distinction between Securities and Derivatives

The criterion distinguishing securities from derivatives is whether there is a possibility of suffering losses exceeding the investment principal, that is, whether an investor of a financial investment product can be obligated to make additional payment after his/her investment in the product. “Securities” means “those financial investment products that are issued by a Korean national or a foreigner and that do not have the obligation of making payment, for any reasons, in addition to the money paid by the investors upon acquisition of the product (except for the payment obligation owed by the investor upon exercising his/her right to enter into a sale and purchase of underlying assets)”.^{38 39} Investors who purchased typical shares or bonds

36. KON SIK KIM & SUNSEOP JUNG, JABONSIJANGBEOB [CAPITAL MARKET LAW], 29, (2d ed. 2010); JUNG, *supra* note 19, at 288; JABONSIJANGTONGHAPBEOBYEONGUHOE [CAPITAL MARKET CONSOLIDATION ACT RESEARCH GROUP], JABONSIJANGTONGHAPBEOBHAESEOLSEO [CAPITAL MARKET CONSOLIDATION ACT GUIDEBOOK], 31-32, 91-92 (2008).

37. Even though negotiable certificates of deposit (CDs) issued by banks are also exposed to market risks, the Act viewed the issuance of CDs can be regulated by the Banking Act and clearly indicated that it is not included in the definition of financial investment products. Capital Markets Act, *supra* note 1, art. 3(1).

38. Capital Markets Act, *supra* note 1, art. 4(1).

39. In the case of a typical option, the option holder will pay an option premium at the beginning of the transaction and will not make any further payments while the option writer will be obligated to make a payment when the option is exercised. Then, a question may arise as to whether an option

would not be obligated to make additional payment other than the purchase price paid upon acquisition. On the other hand, for example, in case of stock price index futures, the amount paid on investment is a margin, and the investors may be obligated to make payment calculated according to the fluctuation of stock price index and therefore, such financial investment product falls under the category of derivatives. Such criterion distinguishing securities from derivatives is the more developed version of what was reflected in the definition of equity linked securities and equity linked warrants under the previous Securities and Exchange Act.⁴⁰ Financial products, once characterized as derivatives, are more tightly regulated than those characterized as securities, as discussed in 3.6 below.

(c) Classification of Securities

The Capital Markets Act classifies securities into six categories⁴¹: debt securities,⁴² equity securities,⁴³ beneficial certificates,⁴⁴ securities

should be treated as a derivative. Commentators' view is split on this issue. One view of an official at the Ministry of Finance and Economy is to treat an option transaction as a derivative where a financial investment service company buys an option from its customer and thereby the customer becomes obligated to make a further payment under the option. Choi, *supra* note 23, 135. Another view is to treat an option as a derivative irrespective of whether the option issuer is a financial investment service company or its customer. KIM & JUNG, *supra* note 36, at 32. In-Sook Shim, "JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul" Sang JangOePasaengSangPum GaeNyeomE DaeHan GoChal [Defining "Over-The-Counter Derivatives" for the Purposes of the Capital Market and Financial Investment Business Act of Korea] 27(3) SANGSABOEYONGU [COM. L. REV.] 265-319 (2008) also raised this issue in connection with various types of financial products which have been treated as derivatives in the market.

40. Article 1-3(2) of the Securities and Exchange Act Enforcement Decree which was added on March 28, 2005, required that "an issuer of the equity linked securities and equity linked warrants shall receive the full amount at the same time of transfer of securities or certificates". It also required non-existence of obligation to make additional payment by providing that "an owner shall not bear the burden of additional payment other than the amount paid according to Article 2 for the period of securities or certificates (except where the owner exercises his/her right to enter into sale and purchase of, or do trading on, the securities or certificates)." This legislation adopted the predominance test of the U.S. Commodity Futures Modernization Act of 2000 with appropriate modification to suit for Korean market. Sunseop Jung, *YuGaJeungGwon GaeNyeomE GwanHan IlGo PasaengGyeolHapSangPumEul JungSimEuRo* [Comment on Concept of Securities - Focusing on Derivatives-linked Securities], 7 JEUNGGWONSEONMUL [KRX REV.] 3, 14 (2005).

41. Capital Markets Act, *supra* note 1, art. 4(2).

42. The term "debt securities" includes government bonds, local government bonds, special bonds (referring to bonds issued by a juridical entity established by direct operation of a statute), corporate bonds, corporate commercial papers (referring to promissory notes issued by a company and satisfying certain requirements), and other similar instruments, which represent a right to claim a payment. *Id.* art. 4(3). Legislation for introducing the concept of "short term corporate bonds" is under progress recently. Press Release, Fin. Serv. Comm'n, "JeonJaDanGiJeungGwonDeungUi BalHaeng Mit YuTongE GwanHan BeobRyul" (IHa 'JeonJaDanGiSaChaeBeob') JeJeongAn ChaGwanHoeUi TongGwa[The Darft "Act on Issuance and Distribution of Electronic Short Term Corporate Bonds" (Hereinafter 'Electronic Short Term Corporate Bond Act') Passed Vice-ministerial Meeting] (Mar. 25, 2010), http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2010-03-25&sch3=2010-03-25&sword=&r_url=&menu=7210100&no=27514.

43. The term "equity securities" means share certificates, instruments representing a right to subscribe shares (warrants and rights), certificates of capital contribution issued by a juridical entity established by direct operation of a statute, equity shares in contribution to a limited partnership

depository receipts,⁴⁵ investment contract securities,⁴⁶ and derivative-linked securities.⁴⁷ The first three types of traditional securities were treated as securities under the previous Securities and Exchange Act, and there has been no substantial change by the enactment of the Capital Markets Act except that the scope of equity securities was expanded by including partnership interests. However, it is not expected that partnership interest transactions will become active in the Korean capital market. The concept of securities depository receipts was adopted by the Securities and Exchange Act in 1997 to establish the legal basis for securities to be issued internationally in the form of depository receipts. Especially, it is setting up the basis for the Korea Securities Depository to issue Korean depository receipts representing shares issued by a non-Korean issuer and held by the Korea Securities Depository, as a depository institution, in cases where foreign companies want to make an offering in Korean market.

The last two kinds, that is, investment contract securities and derivative-embedded securities, are worthy of special mention.

The concept of investment contract securities did not exist in the previous Securities and Exchange Act. Investment contract securities means “those representing rights under a contract where a particular investor invests money into a joint enterprise between the investor and another person(s) (including other investors) and is entitled to the profits earned, or liable for losses sustained, based on the outcomes of the joint enterprise mainly managed by the other person(s).”⁴⁸ The concept of the investment contract is included in the definition of securities under the U.S. Securities Act of 1933 Section 2(a)(1) and the Securities and Exchange Act of 1934 Section 3(10). In *SEC v. W. J. Howey Co.*,⁴⁹ the U.S. court ruled that the criteria of determining whether a contract is an investment contract that falls

company, limited liability company, or undisclosed partnership under the Commercial Code, equity shares in contribution to a partnership under the Civil Code, and other similar instruments, which represent shares of capital contribution. Capital Markets Act, *supra* note 1, art. 4(4).

44. The term “beneficial certificates” means instruments which represent beneficial interests in a trust. *Id.* art. 4(5).

45. The term “securities depository receipts” means instruments issued by a person with whom any of the securities enumerated in paragraph (2) 1 through 5 are deposited and issued in a country other than the country where such underlying securities were issued, which represent the right on the deposited underlying securities. *Id.* art. 4(8).

46. The term “investment contract securities” means those representing rights under a contract where a particular investor invests money into a joint enterprise between the investor and another person(s) (including other investors) and is entitled to the profits earned, or liable for losses sustained, based on the outcomes of the joint enterprise mainly managed by the other person(s). *Id.* art. 4(6).

47. The term “derivatives-embedded securities” means instruments representing a right under which the amount payable or recoverable shall be determined according to a predetermined formula tied to fluctuations in the price of any underlying assets, an interest rate, an indicator, a unit or an index based upon any of the aforementioned. *Id.* art. 4(7).

48. *Id.* art. 4(6).

49. *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946).

under the definition of securities are: (i) investment of money due to, (ii) an expectation of profits arising from, (iii) a common enterprise, and (iv) which depends solely on the efforts of a promoter or third party. The criteria from *Howey* were reflected in the definition of investment contract securities of the Capital Markets Act. Special attention should be brought to the fact that, unlike *Howey*, the Capital Markets Act's degree of dependence on the outcome of others is provided as "mainly", not "solely".⁵⁰ This is intended to include horizontal joint enterprises as well as vertical joint enterprises.⁵¹ In this regard, a question may arise as to whether the concept of investment contracts may overlap with the concept of collective investment securities, which is listed as a type of security and how to distinguish these two types as between them.⁵² Since collective investment securities and collective investment schemes are specifically regulated and the concept of investment contracts is to prevent loopholes, if a financial product falls within the definition of collective investment securities, it should not be treated as an investment contract.⁵³

Derivatives-embedded securities has a derivative factor in that payment amounts can vary according to changes in value of underlying assets or changes in underlying index. In this regard, it can be said that derivatives-embedded securities are similar to derivatives. However, the investors who purchase derivatives-embedded securities by paying full price at the time of purchase will not suffer from losses over their initial investment amount. Therefore, this type of product is considered securities, not derivatives. For example, typical credit default swaps are derivatives, but fully-funded credit-linked notes are derivatives-embedded securities. Derivatives-embedded securities are classified as securities according to the

50. The "solely" test was subject to criticism and was not strictly adhered to in the United States. In *SEC v. Glenn W Turner Enterprises Inc.*, 474 F. 2d 476, 482 (9th Cir. 1973) (footnote omitted), the court held:

[I]n light of the remedial nature of the legislation, the statutory policy of affording broad protection to the public, and the Supreme Court's admonitions that the definition of securities should be a flexible one, the word "solely" should not be read as a strict or literal limitation on the definition of an investment contract, but rather must be construed realistically, so as to include within the definition those schemes which involve in substance, if not form, securities.

... Rather we adopt a more realistic test, whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.

51. JABONSIJANGTONGHAPBEOBYEONGUHOE [CAPITAL MARKET CONSOLIDATION ACT RESEARCH GROUP], *supra* note 36, at 21.

52. Byoung-Youn Kim, *GeumYungTuJaEobGwa JaBonSiJangE GwanHan BeobRyul (GaChing) Sang JeungGwon GaeNyeomE DaeHan GeomTo - TuJaGyeYak(investment contract)Gwa HyeonHaeng GanJeobTuJaJaSanUnYongEobBeobSang TuJaDaeSangEul JungSimEuRo* [Review of Comprehensiveness of Concept of Securities under the Proposed Bill on the Financial Investment Services and Capital Market Act], 57 TUSIN [INVESTMENT TRUST] 1-17 (2006); Jung, *supra* note 19, at 298-99.

53. Jung, *supra* note 19, at 298.

classification principles of securities and derivatives, however, it is treated in the similar manner as derivatives for the purpose of the investor protection.⁵⁴

(d) Derivatives

In the Capital Markets Act, “derivatives” mean forward, option, swap contracts with regard to underlying assets, underlying asset’s price, interest rate, index, unit or the index based on them.⁵⁵ Underlying assets which can be used as such under derivatives as defined under the Act are financial investment products, currencies, commodities, credit risk and other risks on natural, environmental or economic phenomenon, the price or index or unit of which can be calculated or assessed in a reasonable and appropriate manner.⁵⁶ The requirement for reasonableness and appropriateness is intended to protect investors.⁵⁷ As noted in 3.6.4 below, the OTC Derivatives Product Review Committee was formed to review this issue. Derivatives are divided into exchange-traded derivatives and OTC derivatives.⁵⁸

Since derivatives determine the payment amount in the future based on uncertainty, the question of whether it falls under gambling can arise. The Capital Markets Act clearly provides that it does not constitute a crime of gambling (illegal in Korea) if a financial investment service company conducts its business pursuant to the Act.⁵⁹ Although the Capital Markets Act is silent on the validity of derivatives can be challenged based on the gambling issue, such challenge should not be allowed for derivatives which do not constitute the crime of gambling by virtue of the Capital Markets Act.⁶⁰

(e) Classification of Financial Products in Korean Financial Market

In sum, the financial products traded in Korean financial and capital markets are classified as follows:⁶¹

54. For instance, the suitability principle applies to both derivatives and derivatives-embedded securities. See *infra* part 3.4.2 (3).

55. Capital Market Act, *supra* note 1, art. 5(1).

56. Capital Market Act, *supra* note 1, art. 4(10). A commentator indicated concerns about the expansion of the eligible underlying assets which can be used as such under derivatives. Dae-Seob Kang, *GeumYungTuJaSangPum GaeNyeomUi PoGwalJuUiWa GiNeungByeol YeongEobHaengWi GyuJeUi GeomTo* [Comprehensive Definition of Financial Investment Goods and Functional Regulation], 51(1) BEOBHAKYEONGU [PUSAN NAT’L U. L. REV.] 585, 595 (2010).

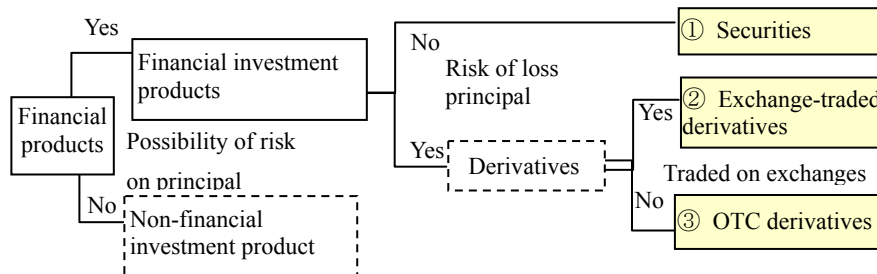
57. Jung, *supra* note 19, at 304.

58. Capital Markets Act, *supra* note 1, art. 5(2) and (3).

59. *Id.* art. 10(2).

60. Ha, *supra* note 31, at 389. Hong-Ki Kim, *PasaengSangPumGwa DoBakGyuJe* [Derivatives and Gaming Regulations], 14(1) BIGYOSABEOB [J. COMP. PRIVATE L.] 557 (2007) (asserting that an express provision on the validity of derivatives in the Capital Markets Act is necessary).

61. Source of diagram: MINISTRY FIN. & ECON., *supra* note 7, at 10.



C. *Expansion of Business Scope Available to Financial Investment Service Companies*

1. *Scope of Business for a Financial Investment Service Company*

(a) Function-based Regulation

Under Article 6(1) of the Capital Markets Act, “financial investment service” is defined as activities conducted continuously or repeatedly for the purpose of earning a profit, which shall fall under one of the six categories: dealing business,⁶² brokerage/arranging business,⁶³ collective investment business,⁶⁴ non-discretionary investment advisory business,⁶⁵ discretionary investment management business,⁶⁶ and trust business.⁶⁷ The classification of financial investment service into six categories is based on the functions such as dealing, brokerage, asset management, investment advisory, and trust. A financial investment service company can perform any kind of financial investment service, however, it must obtain a license to engage in

62. The term “dealing business” means a business purchasing and selling financial investment products, issuing and underwriting securities, soliciting offers, offering, and accepting offers for securities on its own account. Capital Markets Act, *supra* note 1, art. 6(2).

63. The term “brokerage/arranging business” means a business purchasing and selling financial investment products, soliciting offers, offering, and accepting offers for such products, or soliciting offers, offering, and accepting offers for the issuance and acceptance of securities on another person’s account. *Id.* art. 6(3).

64. The term “collective investment business” means a business making collective investments. *Id.* art. 6(4); The term “collective investments” means the activities of acquiring, disposing of, or otherwise managing such assets as are valuable for investment with money or similar pooled by inviting two or more persons for such investment (or with a surplus fund under Article 81 of the National Finance Act), without being bound by ordinary management instructions given by investors (or by any relevant government fund management entity), and distributing the performances therefrom to investors (or the relevant government fund management entity). *Id.* art. 6(5).

65. The term “investment advisory business” means a business providing advice on the value of financial investment products or related judgments (referring to judgments over class, item, acquisition, disposition, methods of acquisition or disposition, quantity, price, time, etc). *Id.* art. 6(6).

66. The term “discretionary investment business” means a business making acquisition, disposition, or other management of financial investment products, earmarking them for each investor, with authorization from investors for discretionary judgment, entirely or partially, over financial investment products. *Id.* art. 6(7).

67. The term “trust business” means a business engaging in trusts. *Id.* art. 6(8).

each financial investment business (in case of dealing business, brokerage/arranging business, collective investment business, and trust), or complete registration (in case of non-discretionary investment advisory business or discretionary investment management business).⁶⁸

(b) Entry Regulation for Each Business Area

License and registration of financial investment business is granted or accepted on the basis of a business unit which can be made by reference to: (i) six types of financial investment services, (ii) the type of financial investment product the line of business intends to transact (in the case of dealing and brokerage/arranging, which of securities, exchange-traded derivatives and OTC derivatives will be dealt with; in the case of collective investment business and trust business where to invest among securities, real estate, special property,⁶⁹ short-term financial products⁷⁰), (iii) the scope of business (whether the contemplated customers are non-professional investors⁷¹ or professional investors⁷²). Different entry requirements apply to each business unit.⁷³ The basic policy of entry requirements for each business unit is as follows:⁷⁴

(i) As compared to registration, the entry requirements of financial investment business that requires authorization are stricter. Where

68. *Id.* arts. 11 & 17.

69. The term means eligible investment, excluding securities and real estate. *Id.* art. 229(iii).

70. The term “short-term financial instruments” means assets falling under any of the following (*Id.* art. 241(1)):

1. Negotiable certificates of deposits with a remaining maturity of six months or less;
2. Government bonds, local government bonds, special bonds, corporate bonds (excluding equity-related corporate bonds), or corporate commercial paper with a maturity of one year or less: *provided*, that repos shall not be subject to the restriction on remaining maturity;
3. Bills or notes issued, discounted, sold, brokered or guaranteed by certain financial institutions with a remaining maturity of one year or less;
4. A short-term loan (within 30 days) to certain financial institutions
5. A deposit in a financial institution with a maturity of six months or less; and
6. Collective investment securities of another money market fund.

71. This term means an investor which is not a professional investor. *Id.* art. 9(6).

72. The term “professional investor” means the following (*Id.* art. 9(5)):

1. Government;
2. Bank of Korea;
3. Financial institutions specified by the Presidential Decree;
4. Stock listed company. However, in the case of entering into OTC derivatives with a financial investment service company, it is treated as a professional investor only if it notifies the financial investment service company of its agreement to be treated as such;
5. Others designated by the Presidential Decree.

Certain professional investors can request the financial investment service company to treat it as non-professional investors and in such case, the financial investment service company may not refuse to accept such request without justifiable reason.

73. Capital Markets Act Enforcement Decree, *supra* note 21, art. 16(10).

74. MINISTRY FIN. & ECON., *supra* note 7, at 28-29; Fin. Serv. Comm’n, “JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul SiHaengRyeong” JuYoSeolMyeongJaRyo [“Financial Investment Services and Capital Markets Act Enforcement Decree” Explanatory Material] 11-19 (April 2008) (on file with author).

authorizations are required, the regulator's can often use their discretion.

(ii) Stricter requirements apply in the order of a business that has direct claim-obligation relationships (dealing business), a business that is entrusted with investors' assets (brokerage/arranging business, collective investment business, trust business), and a business that is not entrusted with assets (discretionary and non-discretionary investment advisory business).

(iii) (Regarding financial investment products) stricter requirements apply in the order of OTC derivatives, exchange-traded derivatives and securities.

(iv) (Regarding investors) stricter requirements apply to dealing with non-professional investors than with professional investors.

For instance, the strictest requirement applies to the OTC derivatives dealing business with non-professional investors, whereas the least strict requirement applies to the non-discretionary investment advisory business of bonds with professional investors. In order to expand the business scope, a financial investment service company may apply for license or registration for the business unit it plans to "add-on" to its existing business.

2. *Licensing Practice under the Capital Markets Act*

The Capital Markets Act became effective in February, 2009 amid the global financial crisis and the Financial Services Commission took a conservative position in regard to its licensing policy. The licensing policy announced by the Financial Services Commission on March 6, 2009, stated that due to the influence of the global financial crisis, the capital market has been in recession and the profit foundation of financial investment services was damaged. Therefore, the Financial Services Commission took the position: (i) at the first stage, considering market risk, it would review applications for low-risks business areas and at the second stage, depending on the recovery of the global financial crisis, expand the scope of business areas available for licensing gradually, (ii) give priority to the addition of business by an existing company to the establishment of a new company, (iii) ensure fairness and the objectivity of the review process by having a private evaluating committee review qualitative factors, such as the appropriateness of business plan.⁷⁵

On July 30, 2009, by which time 29 companies applied for the license of addition of business and preliminary licenses were given to 18 companies

75. Press Release, Fin. Serv. Comm'n, GeumYungTuJaEob InGaUi GiBonBangHyangGwa UnYongGyeHoeg [The Basic Direction and Management Plan of Financial Investment Service License] (Mar. 9, 2009), http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2009-03-09&sch3=2009-03-09&sword=&r_url=&menu=7210100&no=27081.

pursuant to the above licensing policy, the Financial Services Commission announced the second stage licensing policy.⁷⁶ Sticking to the March 2009 policy of expanding the scope of business area available for license gradually, the second stage policy indicated that an application for a license would be reviewed with respect to the business area which had been not permitted under the first stage but which are appropriately regulated and that the review on the qualitative factors would be more carefully considered. Particularly, with respect to OTC derivatives business, in light of the possibility of increasing market risk and the discussion of the reform of regulatory system, licenses would be granted on a limited basis after more careful review on qualitative factors such as sound business plan, sufficient equity capital, risk management and internal control. Also, banks and insurance companies which would like to provide financial investment services can be given license on a limited basis for those business areas which have been already permitted to other banks or insurance companies and which are closely related to the applicant's existing business.

In its recent press release of May 31, 2010,⁷⁷ the Financial Services Commission confirmed its initial policy to gradually expand the scope of business areas for which license would be available. The press release mentioned three criteria for future licensing: (i) the establishment of a new company or additional new business shall not substantially increase market risk and raise supervisory concerns; (ii) the new business shall be relevant to the applicant's existing business and enhance investors' convenience; and (iii) the license shall contribute to the diversification of revenue sources and promote fair competition. The press release also mentioned that the following licenses would be granted: license for the establishment of specialized boutique securities companies, limited OTC derivatives business license to securities companies and banks, government bonds dealing and underwriting business license to banks, collective investment business license to investment advisory companies, trust business license to securities companies and insurance companies.

Since February 2009, when the Capital Markets Act took effect, to May 31, 2010, 47 final licenses and 8 preliminary licenses were granted with respect to 63 applications.⁷⁸

76. Press Release, Fin. Serv. Comm'n, 2DanGye GeumYungTuJaEob InGaBangHyangGwa UnYongGyeHoeg [The Basic Direction and Management Plan of Financial Investment Service License - Second Stage] (July 30, 2009), http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2009-07-30&sch3=2009-07-30&sword=&r_url=&menu=7210100&no=27262.

77. Press Release, Fin. Serv. Comm'n, HyangHu GeumYungTuJaEob InGaBangHyangGwa UnYongGyeHoeg [Direction and Operation Plan of Future Financial Investment Service License] (May 31, 2010), http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2010-05-31&sch3=2010-05-31&sword=&r_url=&menu=7210100&no=27612.

78. *Id.* Since February 2009 to January 2010, 22 companies were granted licenses for dealing and

3. *Control of Conflicts of Interest*

The potential for conflicts of interest between a financial investment service company and their customers can occur at all times. In addition, if a company is engaged in various types of business, it is easier for conflicts of interest to occur due to the characteristics of those businesses. The Capital Markets Act deals with both of these issues.

(a) Conflicts of Interest with Customers

The Capital Markets Act requires financial investment service companies to establish a system to prevent and resolve conflicts of interest between a financial investment service company and investors, or between investors.⁷⁹

The Capital Markets Act provides that conflicts of interest shall be regulated by financial investment service company through a three-step process of “monitoring – disclosure and reduce – avoid”. A financial investment service company must take actions to prevent conflicts of interest between the company and investors or between investors as follows:⁸⁰

(i) It must understand and evaluate the possibility of conflicts of interest, and manage it appropriately in accordance with the methods and procedures under the internal control standards.

(ii) If, as a result of the evaluation, there is a possibility for conflicts of interest to occur, then it must notify the investors of the same.

(iii) Trading and other dealing should be made after lowering the possibility of causing the conflict of interest, following the procedures made by internal control standards, to the level which has no problem in protecting investors.

(iv) If it is impossible to lower the possibility of causing the conflict of interest, the company should not trade or conduct other deals.

Although the Capital Markets Act is silent on this point, it would be reasonable to interpret the above provision to the effect that a financial service provider should not arbitrarily determine the possibility of the occurrence or the existence of a conflict of interest and that more objective criteria should be applied.⁸¹

brokerage/arranging, 20 cases of which were the add-on of exchange-traded derivatives business to existing securities companies. During the same period, eight licenses, six of which were for new entities, were granted to engage in the collective investment business and three licenses, two of which were for new entities, were granted to engage in the trust business. Bo Sung Shin, *JaBonSiJangBeobSangUi JinIpGyuJe HyunHwangGwa GaeSeonBangHyang* [*Current Status and Improvement Direction for Entry Regulation under the Capital Markets Act*], 40 BFL 45, 51-53 (2010).

79. Capital Markets Act, *supra* note 1, art. 12(2)(vii).

80. *Id.* art. 44.

81. However, a commentator indicated a concern that this provision may be interpreted to permit the financial investment service companies to determine whether a conflict of interest situation exists

(b) Blocking Internal Information Provision

There could be conflicts of interest between financial investment services provided to customers and the proprietary trading of the company. Also, there could be a possibility of conflicts of interest between business departments when the operating company is engaged in various types of financial investment businesses. The Capital Markets Act prohibits the exchange of information and certain other activities which may create conflicts of interest issues (i) between (a) proprietary asset management⁸² or dealing and brokerage/arranging, and (b) collective investment business (only if managing collective investment assets in financial investment products) or trust business (only if managing financial investment products or taking custody of financial investment products), and (ii) between (c) corporate finance business⁸³, and (d) proprietary asset management and financial investment business (excluding dealing and brokerage/arranging business for government bonds, local government bonds and bonds issued by certain financial institutions such as banks or certain public enterprises).⁸⁴ The prohibited activities are:

(i) Providing information on trading and holding of financial investment products (except for those specified by the Financial Services Commission) by the financial investment service company, information on trading and holding of financial investment products by investors (except the total amount of deposited securities and the total amount by the kind and other information specified by the Financial Services Commission), information on the composition and management of collective investment assets, assets of discretionary advisory customers and trust assets (except the information after 2 months), and non-public material information acquired in course of conducting corporate finance business.

(ii) Executives (except representative directors and statutory auditors) and employees having a concurrent position.

(iii) Failure to separate office by wall or partition, co-use of the office area such as using a common entrance, and sharing a computer system

and asserts that the provision need to be amended to provide that the existence of a conflict of interest shall be determined from the perspective of an objective third party. Jonghoon Lee, “*JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul*” *E DaeHan SoGo* [*A Study on the Financial Investment Services and Capital Market Act*] 29(1) BEOBHAKNONCHONG [CHONNAM L. REV.] 195, 210 (2009).

82. The term “proprietary asset management” means trading or owning financial investment products on its own account, which does not constitute dealing business. Capital Markets Act Enforcement Decree, *supra* note 21, art. 50(1)(ii).

83. For the purpose of the regulation of information exchange, corporate finance means underwriting, arranging public offering and private placement, M&A brokerage/arranging/agency/advisory, management of private equity fund, but excludes underwriting and arranging public offering and private placement of collective investment securities. Capital Markets Act Enforcement Decree, *supra* note 21, arts. 50 (2) (i) & 68(2).

84. Capital Markets Act, *supra* note 1, art. 45(1); Capital Markets Act Enforcement Decree, *supra* note 21, arts. 50(2), (3) and (4).

without taking measures to prevent the information flow mentioned in (i) above.

(iv) Failure to establish separate department for each of (a) and (b) (or (c) and (d), as the case may be) or failure to conduct the business of (a) and (b) (or (c) and (d), as the case may be) independently (except as allowed by the Financial Services Commission) or

(v) Failure to keep records of meetings or communications between executives or employees in the business of (a) and (b) (or (c) and (d), as the case may be) in accordance with the methods and procedures under the internal control standards or failure to obtain the confirmation from the compliance officer.

(c) Blocking Information Exchange with Affiliates/Distributors/ Head Office

Financial investment service companies are prohibited from exchanging information, sharing office/computer system, having a concurrent position and other action which has potential to create conflicts of interest, with affiliates, (in case of collective investment business companies) distributors of collective investment securities, or (in case of Korea branch of a foreign financial investment service company) head office or other branches,⁸⁵ with certain limited exceptions. Information provision for the purpose of reporting required under laws and regulations or for monitoring internal control is allowed.⁸⁶ Also, in specific and limited cases such as in regard to non-standing employee, the ban on holding more than one office does not apply.⁸⁷

The above described regulation of information flows under the current Capital Markets Act Enforcement Decree is a result of an amendment to the initial provisions of the Capital Markets Act Enforcement Decree on July 1, 2009. The initial provisions were criticized by the business community as being too strict to engage in proper business activities.⁸⁸ Although the provisions were improved by such amendment, there still remain some uncertainties. The Capital Markets Act is silent on the effect of the compliance with the information blocking provisions of the Act. In addition, it may be a controversial issue under what circumstances the wall may be crossed even in the absence of a specific provision on such information flow.

85. Capital Markets Act, *supra* note 1, art. 45(2).

86. Capital Markets Act Enforcement Decree, *supra* note 21, art. 51 (2)(i).

87. *Id.* art. 51 (2)(ii).

88. Jong-Mi Yoon, *IHaeSangChungBangJiReul WiHan NaeBuTongJeSiSeuTemE GwanHan YeonGu - JaBonSiJangBeobEul JungSimEuRo* [Study on the Internal Control System to Prevent Conflicts of Interest - Focused on the Capital Market Act], 24(3) *GIEOBBEOBYEONGU* [BUS. L. REV.] 234 (2010).

D. *Reinforcing Investor Protection*

1. *Overview*⁸⁹

Investor protection is a basic directive behind the enactment of the Capital Markets Act, and provisions on investor protection were reinforced in various ways. The Capital Markets Act declared that a financial investment service company shall, as basic principle in providing financial investment services, fairly conduct financial investment service business in good faith and shall not make itself or the third party to be benefitted unreasonably while prejudicing investors.⁹⁰ This provision strengthens the duty of a financial investment service company to its customers but it is not clear whether it provides for the duty equivalent to a fiduciary duty under the English or American law.⁹¹

In addition to the circumstances where conflicts of interest problems may arise as discussed in 3.3.3., above, the investor protection issue can arise in connection with complex financial products. As the products traded in capital markets have become more complex, it is becoming increasingly difficult for non-professional investors to assess the potential risks of the products. The Capital Markets Act provides a mechanism to ensure that in case where a financial investment service company recommends a financial investment product to an investor, the investor understands the risks under the product and make an informed decision.

2. *Regulations on Investment Recommendations*

(a) “Know Your Customer” and Suitability Principle

A financial investment service company must confirm whether an investor is a professional investor or a non-professional investor.⁹² Also, it

89. In line with the financial reform after the global financial crisis such as the Wall Street Reform and Consumer Protection Act of the United States which emphasized protection of customers and contemplates the establishment of the Consumer Financial Protection Agency, since late 2009, there have been extensive discussions in Korea on the necessity of enacting new legislation to improve the protection of customers of financial institutions. See Sunseop Jung, *GeumYungGyuJeGaeHyeogGwa GeumYungSoBiJa BoHo* [Financial Regulatory Reform and Consumer Financial Protection], 23(2) SANGSAPANRYEYEONGU [COM. CASES REV.] 3 (2010).

90. Capital Markets Act, *supra* note 1, art. 37.

91. Soo Hyun Ahn, *GeumYungSoBoJa BoHoWa JaBonSiJangBeobUi GwaJe* [Meeting the Demanding Challenges in Protecting the Financial Consumers by the Capital Market and Investment Service Provider Act], 22(4) GiEOBBEOBYEONGU [BUS. L. REV.] 73, 105 (2008); KOREAN SECURITIES LAW ASSOCIATION, *JABONSIJANGBEOB (JUSeOKSEO I)* [CAPITAL MARKET LAW (ANNOTATION I)] 179 (2009).

92. A non-professional investor means an investor who is not a professional investor. A professional investor is one who is capable of taking risks based on his/her expertise on financial investment products or asset size and the term includes certain public agencies, funds, local governments, stock listed companies, voluntary professional investors such as the Government, the

must understand the non-professional investor's investment purpose, financial conditions, or investment experience through interviews or questions and confirm the fact with the non-professional investor before recommending investment.⁹³ It must not recommend investment that is not suitable for non-professional investors in light of the non-professional investor's investment purpose, financial conditions, or investment experience.⁹⁴ Although the suitability principle and the "Know Your Customer" rule had been provided in the Financial Services Commission's regulations, it did not have any express statutory basis in the previous Securities and Exchange Act.

Although there was no specific statutory provision, Korean courts had recognized this principle. In a case where an employee of a security company had solicited the investment with a profit guarantee, which was specifically prohibited under the Securities and Exchange Act and invalid, the customer made a loss and the Korean Supreme Court held that, after considering the background and manner of trading, the customer's investment status (the status of property, age, social experience, etc), risk of trading and level of explanation of such risk, if it is regarded as interfering in experienced ordinary customer's acknowledgement of risk inevitably following investment or as a solicitation of the investment with high risk without proper explanation to inexperienced ordinary investors, it is a failure to comply with the duty of customer protection and thus is illegal and thus the company is liable in tort (Supreme Court Decision of January 11, 1994, case no. 93Da26205). The Korean Supreme Court has applied the same principle to investment solicitation where the employee of a securities company did not conduct an action which was specifically prohibited under laws and regulations.⁹⁵ Recently, Seoul District Court⁹⁶ and Seoul High Court⁹⁷ also recognized the suitability principle and the duty of explanation in so-called KIKO (knock in-knock out currency option) cases even if the KIKO contracts were entered into before the enactment of Capital Markets Act.⁹⁸ Now, the Capital Markets Act incorporated the rule in statute.

Bank of Korea, certain financial institutions, the Korean Deposit Insurance Corporation, the Korean Investment Corporation, etc (corporations and individuals who met the requirements of possessing certain financial investment products (5 billions for individuals, 10 billions for corporations) and report to the Financial Services Commission). Capital Markets Act, *supra* note 1, arts. 9(5) and 9(6); Capital Markets Act Enforcement Decree, *supra* note 21, art. 10. Among these, a stock listed company is considered as a professional investor only when it reports its intention to be treated as a professional investor if it does OTC derivatives trading. *See infra* part 3.6.2.

93. Capital Markets Act, *supra* note 1, arts. 46(1) & (2).

94. *Id.* art. 46(3).

95. Supreme Court [S. Ct.], 93Da26205, Jan. 11, 1994; Supreme Court [S. Ct.], 2000Da30943, Apr. 27, 2001.

96. Seoul Central District Court [Dist. Ct.], 2008Gahab108359, Feb. 8, 2009.

97. Seoul High Court [Seoul High Ct.], 2009Ra997, August 21, 2009.

98. Disputes arose in KIKO transactions due to the radical exchange rate swings during the early

However, unlike the recent proposal of the Financial Industry Regulatory Authority (FINRA) of the United States, which set forth the three main suitability obligations, i.e., (i) reasonable basis (members must have a reasonable basis to believe, based on adequate due diligence, that a recommendation is suitable for at least some investors), (ii) customer specific (members must have reasonable grounds to believe a recommendation is suitable for the particular investor at issue); and (iii) quantitative (members must have a reasonable basis to believe the number of recommended transactions within a certain period is not excessive),⁹⁹ the Capital Markets Act does not have such details. In light of the broad language of Article 46(3) of the Capital Markets Act,¹⁰⁰ there is no reason why the suitability rule adopted by the Act does not encompass any of the foregoing three main obligations.

(b) Duty of Risk Warning and Explanation

When a financial investment service company recommends investment to non-professional investors, it must explain in a clear manner the contents of the financial investment products, the risks following the investment, the structure and characteristics of investment risks of the financial investment product, fees, early redemption conditions (if any), and the conditions on termination/cancellation of the contract, and must receive a confirmation from the investor that the investor understands them.¹⁰¹ The Supreme Court of Korea has held that a securities company owes a duty to provide its customer with material information on the value of the relevant securities and properly explain the same to the customer.¹⁰² The Capital Markets Act codified the principle recognized by the Supreme Court of Korea.

In providing such explanations, the financial investment service company shall not misrepresent or omit material facts (facts that can reasonably influence an investor's investment decision or facts that can substantially influence the value of a financial investment product).¹⁰³

The previous Securities and Exchange Act was silent on this duty. The Financial Supervisory Commission's Securities Business Supervisory Regulations provided that when an ordinary customer is willing to open an

stage of the recent global financial crisis.

99. FINRA proposed to adopt Rule 2111 (Suitability) and FINRA Rule 2090 (Know Your Customer) as part of the Consolidated FINRA Rulebook. The proposed Rule 2111.03 would codify interpretations of the three main suitability obligations. FINRA, Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook, Rule Filings no. SR-FINRA-2010-039, <http://www.finra.org/Industry/Regulation/RuleFilings/2010/P121836> (the text of proposed rule change is available as a PDF file at this web page).

100. See *supra* text accompanying notes 93 & 94.

101. Capital Markets Act, *supra* note 1, arts. 47(1) & (2).

102. E.g., Supreme Court [S. Ct.], 2005Da49799, June 29, 2006.

103. Capital Markets Act, *supra* note 1, art. 47(3).

account to trade in derivatives, margin transactions, foreign currency securities or other equivalent transactions involving high risk, a securities company had the duty of explanation before opening the account.¹⁰⁴ Now, this duty is reflected in the Capital Markets Act.

A financial investment service company which violated this duty of explanation bears the burden of compensating the investor for his or her losses. The amount of losses is estimated as: [the total amount the investor paid or shall pay to acquire the financial investment product] minus [the total amount the investor recovered or shall recover through disposing of the financial product].¹⁰⁵ The burden of proof that the losses are less than estimated amount is on the financial investment service company. The Capital Markets Act is silent on who bears the burden of proof as to the compliance or breach of the duty to warn of risks and to explain them. In light of the absence of such provision, it would be difficult to interpret the above mentioned loss estimate provision as imposing a burden of proof of compliance with the duty of to warn of and explain the risks against financial investment service companies.^{106 107}

(c) Duty of Appropriateness Test

Even if a financial investment service company does not make an investment recommendation to its customers, it still needs to evaluate the investor's information such as purpose of investment, status of property and investment experience in order to sell the derivatives, derivatives-embedded securities and collective investment securities (that invest in derivatives and the derivatives-embedded securities) to non-professional investors. Furthermore, if the product the investor want to purchase is not appropriate to the non-professional investor, the company must inform the investor of (i) the information on the product, (ii) the risk under the product, (iii) the product is not appropriate to the investor in light of his/her purpose of investment, the status of property and investment experience, and obtain a

104. JeungGwonEobGamDokGyuJeong [Securities Business Supervisory Regulations], art. 4-17(2), Financial Supervisory Commission Public Notice No. 2000-124, Dec. 29, 2000, last amended by Public Notice No.2008-11, Feb. 21, 2008.

105. Capital Markets Act, *supra* note 1, art. 48.

106. Ki Jeong Han, *JaBonSiJangTongHapBeob JeJeongBangAnGwa GeumYungGoGaeg BoHoJeDoUi SeonJinHwa* [Draft Capital Market Consolidation Act and Improvement of Financial Customer Protection], 18 BFL 17, 24 (2006).

107. Reported court cases made a decision as to whether the financial institution performed such duties based on the facts without relying on the rule of the burden of proof. This is because the issue of whether certain facts constitute the performance of such duties or breach of such duties is a legal rather than a factual matter which need to be proved. *E.g.*, Supreme Court [S. Ct.], 2010Da55699, Nov. 11, 2010 (finding partly breach of duty to warn of and explain risks and partly performing such duty by a financial institution which entered into forward exchange transaction); Supreme Court [S. Ct.], 2008Da52369, Nov. 11, 2010 (finding breach of duty of risk warning by a financial institution which sold a fund product investing in derivatives).

confirmation from the investor that the investor was so informed.¹⁰⁸

(d) Prohibition of Certain Investment Solicitation

The previous Securities and Exchange Act also banned various unjust solicitation practices, such as profit guaranteed solicitation and solicitation based on conclusive judgment.¹⁰⁹ Article 49 of the Capital Markets Act expanded the range of unjust solicitation practices. Notably, the Capital Markets Act prohibits 'unsolicited calls' and 'continuing solicitation against a customer's will'.

For sale of OTC derivatives, visits and phone calls not made at the investor's request are prohibited. This prohibition is not applicable to solicitation of securities and exchange-traded derivative as the regulator and legislators believed that there is no potential threat to customer protection and sound orderly trading.¹¹⁰ However, it is questionable whether these exclusions are reasonable because the purpose of prohibiting unrequested investment solicitation includes the protection of customer's privacy and prevention of intrusions on his or her daily life.^{111 112} In addition, it is also questionable whether it is reasonable to treat derivatives-embedded securities and exchange-traded derivatives in the same manner as traditional securities. This provision sets the boundary of prohibited solicitation based on the types of financial investment product and not on the types of its services. Therefore, a prohibition on solicitation without request can apply even if the services to be provided are investment advisory or trust with respect to OTC derivatives.

Also, the activity of recommending an investment shall not be continued if the investor receiving the recommendation expresses his/her intention to decline. However, in the case of recommending investment in an insurance contract with investment risk, recommending re-investment, after a month has passed, is permissible.¹¹³

108. Capital Markets Act, *supra* note 1, art. 46(2); Capital Markets Act Enforcement Decree, *supra* note 21, art. 52-2(2).

109. Securities and Exchange Act, *supra* note 17, art. 52; Securities and Exchange Act Enforcement Decree, *supra* note 18, art. 36-3.

110. Capital Markets Act Enforcement Decree, *supra* note 21, art. 54(1).

111. Fin. Serv. Comm'n, *supra* note 74, at 29. Another view is that the purpose of this provision is to provide an opportunity for the investor to make its own decision. Wan-Suk Suh, *JaBonSiJangBeobSangUi GeumYungTuJaJa BoHo* [Protection of Financial Consumers under the Capital Market and Financial Investment Industry Act] 24(3) GIEOBBEOBYEONGU [BUS. L. REV.] 393, 405 (2010).

112. JAI YUN LIM, *JABONSIJANGBEOB* [CAPITAL MARKET LAW] 147 (2010); Lee, *supra* note 81, at 210 (also raising the question on the appropriateness of this provision); Soo Hyun Ahn, *(GaChing)JaBonSiJangTongHapBeobGwa SoBiJaBoHoBeobUi JeobJeom* [Consumer Protection in the Financial Investment Services and Newly Proposed Bill on Capital Market Consolidation Act], 7(2) JEUNGKWONBEOBYEONGU [KOREAN J. SEC. L.] 199, 240 (2006) (arguing that structurally complicated products shall not be marketed through unsolicited calls even if they do not fall within the term derivatives).

113. Capital Markets Act Enforcement Decree, *supra* note 21, art. 54(2).

(e) Establishment of Investment Solicitation Standards

A financial investment service company is required to prepare detailed standards and procedures with which its employees shall comply in making investment recommendations. It is also required to prepare differentiated standards and procedures for derivative products by reference to the types of investors, taking into consideration the investment purpose, status of property, experience in investment, etc., and announce it on its internet homepage.¹¹⁴ The Korea Financial Investment Association drafted the model form of the investment recommendation standards and most financial investment service companies adopted the same as their standards.¹¹⁵

3. *Introduction of Cooling-off*

An investor who entered into certain contracts specified in the Presidential Decree with a financial investment service company may cancel the contract within 7 days after receiving the contract documents.¹¹⁶ The current Presidential Decree specifies only non-discretionary investment advisory contract as such contract.¹¹⁷ This is intended to provide customers with the opportunity for more careful decision.

E. *Reinforcing Regulation of Insider Trading and Other Fraudulent Transactions*

1. *Overview*

Under the previous Securities and Exchange Act and Futures Trading Act, insider trading using non-public material information and price manipulation on securities and exchange-traded derivatives were strictly regulated. However, since two separate laws governed securities market and exchange-traded derivatives market, respectively, there was a loophole in regulating on unfair transactions which linked the two markets. Moreover,

114. Capital Markets Act, *supra* note 1, arts. 50(1) & 50(2).

115. There is a criticism on the result of the adopting the model form. "Many customers want to buy products that are far from those which would be appropriate to the relevant category of customers based on the investment information confirmation document prepared by the customers themselves. The ratio of buying products that do not fit his/her own category consists of 60% of the whole purchase. ... As long as they sign a document confirming to the effect that even though the customer knows the product does not fit, the customer buys the product based on his/her own decision," they are able to buy the products they want. Thus, they do not have motivation to fill out the investor information document correctly." (Author's translation of Jung-Sook Lee's remark.) Joon Park et al., *JwaDamHoe, JaBonSiJangBeob SiHaeng 1 JuNyeon HoeGoWa JeonMang* [Roundtable Talk, *One Year after Enactment of the Capital Markets Act - Retrospect and Prospect*], 40 BFL 6, 16 (2010).

116. Capital Markets Act, *supra* note 1, art. 59(2).

117. Capital Markets Act Enforcement Decree, *supra* note 21, art. 61(2).

due to the limited enumeration of securities which were subject to regulation, some type of financial products could be issued outside the scope of regulation. In addition OTC derivative transactions become more active. The Capital Markets Act has expanded the concept of securities substantially and started regulating OTC derivatives as financial investment product. As a result, there was a need to supplement the regulation on fraudulent transactions. The Capital Markets Act improved the regulations on fraudulent transactions related to multiple financial investment products and introduced a comprehensive anti-fraud provision to regulate fraudulent transactions which are difficult to regulate through traditional insider trading regulations and price manipulation regulation.

2. Introduction of General Anti-fraud Provisions

(a) Fraudulent Transactions

The previous Securities and Exchange Act prohibited two types of unlawful securities transactions: insider trading and price manipulation. In addition to provisions prohibiting these two types of unlawful transactions, the Capital Markets Act added a new provision prohibiting following fraudulent transactions as another type of unlawful transaction.¹¹⁸

(i) any of the following acts in connection with sale and purchase (including public offering and private placement) or other transactions of financial investment products:

- i. using any dishonest device, scheme, or artifice;
- ii. attempting to earn money or financial profit, by using a document containing a false description or statement of a material fact, or an omission of a description or statement of a material fact necessary for preventing others from being misled, or using any other description or statement; and
- iii. using a false market price for the purpose of inducing sale/purchase or any other transaction of financial investment products.

(ii) disseminating a rumor, using a deceptive scheme, or committing an act of violence or a threat of violence, for the purpose of sale/purchase or any other transaction of financial investment securities or for the purpose of changing the market price.

(b) Comparison with Previous Securities and Exchange Act

The previous Securities and Exchange Act also prohibited (i) disseminating a false price or rumor and use a deceptive scheme for the purpose of making undue profit; (ii) attempting to earn money or any financial profit by misleading others using a document containing a false description or statement of a material fact, or an omission of a material

118. Capital Markets Act, *supra* note 1, arts. 178(1) and 178(2).

fact.¹¹⁹ Some Korean scholars believed such provision in the previous Securities and Exchange Act could function as a general anti-fraud provision. The Korean Supreme Court also interpreted the meaning of “undue profit” under Article 188(4)(iv) of the previous Securities and Exchange Act broadly and thus, it could be expected for this provision to be applied broadly.¹²⁰ However, other scholars did not concur because the previous Securities and Exchange Act provisions did not embrace a broad scope of fraudulent activities and required a subjective element such as “the purpose of making undue profit”.¹²¹

In comparison with the previous Securities and Exchange Act, the Capital Markets Act, Article 178 (1)(ii) and (iii) and Article 178(2) expanded the scope of application by expanding (i) the object product from securities to all financial investment products, (ii) the applicable transaction to secondary market as well as primary market and (iii) the applicable type of activities to those that use dishonest device, scheme, or artifice.

(c) Issues

There could be some legal issues due to comprehensive prohibition. First, there could be some controversy as to whether it complies with the rule of clarity in providing for the elements of a criminal act. The question is, whether it is possible to draw a credible principle in interpreting and applying this provision and predicting the purpose of the provision. The Korean Constitutional Court viewed that if it is possible, it is not a violation of the principle of clarity because a judge may find the ordinary meaning of the contents by interpreting the text of the provision through supplemental value judgments.¹²²

The second issue is which provision shall apply in case where the activities which fall under acts regulated by the general anti-fraud provisions of Articles 178(1) and 178(2) also constitute acts which are specifically subject to criminal sanctions under another provision of the Capital Markets Act (e.g., insider trading, price manipulation, violation of public disclosure obligations, etc.). For example, in cases of misrepresentation regarding the purpose or the source of funds of acquiring shares in large shareholding report (5% report), there could be a problem on whether it is simply a misstatement in such report or a violation of anti-fraud provision.¹²³ If such

119. Securities and Exchange Act, *supra* note 17, art. 188(4).

120. Supreme Court [S. Ct.], 2002Do1696, July 22, 2002.

121. LIM, *supra* note 112, at 815.

122. Constitutional Court [Const. Ct.] 2001Hunba9, Oct. 25, 2001.

123. Under the previous Securities and Exchange Act, the Korean Supreme Court ruled that it is a violation of Article 188-4(4)(ii) of the previous Securities and Exchange Act where the reporter made a false statement in his 5% report that he purchased the shares with his own funds (actually shares were purchased with money borrowed) and that shares were purchased by several investors (actually all those shares were purchased by himself) Supreme Court [S. Ct.], 2003Do686, Nov. 14, 2003.

act can be penalized as a violation of Article 178 of the Capital Markets Act notwithstanding the express provision on such act, cases applying general anti-fraud provisions are likely to increase.¹²⁴ It appears that such a result is not consistent with the legislative intent to have an express separate provision in the Capital Markets Act for certain, specific acts. A similar issue may arise where an act is committed in a pattern categorically similar to illegal insider trading or market manipulations but does not constitute illegal insider trading or market manipulation as defined in the Capital Markets Act because one or more criteria is not met. Can the new general anti-fraud provisions catch such act?¹²⁵ The conclusion may vary depending on the factual circumstances.

3. *Prohibition of Cross-Market Manipulation*

Under the old laws, cash securities market was governed by the Securities and Exchange Act, while futures market was governed by Futures Trading Act, separately. The Securities and Exchange Act prohibited price manipulation of cash securities market for the purpose of earning profit in futures market. However, there was no clear provision regulating transactions in the opposite direction, i.e., price manipulation in futures market for the purpose of earning profit in cash securities market.

Also, as the issuance and transaction of derivatives-embedded securities have increased due to development of new financial instruments, the need for regulating price manipulation of underlying assets for the purpose of profiting in derivatives-embedded securities have increased.

The Capital Markets Act, reflecting these circumstances and developments, prohibited (i) price manipulation in either the securities or futures market to earn profit from the other market, (ii) price manipulation of either derivatives-embedded securities or the underlying securities for the purpose of making profit under the other securities.¹²⁶ With respect to this, recently, an issue arose as to whether and under what circumstances trading of shares which are underlying assets of an ELS would constitute price manipulation. This discussion is not only related to the scope of hedging activities of an ELS issuer, but also related to interpretation of specific text

124. Especially, because the maximum level of sentence for violation of general anti-fraud provisions is more severe than that for violation of each specific provision (ex: the provision regarding large shareholding report), it may be necessary to apply the general anti-fraud provision.

125. But see Inho Cho, *JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyulSang NaeBuJaGeoRae GyuJe GyuJeongE GwanHan SoGo* [A Comment on the Insider Trading Regulation Provisions in the Act on Capital Market and Investment Banking] 23(3) SANGSAPANRYEYONGU [COM. CASES REV.] 209 (2010) (taking the negative view).

126. Capital Markets Act, *supra* note 1, art. 176(4); Capital Markets Act Enforcement Decree, *supra* note 21, art. 207.

of the provision of the Capital Markets Act.¹²⁷

4. *Prohibition of Insider Trading*

The Capital Markets Act expanded the scope of insiders and quasi-insiders who are subject to the insider regulation provisions by adding such persons as companies affiliated to the issuer, their officers and employees, and persons who are negotiating with the issuer.¹²⁸ The Act also expanded the scope of securities insiders or quasi-insiders who are prohibited from trading by adding exchangeable bonds or depositary receipts issued by a third party and derivatives or derivative-embedded securities the underlying asset of which is solely the securities issued by the issuer.¹²⁹ Bonds other than equity linked bonds (e.g., convertible bonds) are not included in the scope of securities regulated by the insider trading provisions. The legislative intent of not including bonds is not clear. The Act should be changed so that bonds are also subject to the insider trading under the Capital Markets Act.¹³⁰

The Capital Markets Act also prohibits a person making a tender offer from using information on such tender offer in connection with the trading of securities (or other related securities) which is subject thereto.¹³¹ The Act also has a provision prohibiting a person who plans to purchase 10% or more of the total number of shares issued and outstanding for the purpose of participating in the issuer's management and a person who already holds such shares and plans to sell such shares from using the information on such purchase or sale in connection with the trading of the relevant shares (or other related securities).¹³² As the Act is not entirely clear on this point, it could become a controversial issue whether a person who plans to make a

127 . Lim, *supra* note 112, at 813; Seong Hye Hwal, *JaBonSiJangBeobSang BulGongJeongGeoRaeUi GyuJeHyeonHwangGwa GaeSeonBangHyang – JuGaYeonGyeJeungGwon (ELS) YeonGyeGeoRaeReul JungSimEuRo [A Study on the Cross-product Manipulation under the FSCMA - Focusing on the Equity-linked securities in Korea]*, 6(2) GEUMYUNGBEOBYEONGU [KOREAN J. FIN. L.] 48, 73-77 (2009); Soo Hyun Ahn, *JaBonSiJangBeob SiHaeng IHu BulGongJeongGeoRae GyuJeByeonHwaWa GwaJe [Change of Unfair Trading Regulation After Enforcement of the Capital Markets Act and Future Issues]*, 40 BFL 70, 80-81 (2010); Press Release, Fin. Serv. Comm'n, ELS BalHaeng Mit UnYeongGwanRyeon JeDo GaeSeon BangAn [Improvement Plan for ELS Issuance and Management] (Sept. 11, 2009), http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2009-09-11&sch3=2009-09-11&sword=&r_url=&menu=7210100&no=27299; Press Release, Korea Exchange, "JuGaYeonGyeJeungGwon (ELS) Hedge GeoRae Guideline" jejeong sihaeng [Issuance of "Equity Linked Securities Hedge Transaction Guidelines"] (Sept. 21, 2009), http://moc.krx.co.kr/m4/m4_2/JHPMOC04002_01.jsp?seq_cd=123&sch=all&gubun=&word=&cur_page=8.

128. Capital Markets Act, *supra* note 1, art. 174(1).

129. *Id.* arts. 174(1) & 172(1).

130. Ahn, *supra* note 127, at 73.

131. Capital Markets Act, *supra* note 1, art. 174(2).

132. *Id.* art. 174(3).

tender offer may purchase shares in the subject company on the market before making the tender offer.¹³³

F. *Regulation of OTC Derivatives*

1. *Background*

In December 2008, the Korean Financial Services Commission announced its policy statement to improve the monitoring system on derivatives market, reinforce investor protection system that fit each product's characteristics, prevent insolvency of financial institutions and system risks which may arise from derivatives transactions, and re-establish the supervisory functions on derivatives markets.¹³⁴ The Financial Services Commission viewed it was essential to establish an appropriate supervision system on derivatives market under the circumstance where, globally, the problem arising from non-performing subprime mortgage loans had spread to global financial market through securitization and credit derivative transaction, and domestically, a number of disputes arose on KIKO transactions and derivatives investment funds.

2. *Reinforcement of Investor Protection in OTC Derivatives Transactions*

By amendments to the Capital Markets Act, a few additional provisions were added in order to strengthen investor protection.

First, a listed company is treated as non-professional investors for the purpose of OTC derivatives transactions unless it otherwise agrees.¹³⁵

Second, as mentioned above, the Capital Markets Act requires a financial investment service company to comply with the appropriateness principle when it sells derivative products to non-professional investors without making any recommendation or solicitation to make an investment.¹³⁶

Third, a financial investment service company may enter into OTC derivatives with a non-professional investor only for hedging purpose as prescribed by the Presidential Decree of the Capital Markets Act and is

133. Ahn, *supra* note 127, at 74.

134. Press Release, Fin. Serv. Comm'n, PaSaengSangPum SiJang GamDogCheJe GaeSeonBangAn MaRyeon [Improvement Plan for Supervisory System of Derivatives Market] (Dec. 22, 2008), http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2008-12-22&sch3=2008-12-22&sword=&r_url=&menu=7210100&no=26960.

135. Capital Markets Act, *supra* note 1, art. 9 (5)(iv).

136. See *supra* part III.D.2.(c) in regard to the appropriateness principle.

required to confirm such purpose and keep related documents.^{137 138}

Fourth, the investment recommendation on derivatives cannot be entrusted to an agent.¹³⁹

Fifth, a financial investment service company is required to prepare differentiated standards and procedures for derivative products by reference to the types of investors, taking into consideration the investment purpose, status of property, experience in investment, etc.¹⁴⁰

3. Reinforcement of Internal Control on OTC Derivatives Business

The internal control system which a financial investment service company must establish was also reinforced. (i) A company which is engaged in dealing or brokerage/arranging business with respect to OTC derivatives, and (ii) a company which is engaged in dealing or brokerage/arranging business with respect to exchange-traded derivatives and has total assets of not less than 100 billion won must have one or more executive officer in charge of derivatives business.¹⁴¹ Each OTC transaction needs to be approved by said officer unless the transaction satisfies certain requirements prescribed by the Financial Services Commission.¹⁴²

4. Advance Review of OTC Derivatives Products

Experiencing global financial crisis, some legislators proposed the legislation of the advance review of OTC derivatives in December 2008. The proposed amendments passed the National Assembly on March 12, 2010, and are scheduled to come into effect on June 13, 2010. According to the amendments, except for those prescribed in the Presidential Decree, (i) OTC derivatives underlying asset of which is credit risk (a change in credit owing to a change in credit rating, bankruptcy, or debt restructuring of a party or a third party) or the risk on natural environmental or economic phenomenon and (ii) OTC derivatives to be sold to non-professional investors for the first

137. Capital Markets Act, *supra* note 1, art. 166(2).

138. Some KIKO transactions which were subject to disputes (*supra* note 98 and accompanying text) were overhedging transactions, i.e., the amount of the currency option exceeded the amount of the foreign currency exposure of the company involved. As the transactions were entered into before the Capital Markets Act took effect, the requirement that the transaction be entered into for hedging purpose was not applicable. Press Release, Fin. Serv. Comm'n, KIKO GeoRae HyeonHwang Mit DaeChaeg [Current Status of KIKO Transactions and Measures to be Taken] (Aug. 1, 2008), http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2008-08-01&sch3=2008-08-01&sword=&r_url=&menu=7210100&no=26732.

139. Capital Markets Act, *supra* note 1, art. 55(1).

140. *Id.* art. 50(1). *See supra* Part III.D.2.(e).

141. Capital Markets Act, *supra* note 1, art. 28(2); Capital Markets Act Enforcement Decree, *supra* note 21, art. 32-2(1).

142. Capital Markets Act, *supra* note 1, art. 166-2(1)(iv).

time required advance review by OTC Derivative Product Review Committee.¹⁴³ According to the draft amendment to the Capital Markets Act Enforcement Decree announced by the Financial Services Commission on April 9, 2010, such advance review is exempted if the information on underlying asset or the information on the price, interest rate and unit of underlying asset or index based thereon is publicly disclosed by a domestic or foreign securities or derivatives market or another market announced by the Financial Services Commission, or if satisfying the requirements as announced by the Financial Services Commission as having no potential threat to customer's protection.

The OTC Derivative Products Committee which is in charge of advance review of OTC derivatives will be established at the Korea Financial Investment Association. During the advance review, the OTC Derivative Products Committee must take into consideration the possibility of providing information about price change in the underlying asset in case of OTC derivative classified in (i) above. In case of OTC derivatives targeting non-institutional investors as classified in (ii) above, the risk hedging structure, the adequacy of explanatory materials to be distributed to the investors, the appropriateness of marketing plan including qualification and education of marketing personnel should be reviewed.¹⁴⁴ Other matters necessary to protect investors can also be considered. However, it is questionable whether it is necessary and desirable to review officially in advance the feasibility of the product based on evaluation of structure of the product or level of potential risk rather than the disclosure of such structure and risk. It is also more questionable whether it is necessary to officially review the feasibility of an OTC derivative product targeting professional investors on the ground that the information about price change in underlying assets is not announced officially by an exchange. Professional investors are prepared to assess and take risk on its own decision and thus it would not be necessary to guard the interest of such professional investor through an advance review.¹⁴⁵ Although it is a little bit premature to predict, depending on how to operate this advance review system, the development of OTC derivative products could be affected significantly by this advance screening requirement.

143. *Id.* art. 166-2(1)(vi).

144. *Id.* art. 288-2(4).

145. Kang, *supra* note 56, at 595 (supporting the advance review system to prevent abuse of highly speculative derivatives).

G. *Regulations of Cross-border Financial Investment Services*

1. *Declaration of Effects Test*

The Capital Markets Act made it clear that it adopted the effects test. Article 2 provides that the Act does apply when an activity performed outside Korea reaches its effect within Korea. There is no specific standards on which activities performed outside Korea has a domestic effect. The case that has domestic effect should be interpreted as the case where it has an effect on credibility and stability of domestic capital markets or on domestic investor protection.¹⁴⁶

2. *Regulation on Cross-border Dealing/Brokerage*

Under the Capital Markets Act, in order to engage in the dealing and brokerage business, a subsidiary, branch and business office must be established in Korea. Dealing and brokerage through direct contact with or by means of communication with Korean customers without having such an office in Korea is not permitted.¹⁴⁷ However, under certain circumstances, foreign dealer/broker with no subsidiary or branch offices in Korea can do business with Korean customers.

First, the Capital Markets Act has provisions on primary market activities. Where a Korean issuer makes a public offering or private placement and (i) a foreign dealer enters into an underwriting agreement with the Korean issuer within Korea in accordance with the criteria set by the Financial Services Commission and the act is approved by Financial Services Commission or (ii) if only the deliberation to determine the contents of the underwriting agreement is made within Korea and related documents are submitted to the Financial Services Commission beforehand, these activities are not regarded as doing financial investment service business in Korea.¹⁴⁸ In order to obtain approval mentioned in (i) above, foreign dealer must have been engaged in the business at least three years and have equity capital of not less than 50 billion won. Foreign dealers which participate in issuing bonds issued or guaranteed by the Korean government bond are assumed as qualifying (i) and (ii) above.¹⁴⁹

146. KIM & JUNG, *supra* note 36, at 597-98.

147. Capital Markets Act, *supra* note 1, arts. 11 & 12(2)(i).

148. *Id.* art. 7(6)(iii), Capital Markets Act Enforcement Decree, *supra* note 21, art. 7(3)(v). With regard to interpretation of this provision, an issue may arise as to whether marketing or recommendation activities to get mandate or due diligence about the issuer are also regarded as exempted activities. Joon Park et al., *supra* note 115, at 25.

149. GeumYungTuJaEobGyuJeong [Financial Investment Business Regulation], art. 1-5(2), Financial Services Commission Public Notice No. 2008-25, Aug. 4, 2008, last amended by Public

Second, the Capital Markets act has provision on secondary market activities. If a foreign dealer/broker conducts outside Korea (i) business activities with dealers/brokers licensed under the Capital Markets Act or (ii) receiving trade order from Korean residents without solicitation or advertisement, such activities are not regarded as financial investment service business in Korea.¹⁵⁰ Therefore, if a foreign dealer/broker is engaged in any solicitation for Korea investor (irrespective of whether institutional or professional investors or non-professional investors), it will be regarded as conducting business in Korea and if it is proceeded without license, it would be a violation of the Capital Markets Act which may be subject to criminal sanctions.¹⁵¹

3. *Regulations on Cross-border Investment Advisory Business and Discretionary Investment Management Business*

Unlike dealing or brokerage/arranging business, foreign investment advisors can conduct discretionary or non-discretionary investment advisory business for Korean residents, without having an office in Korea, by means of direct communications with Korean residents. Of course, even in this type of business operations, foreign investment advisors are required to complete registration with the Financial Services Commission. Failure to register could subject the foreign investment advisor to criminal sanctions.¹⁵²

The Capital Markets Act exempts certain cross-border investment advisory activities from such registration requirement. Providing discretionary or non-discretionary investment advisory services (i) outside Korea, (ii) without investment recommendation or advertisement, (iii) to the Korean government, the Bank of Korea, the Korea Investment Corporation or an entity designated by certain statutory pension fund or other financial commission, is not considered as conducting discretionary or non-discretionary investment advisory business.¹⁵³ Therefore, in order for a non-Korean investment advisor, whether discretionary or non-discretionary, to do business activities for Korean residents (whether corporations or individuals) without having an office in Korea, a registration with the Financial Services Commission is required even if it is operated on an unsolicited basis.

A non-Korean investment advisor which is duly registered with the

Notice No. 2011-4, January 18, 2011.

150. Capital Markets Act, *supra* note 1, art. 7(6)(iii); Capital Markets Act Enforcement Decree, *supra* note 21, art. 7(3)(vi).

151. Capital Markets Act, *supra* note 1, arts. 11 & 444(i).

152. *Id.* arts. 17 & 445(i).

153. *Id.* art. 7(6)(iii); Capital Markets Act Enforcement Decree, *supra* note 21, art. 7(3)(vii).

Financial Services Commission for its cross-border discretionary or non-discretionary investment advisory business with Korean residents is required to appoint a person in charge of liaison within Korea for protection of investors.¹⁵⁴ Banks, financial investment service companies, certain financial institutions, lawyers and accountants are qualified to be appointed as such person. Such a duly registered non-Korean investment advisor is also required to use an investment advisory contract or a discretionary investment contract with Korean residents which is governed by Korean law and which contains a clause that Korean courts have jurisdictions over the disputes under the contract.¹⁵⁵ Such a non-Korean investment advisor is required to establish appropriate standards and procedures that should be followed by its employees in order to prevent unsound business activities, periodically monitor and report it to the Financial Services Commission.¹⁵⁶ Non-Korean investment advisors are subject to these regulations because they do not have an office in Korea and therefore there is a concern for inadequate supervision and customer protection.

Duly registered non-Korean discretionary investment advisors conducting their business on a cross-border basis are subject to additional regulations. Korean resident customers to which such non-Korean investment advisors can provide discretionary investment advisory service are limited to the Korean government, local governments, the Bank of Korea, certain financial institutions such as banks, certain statutory financial agencies and institutions (such as the Korea Deposit Insurance Corporation, the Korea Investment Corporation, the Korea Exchange, the Korea Securities Depository) and certain statutory funds.¹⁵⁷ Moreover, such a non-Korean discretionary investment advisors are required to keep in custody with foreign depository institution designated by Korea Securities Depository foreign currency securities acquired as the discretionary investment assets for customers.¹⁵⁸ They are also required to send a discretionary investment report at least once a month to their customers in person or by mail or (if the customer agreed) by electronic mail.¹⁵⁹

154. Capital Markets Act, *supra* note 1, art. 100(2); Capital Markets Act Enforcement Regulation, *supra* note 21, art. 11.

155. Capital Markets Act, *supra* note 1, art. 100(3).

156. Capital Markets Act, *supra* note 1, arts. 100(4) and 100(5).

157. *Id.* art. 100(6); Capital Markets Act Enforcement Decree, *supra* note 21, art. 101(2).

158. Capital Markets Act, *supra* note 1, art. 100(7); Capital Markets Act Enforcement Decree, *supra* note 21, arts. 101(3) & 63(2).

159. Capital Markets Act Enforcement Decree, *supra* note 21, art. 101(4).

IV. CONCLUDING REMARKS

As the economy grows and the financial market and industry structure change in Korea, the necessity to review and revise financial laws and regulations has increased. Such revisions should be made with the objectives of maintaining market integrity and soundness, promoting fair competition among market participants, protecting customers, and to the extent the achievement of the foregoing is not hindered, promoting creativity. The Capital Market Act was timely enacted and is expected to achieve the above goals. The contents of the Capital Markets Act and potential issues relating thereto as discussed above can be summarized as follows:

A. It established a system which can regulate all financial investment products traded in capital markets and introduced regulations classifying financial investment services, financial investment products and investors based on functions. The Capital Markets Act applies to a broadly defined “financial investment products”, which consist of securities and derivatives. The term “securities” is newly defined and comprises investment contracts. By such new definitions, the scope of application of the Capital Markets Act has been much expanded when compared to the previous Securities and Exchange Act. Such change can make financial investment service companies to develop new products, however, at the same time legal uncertainties may arise due to the broad definition of financial investment products and securities.

B. It expanded the business scope of financial investment service companies and at the same time reinforced customer protection mechanisms. Financial investment service companies have more business opportunities under the Capital Markets Act than under the previous Securities and Exchange Act. As the financial products dealt with by financial investment service companies will become more diverse and complicated, the protection of customers will become more important. The new provisions of the Capital Markets Act to protect customers (such as the declaration of the basic duty of a financial investment service company, suitability and appropriateness principles and the duty of warn of and explain risks and the provisions relating to conflicts of interest) are appropriate. Nevertheless, it will be necessary to develop good industry practice to achieve the goals of these customer protection provisions.

C. It improved the structures for maintaining the market’s integrity by reinforcing regulations against unlawful transactions. The Capital Markets Act introduced general anti-fraud provisions so that a wider range of fraudulent transactions can be treated as unlawful. The Act also strengthened the market manipulation and insider trading provisions. The new general anti-fraud provisions is expected to work against new, unexpected type of

fraudulent acts which may arise as the financial market rapidly develops and financial products traded in the market become more diverse. However, due to the strict interpretation principle of criminal law, there may arise some controversies on the application of the general anti-fraud provisions.

D. It introduced new regulations on cross-border capital market transactions and business activities. As Korean financial market is heavily exposed to international investors, these new provisions will become more meaningful.

These contents of the Capital Markets Act are expected to be a foundation for the development of the Korean capital markets. Even though most of the provisions in the Capital Markets Act are self-sufficient by themselves or through supplementation of detailed provisions in the enforcement decree, the enforcement regulation or the regulations already issued by the Financial Services Commission, some provisions are subject to regulatory policy (e.g., license for financial investment business) or to interpretation of courts (e.g., application of general anti-fraud provisions). It is necessary to watch the policy and interpretation to figure out how the Capital Markets Act will work going forward.

REFERENCES

- Ahn, S. H. (2006). (GaChing) JaBonSiJangTongHapBeobGwa SoBiJaBoHoBeobUi JeobJeom [Consumer protection in the financial investment services and newly proposed bill on Capital Market Consolidation Act]. *JeungKwonBeobYeonGu [The Korean Journal of Securities Law]*, 7(2), 199-248.
- Ahn, S. H. (2008). GeumYungSoBoJa BoHoWa JaBOnSiJangBeobUi GwaJe [Meeting the demanding challenges in protecting the financial consumers by the Capital Market and Investment Service Provider Act]. *GiEobBeobYeonGu [Business Law Review]*, 22(4), 73-122.
- Ahn, S. H. (2010). JaBonSiJangBeob SiHaeng IHu BulGongJeongGeoRae GyuJeByeonHwaWa GwaJe [Change of unfair trading regulation after enforcement of the Capital Markets Act and future issues], *BFL*, 40, 70-88.
- Center for Financial Law, Seoul National University, (2002). *GeumYungSiJangHwanGyeongUi ByeonHwaE TtaReun GeumYungGwanGyeBeobRyulUi CheGeJeongBiE GwanHanYeonGu* [Research on Financial Law System Improvement Due to Changes in Financial Market Environment]. On file with author.
- Cho, I. (2010). JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyulSang NaeBuJaGeoRae GyuJe GyuJeongE GwanHan SoGo [A comment on the insider trading regulation provisions in the Act on Capital Market and Investment Banking]. *SangSaPanRyeYeonGu [Commercial Cases Review]*, 23(3), 209-235.
- Choi, W. (2006). JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul JejeongAnUi JuYoNaeYong Mit UiGyeonSuRyeom KeongGwa [Main contents and progress of the Financial Investment Services and Capital Markets Act]. *GeumYungBeobYeonGu [The Korean Journal of Financial Law]*, 3(1), 127-157.
- Constitutional Court [Const. Ct.] 2001Hunba9, Oct. 25, 2001.
- Financial Services Commission. (2008, April). “JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul SiHaengRyeong” JuYoSeolMyeongJaRyo [“Financial Investment Services and Capital Markets Act Enforcement Decree” Explanatory Material]. On file with author.
- Financial Services Commission. (2008, August 1). *KIKO GeoRae HyeonHwang Mit DaeChaeg [Current status of KIKO transactions and measures to be taken]* (Press Release). Retrieved from http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1

&sch1=subject&sch2=2008-08-01&sch3=2008-08-01&sword=&r_url=&menu=7210100&no=26732

Financial Services Commission. (2008, December 22). *PaSaengSangPum SiJang GamDogCheJe GaeSeonBangAn MaRyeon* [Improvement plan for supervisory system of derivatives market] (Press Release). Retrieved from http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2008-12-22&sch3=2008-12-22&sword=&r_url=&menu=7210100&no=26960

Financial Services Commission. (2009, March 9). *GeumYungTuJaEob InGaUi GiBonBangHyangGwa UnYongGyeHoeg* [The basic direction and management plan of financial investment service license] (Press Release). Retrieved from http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2009-03-09&sch3=2009-03-09&sword=&r_url=&menu=7210100&no=27081

Financial Services Commission. (2009, July 30). *2DanGye GeumYungTuJaEob InGaBangHyangGwa UnYongGyeHoeg* [The basic direction and management plan of financial investmetn service license – Second stage] (Press Release). Retrieved from http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2009-07-30&sch3=2009-07-30&sword=&r_url=&menu=7210100&no=27262

Financial Services Commission. (2009, September 11). *ELS BalHaeng Mit UnYeongGwanRyeon JeDo GaeSeon BangAn* [Improvement plan for ELS issuance and management] (Press Release). Retrieved from http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2009-09-11&sch3=2009-09-11&sword=&r_url=&menu=7210100&no=27299

Financial Services Commission. (2010, March 25). “*JeonJaDanGiJeungGwonDeungUi BalHaeng Mit YuTongE GwanHan BeobRyul*” (IHa ‘JeonJaDanGiSaChaeBeob’) *JeJeongAn ChaGwanHoeUi TongGwa* [The Darft “Act on Issuance and Distribution of Electronic Sshort Term Corporate Bonds (hereinafter ‘Electronic Short Term Corporate Bond Act’) passed vice-ministerial meeting] (Press Release). Retrieved from http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2010-03-25&sch3=2010-03-25&sword=&r_url=&menu=7210100&no=27514

Financial Services Commission. (2010, May 31). *HyangHu GeumYungTuJaEob InGaBangHyangGwa UnYongGyeHoeg* [Direction and operation plan of future financial investment service license] (Press Release). Retrieved from http://www.fsc.go.kr/info/ntc_news_view.jsp?

bbsid=BBS0030&page=1&sch1=subject&sch2=2010-05-31&sch3=2010-05-31&sword=&r_url=&menu=7210100&no=27612

- FINRA. (2010). *Proposed Rule Change to Adopt FINRA Rules 2090 (Know Your Customer) and 2111 (Suitability) in the Consolidated FINRA Rulebook* (Rule Filings no. SR-FINRA-2010-039). Retrieved from <http://www.finra.org/Industry/Regulation/RuleFilings/2010/P121836>
- GeumYungSilMyeongGeoRae Mit BiMilBoJangE GwanHan BeobRyul [Law Concerning Real Name Financial Transaction Law], Act No. 5493, Dec. 31, 1997, last amended by Act No. 10303, May 17, 2010.
- GeumYungTuJaEobGyuJeong [Financial Investment Business Regulation], Financial Services Commission Public Notice No. 2008-25, Aug. 4, 2008, last amended by Public Notice No. 2011-4, January 18, 2011.
- Ha, S. J. (2007). "JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul" Sang GeumYungTuJaSangPumUi GaeNyeom [The definition of the financial investment instrument under the Capital Market and Financial Investment Services Act]. *SangSaBeobYeonGu [Commercial Law Review]*, 26(2), 365-397.
- Han, K. J. (2006). JaBonSiJangTongHapBeob JeJeongBangAnGwa GeumYungGoGaeg BoHoJeDoUi SeonJinHwa [Draft Capital Market Consolidation Act and improvement of financial customer protection]. *BFL*, 18, 17-28.
- JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul [Financial Investment Services and Capital Markets Act], Act No. 8635, Aug. 3, 2007, last amended by Act No. 10361, June 8, 2010.
- JaBonSiJangGwa GeumYungTuJaEopE GwanHan BeobRyul SiHaengRyeong [Capital Markets Act Enforcement Decree], Presidential Decree No. 20947, Jul. 29, 2008, last amended by Presidential Decree No. 22637, Jan. 24, 2011.
- JaBonSiJangTongHapBeobYeonGuHoe [Capital Market Consolidation Act Research Group]. (2008). *Jabonsijangtonghapbeobhaeseolsoe* [Capital Market Consolidation Act Guidebook]. Seoul, Korea: HanGugJeungGwonEobHyeobHoe [Korea Securities Dealers Association].
- JeungGwonEobGamDokGyuJeong [Securities Business Supervisory Regulations], Financial Supervisory Commission Public Notice No. 2000-124, Dec. 29, 2000, last amended by Public Notice No.2008-11, Feb. 21, 2008.
- JeungGwonKeoRaeBeob [Securities and Exchange Act], Act No. 972, Apr. 1, 1962, last amended by Act No. 8985, Mar. 21, 2008.

- JeungGwonKeoRaeBeobSiHaengRyeong [Securities and Exchange Act Enforcement Decree], Presidential Decree No. 618, Apr. 1, 1962, last amended by Presidential Decree No. 20653, Feb. 29, 2008.
- Jung, S. (2005). Yugajeunggwon gaenyeome gwanhan ilgo pasaenggyeolhapsangpumeul jungSimEuRo [Comment on concept of securities - Focusing on derivatives-linked securities]. *JeungGwonSeonMul [KRX Review]*, 7, 3-20.
- Jung, S. (2008). GeumYungGyuJeBeobSang PoGwalGaeNyeom DoipUi GaneungSeongGwa TadangSeong JaBonSiJangTongHapBeobSang GeumYungTuJaSangPumUi GaeNeomEul JungSimEuRo [Definition of financial investment products from a legal perspective]. *BeobHak [Seoul Law Journal]*, 49(1) 281-314.
- Jung, S. (2010). GeumYungGyuJeGaeHyeogGwa GeumYungSoBiJa BoHo [Financial regulatory reform and consumer financial protection]. *SangSaPanRyeYeonGu [Commercial Cases Review]*, 23(2), 3-67.
- Kang, D.-S. (2010). GeumYungTuJaSangPum GaeNyeomUi PoGwalJuUiWa GiNeungByeol YeongEobHaengWi GyuJeUi GeomTo [Comprehensive definition of financial investment goods and functional regulation]. *BeobHakYeonGu [Law Review, College of Law & Institute of Law Studies, Pusan National University]*, 51(1), 585-619.
- Kim, B.-Y. (2006). GeumYungTuJaEobGwa JaBonSiJangE GwanHan BeobRyul (GaChing) Sang JeungGwon GaeNyeomE DaeHan GeomTo – TuJaGyeYak (investment contract) Gwa HyeonHaeng GanJeobTuJaJaSanUnYongEobBeobSang TuJaDaeSangEul JungSimEuRo [Review of comprehensiveness of concept of securities under the proposed bill on the Financial Investment Services and Capital Market Act]. *TuSin [Investment Trust]*, 57, 1-17.
- Kim, H.-K. (2007). PasaengSangPumGwa DoBakGyuJe [Derivatives and gaming regulations]. *BiGyoSaBeob [Journal of Comparative Private Law]*, 14(1), 531-562.
- Kim, K. S. (2003). GeumYungSiJangUi HwanGyeongByeonHwaWa GeumYungGyuJeUi TongHap [Changes in financial market environment and consolidation of financial regulation]. *JeungGwon [Securities]*, 117, 7-13.
- Kim, K. S., & Jung, S. (2004). GeumYungBeobTongHapJagEobUi ChuJinHyeonHwang [Current status of the financial law consolidation project]. *GeumYungYeonGu [Journal of Money and Finance]*, 18(Supplement), 103-121.
- Kim, K. S., & Jung, S. (2010). *JaBonSiJangBeob* [Capital market law] (2nd ed.). Seoul, Korea: DuSeongSa.

- Kim, Y. (2004). GaChing “TongHapGeumYungBeob” ChuJinE DaeHan BiPan - EunHaengUi TeukSuSeongGwa SiSeuTemGyuJeUi BunRi PilYoSeong [Some criticisms to the consolidation movement of financial laws in Korea — The special features of banks and systemic regulations]. *GeumYungBeobYeonGu [The Korean Journal of Financial Law]*, 1(1), 134-171.
- Korea Exchange. (2009, September 21). “JuGaYeonGyeJeungGwon(ELS) Hedge GeoRae Guideline” jejeong sihaeng [Issuance of “Equity Linked Securities Hedge Transaction Guidelines”] (Press Release). Retrieved from http://moc.krx.co.kr/m4/m4_2/JHPMOC04002_01.jsp?seq_cd=123&sch=all&gubun=&word=&cur_page=8
- Korean Securities Law Association. (2009). *Jabonsijangbeob (Juseokseo I, II)* [Capital market law (Annotation I, II)] Seoul, Korea: PakYoungSa.
- Lee, J., & Gu, B.-S. (2006). *JaBonSiJang GwanRyeonBeob TongHapE TtaReun GeumYungBeob TongHapUi GiBonBangHyangGwa JuYoGwaJe* [The new legislation on investment and its implications for the integration of financial services law]. Seoul, Korea: Korea Institute of Finance.
- Lee, J. (2009). “JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul” E DaeHan SoGo [A study on the Financial Investment Services and Capital Market Act] *BeobHakNonChong [Chonnam Law Review]*, 29(1), 195-217.
- Lim, J. Y. (2010). *Jabonsijangbeob* [Capital market law]. Seoul, Korea: PakYoungSa.
- Ministry of Finance and Economy et al., (2003, January 8). *2003 Neyon GyeongJeUnYongBangHyang* [Economy management direction in 2003]. Retrieved from http://www.mosf.go.kr/_policy/policy01/policy_search_new.jsp?boardType=general&hdnBulletRunno=&cvbnPath=&sub_category=&hdnFlag=&cat=&hdnDiv=&hdnSubject=2003%EB%85%84+%EA%B2%BD%EC%A0%9C%EC%9A%B4%EC%9A%A9%EB%B0%A9%ED%96%A5&&actionType=view&runno=38800&hdnTopicDate=2003-01-08&hdnPage=1
- Ministry of Finance and Economy. (2006, February 17). “GeumYungTuJaEobGwa JaBonSiJangE GwanHan BeobRyul (GaChing)” jejeong bangan [“Financial Investment Services and Capital Markets Act (tentative)” legislative plan]. Retrieved from http://www.fsc.go.kr/info/ntc_news_view.jsp?bbsid=BBS0030&page=1&sch1=subject&sch2=2006-02-20&sch3=2006-02-20&sword=&r_url=&menu=7210100&no=26129

- Ministry of Finance and Economy. (2006, December 28). “*JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul*” *SeolMyeongJaRyo* [“The Proposed Bill on Financial Investment Services and Capital Markets Act” explanatory material]. GwaCheon, Korea: Ministry of Finance and Economy, Republic of Korea.
- Park, J., Ko, C.H., Lee, J.-S., & Jung, S. (2010). Jwadamhoe, JaBonSiJangBeob SiHaeng 1 JuNyeon HoeGoWa JeonMang [Roundtable talk, One year after enactment of the Capital Markets Act - Retrospect and prospect]. *BFL*, 40, 6-27.
- SEC v. Glenn W Turner Enterprises Inc., 474 F.2d 476 (9th Cir. 1973).
- SEC v. W. J. Howey Co., 328 U.S. 293 (1946).
- Seong, H. H. (2009). JaBonSiJangBeobSang BulGongJeongGeoRaeUi GyuJeHyeonHwangGwa GaeSeonBangHyang – JuGaYeonGyeJeungGwon (ELS) YeonGyeGeoRaeReul JungSimEuRo [A study on the cross-product manipulation under the FSCMA - Focusing on the equity-linked securities in Korea]. *GeumYungBeobYeonGu [The Korean Journal of Financial Law]*, 6,(2), 48-84.
- Seoul Central District Court [Dist. Ct.], 2008Gahab108359, Feb. 8, 2009.
- Seoul High Court [Seoul High Ct.], 2009Ra997, August 21, 2009.
- Shim, I.-S. (2008). “JaBonSiJangGwa GeumYungTuJaEobE GwanHan BeobRyul” sang jangoepasaengsangpum gaenyeome daehan gochal [Defining “over-the-counter derivatives” for the purposes of the Capital Market and Financial Investment Business Act of Korea]. *SangSaBeobYeonGu [Commercial Law Review]*, 27(3), 265-319.
- Shin, B. S. (2010). Jabonsijangbeobsangui jinipgyuje hyunhwanggwa gaeseonbanghyang [Current status and improvement direction for entry regulation under the Capital Markets Act]. *BFL*, 40, 45-55.
- SinYongJeongBoUi IYong Mit BoHOE GwanHan BeobRyul [Law Concerning the Use and Protection of Credit Information], Act No. 4866, Jan. 5, 1995, last amended by Act No. 10228, Apr. 5, 2010.
- Suh, W.-S. (2010). JaBonSiJangBeobSangUi GeumYungTuJaJa BoHo [Protection of financial consumers under the Capital Market and Financial Investment Industry Act]. *GiEobBeobYeonGu [Business Law Review]*, 24(3), 393-426.
- Supreme Court [S. Ct.], 93Da26205, Jan. 11, 1994.
- Supreme Court [S. Ct.], 2000Da30943, Apr. 27, 2001.
- Supreme Court [S. Ct.], 2002Do1696, July 22, 2002.
- Supreme Court [S. Ct.], 2003Do686, Nov. 14, 2003.

Supreme Court [S. Ct.], 2005Da49799, June 29, 2006.

Supreme Court [S. Ct.], 2008Da52369, Nov. 11, 2010.

Supreme Court [S. Ct.], 2010Da55699, Nov. 11, 2010.

United Housing Foundation Inc. v. Forman, 421 U.S. 837 (1975).

Yoon, J.-M. (2010). IHaeSangChungBangJiReul WiHan NaeBuTongJeSiSeuTemE GwanHan YeonGu - JaBonSiJangBeobEul JungSimEuRo [Study on the internal control system to prevent conflicts of interest - Focused on the Capital Market Act]. *GiEobBeobYeonGu [Business Law Review]*, 24(3), 217-241.

韓國金融市場管制規範 的統合與改革

——評介金融投資服務與資本市場法

Joon Park

摘 要

韓國進行金融管制改革的方式是制訂新法：金融投資服務與資本市場法已於2009年2月4日生效。此一新法改善韓國資本市場管制規範的方法，是整合以往個別規制不同型態金融行業的多種法律，並同時嘗試促進其管制成效。本法建立了一套能夠規範資本市場中所有金融投資商品的體系，並且引入了以功能為判準，對金融投資服務、金融投資商品與投資者進行分類的管制方法。本法拓展了金融投資服務公司的營業範圍，並同時增強了投資者保障機制。藉由強化杜絕不法交易的管制規範，本法健全了維繫資本市場整全性所需的規範架構。本法同時也引入了針對跨國資本市場交易與商業活動的新管制規範。雖然本法引入的新概念引發了若干爭議，我們仍預計它將成為韓國資本市場發展的基礎。

關鍵詞： 韓國金融管制、資本市場管制、金融管制規範之整合、資本市場法、金融投資商品、功能導向之管制