

Capital Markets and Financial Investment Services Act of 2007: An Overview

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I. Introduction

On March 2006, the then Ministry of Finance and Economy of Korea (“MOFE”), now the Financial Services Commission, announced its intention to consolidate existing capital market-related laws into a single statute. The reform, said the MOFE, is to enhance the quality of capital markets and to promote the development of financial investment services in Korea. Korea was traditionally considered to be a bank-based system rather than a market-based system. One of the main purposes of the reform was said to make our capital circulation system more multiple. The *Capital Markets and Financial Investment Services Act 2007* (hereinafter the “CMFISA”), which passed the National Assembly on 13 June 2007, came into effect on February 4th, 2009.

II. Background of CMFISA

The CMFISA was enacted in an effort to revamp the capital market regulatory system based on product and institutional distinctions. Such an institution or product-based regulation was a creature of the days when sectoral differences in capital markets were clear enough to justify different regulatory approaches. Capital markets existing today are markedly different

* This memo is based on Kon Sik Kim & Sunseop Jung, *Consolidation of Financial Services Laws in Korea: An Interim Report* in REGULATORY REFORM IN THE AGE OF FINANCIAL CONSOLIDATION (Lee-Jay Cho & Joon-Kyung Kim eds., Korea Development Institute, 2006).

from the model presupposed by the traditional regulations. It was noted that the previous laws were deficient primarily in the following three respects: insufficient and inflexible key statutory definitions, regulatory inequality among financial sectors, and unsystematic vertical and horizontal distribution of regulatory measures. Truly, the CMFISA is not necessarily the only option to address these alleged defects. It is believed, however, to be a most ideal solution to these problems.

III. Scope and Structure of the CMFISA

1. Scope of the CMFISA

The applicability of the CMFISA is, in principle, dependent on two core concepts, **financial investment products** and **financial investment services**. “Financial investment products” involve the extent to which the areas of financial regulation should be covered in the CMFISA. “Financial investment services” are concerned with the scope of financial activities included in the CMFISA.

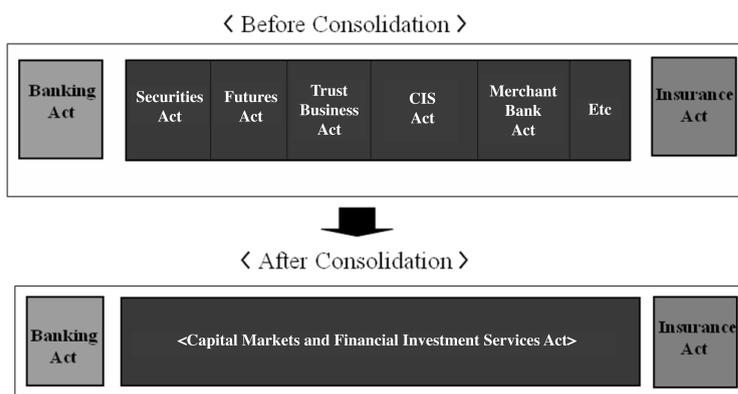
The CMFISA will cover all areas of capital markets and financial investment services including licensing, prudential regulation and non-prudential regulation of financial investment services providers. It will also cover market infrastructures such as exchanges, clearing and settlement facilities. The table below shows the acts to be incorporated into the CMFISA.

Acts Covered by the CMFISA

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1. Securities Transaction Act
 2. Futures Trading Act
 3. Trust Business Act
 4. Indirect Investment Asset Management Business Act
 5. Merchant Bank Act
 6. Korea Securities and Futures Exchange Act
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The scope of regulated activities covered by the CMFISA will be determined based on the three core concepts: financial investment products, financial investment services and classification of the investors. In principle,

the CMFISA applies to all financial investment services dealing with financial investment products. Financial investment products refer to products carrying out specific financial investment functions, while financial investment services cover dealing, brokerage, advising and other activities involving financial investment products. The CMFISA distinguishes between wholesale and retail investors. Several conduct of business regulations do not apply to the financial investment services with professional investors.



2. Structure of the CMFISA

The CMFISA consists of the following 10 parts.

| Part | Chapter | |
|--|-----------|--|
| Part 1 General Provisions | - | General Provisions |
| Part 2 Financial Investment Services | Chapter 1 | Authorization and registration |
| | Chapter 2 | Corporate governance |
| | Chapter 3 | Maintenance of Prudent Management |
| | Chapter 4 | Regulations on Conduct of Business |
| Part 3 Issuance and Distribution of Securities | Chapter 1 | Registration statement |
| | Chapter 2 | Corporate Merger and Acquisition |
| | Chapter 3 | Annual Report of Stock-listed Corporations |
| | Chapter 4 | Over-the-counter Transactions |

(continued)

| Part | Chapter | |
|---|-----------------------------|---|
| Part 4 Market Misconduct | Chapters 1~2 Chapter 3 | Insider trading, market manipulation Market misconduct |
| Part 5 Collective Investment Scheme | Chapters 1~10 Chapter 11 | Collective investment scheme Foreign Collective Investment Securitie |
| Part 6 Financial Investment Services-related Institutions | Chapters 1~8 | Financial investment services-related institutions |
| Part 7 Korea Exchange | Chapters 1~6 | Korea Exchange |
| Part 8 Supervision and Disciplinary Action | Chapters 1~4 | Enforcement |
| Part 9 Supplementary Provisions | - | |
| Part 10 Penal Provisions | - | Penalties |

IV. Financial Investment Products, Financial Investment Services, Investors

1. Financial Investment Products

1) Overview

The term “financial investment products” is a core concept for determining the coverage of the CMFISA. In defining the term “financial investment products,” the following two issues were considered: (1) comprehensive definition of financial products; and (2) consumer protection by minimizing the regulatory gap.

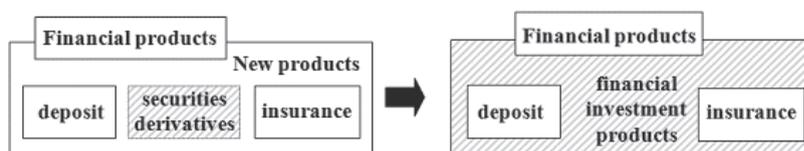
In principle, the new concept “financial investment products” covers all products regulated under the current capital market laws. If a certain instrument meets the requirements for “financial investment products,” it must in principle be regarded as such, regardless whether the law covering it

is in the jurisdiction of the MOFE.

2) *Financial investment products*

There are 4 elements in defining financial investment products: rights, purpose, investment factor, and money. Financial investment products are contractual rights. Its purpose should be to get profits or to avoid losses. There should be an investment factor which means potential loss of principal or potential liability of additional payment (contingent liability). This element may differentiate deposit and insurance products from financial investment products. Financial investment products involve the movement of money or money equivalent from one party to the other.

Financial investment products consist of securities and derivatives. Derivatives are classified into on-exchange derivatives and off-exchange (OTC) derivatives according to their trading place.



3) *Securities*

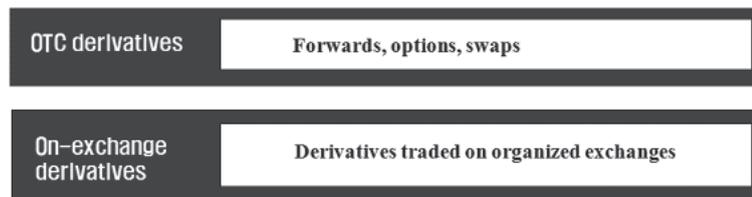
Securities are classified into 6 types, debt securities, equity securities, beneficiary certificates, securities deposit receipts, investment contract securities and derivatives-linked securities, according to the nature of rights embodied in the securities.

| | Definition | Example | |
|-------------------------|----------------------------------|------------------------|----------------------|
| Traditional Securities | Debt securities | Debt | Treasury bond, CP et |
| | Equity securities | Investment share | Stock etc |
| | Beneficial securities | Beneficial right | Investment trust etc |
| | Securities depository securities | Depository receipt | KDR, GDR, ADR etc |
| Investment Contract | Investment contract securities | Non-typical CIS etc | |
| Securitized Derivatives | Derivatives-linked securities | CLS, ELS, ELW, ILS etc | |

Debt security is a security indicating rights to claim a monetary obligation to the issuer. It includes government bonds, municipal bonds, special bonds,¹⁾ corporate bonds, commercial papers²⁾ and other similar securities. Equity security is a security indicating invested equity to the issuer. It covers stock certificates, instruments representing preemptive rights, certificates of contribution issued by a corporation established by statute, invested equity of limited partnership companies, limited liability companies, or undisclosed associations under the Commercial Act, invested equity of associations under the Civil Act and others similar securities. Beneficiary certificate means a security indicating beneficiary's interests in a trust structure. Investment contract security is modeled after the concept of invest contract in the US securities law. And derivative-linked security is a securitized derivative, whose returns are fixed according to a predetermined method based on changes in the price, interest rate, indicator, unit of underlying assets or index based thereon. Securities depository receipt is a facility indicating rights of deposited securities, which has been issued outside the country where such relevant securities were issued.

4) Derivatives

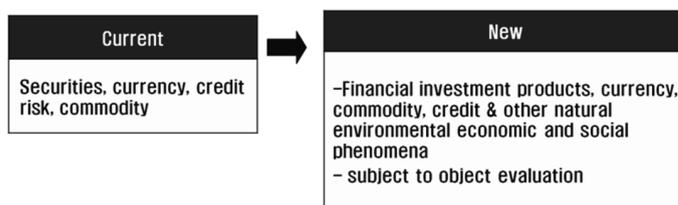
Derivatives are composed of forwards, options and swaps (§5(1)). The CMFISA classifies derivatives into exchange-traded derivatives and OTC derivatives. Exchange-traded derivatives are those traded on a derivatives markets or foreign derivatives markets. Over-the-counter derivatives are those which are traded on an organized exchanges.



1) Refers to bonds issued by a corporation established in accordance with a statute.

2) Refers to bills meeting the requirements prescribed by the *Presidential Decree* issued for the purpose of raising funds for businesses.

The CMFISA broadly defines the underlying assets of derivatives. Formerly, the STA listed only four types of underlying assets, including securities, currency, commodity and credit risk. However the CMFISA adds “other risks derived by natural, environmental, or economical phenomena, etc. whose price, interest rate, index, and unit can be calculated or assessed in a reasonable and appropriate method” to the list (§4(10)). This comprehensive definition is subject to only one condition that the underlying assets’ price, interest rate, index, and unit can be calculated or assessed in a reasonable and appropriate method. The financial regulator and the court can use the “reasonableness and appropriateness test” as a last resort to expel pure bets or gamings from the markets.



2. Financial Investment Services

The second element that is crucial in determining the applicability of the CMFISA is the concept of “financial investment services”. Under the CMFISA, “financial investment services” will serve as a core concept. In principle, all financial activities regulated under the previous capital market-related laws may be included in the definition of “financial services”. The term “financial investment services” may cover two sub-categories of services: one is services directly related to financial investment products; and, the other is services not directly related to financial investment products, but performs a financial investment function. The former may include dealing, brokerage or other transactions involving newly defined “financial investment products”. The latter may include the business of trust.

Under the CMFISA, “financial investment services” covers 6 investment businesses including dealing, brokerage, collective investment scheme service, non-discretionary investment advisory service, discretionary investment advisory service, and trust service (§6(1)). “Dealing” means a service, for its

own account regardless of the title, purchasing and selling financial investment products, issuing and underwriting securities, or soliciting an offer, offering, and accepting an offer thereof (§6(2)). “Brokerage” refers to a service, for other’s account regardless of the title thereof, purchasing and selling financial investment products, soliciting an offer, offering, and accepting an offer or such soliciting, offering and accepting as to issuance and underwriting of securities (§6(3)). The difference of these two services is who holds the economic risks and returns of the transaction. “Collective investment scheme service” is a collective investment management service (§6(4)). Collective investment is an activity to manage money, etc. raised by soliciting more than two investors in a way of acquiring, disposing of, or otherwise managing investment assets with property values without any ordinary direction from the investors or each fund manager, and to distribute the result thereof to the investors or each fund manager (§6(5)). The term “non-discretionary investment advisory service” shall mean a service provided upon request for advice on the value of financial investment products or the investment decision on the financial investment products (§6(6)). “Discretionary investment advisory service” is a service to acquire, dispose of, or otherwise manage financial investment products for each investor after the delegation from investors of all or a part of investment decisions on the financial investment products (§6(7)). The term “trust service” refers to a service carrying on a trust (§6(8)).

3. *Investors*

The CMFISA classifies the investors into professional and non-professional investors according to their risk-taking capacity. The term “professional investor” refers to “an investor who has risk-taking capacity over the investment taking into account its expertise for the financial investment products and its asset size” (§9(5)). Professional investors include the Government, the Bank of Korea, financial institutions, stock-listed corporations or others prescribed by the Presidential Decree. Non-professional investor means an investor who is not a professional investor (§9(6)). Several conduct of business regulation such as suitability and appropriateness rule (§§46 & 46-2) and the duty to explain (§47) do not apply to a financial investment transaction with professional investors.

So far, there has been no such approach in Korea except in the case of OTC derivatives. Presidential Decree for the Securities Transaction Act §84-28(2) limited the capacity of counterparties for OTC derivatives transactions of securities companies to a small group of wholesale investors. By concentrating regulatory resources on the retail, non-professional investors, the CMFISA tries to promote efficient use of scarce regulatory resources and to lower the overall level of regulation in capital markets. As a whole, this could be a momentum to convert investor protection by “prohibition of risky products” to investor protection by “isolation of non-professional clients from risky products”. This feature of the CMFISA may work to reduce apprehension on the comprehensive definition of financial investment product.

V. Investor Protection Regime

Investor protection is one of the main features of the CMFISA. With the comprehensive definition of financial products and expanded scope of investment businesses, there arises a concern on the potential market abuse and investors’ information asymmetry. The CMFISA enhanced the level of investor protection compared to the Securities Transaction Act.

In particular, the CMFISA adds Know your customer/suitability rule (§46), duty to provide product information (§47), prohibition of unsolicited call (§49(iii)) and financial promotion regulation (§57) to the current investor protection measures. In addition, the CMFISA also introduced the appropriateness rule (§46-2). Suitability rule means that a financial investment firm shall not solicit investment from non-professional investors where the solicitation is found to be unsuitable for the investors taking into account their investment objectives, financial status, investment experiences, etc. However, it should be noted that the suitability rule is applicable only if there exists a financial investment firm’s solicitation to a non-professional investor. If there exists no elements of solicitation, then the appropriateness rule will be applicable. Where a non-professional investor asks a financial investment firm to sell him risky products such as derivatives, the firm must check the appropriateness of the products to the investor.

In addition, a financial investment firm, when it intends to solicit investment from non-professional investors, must provide product

information such risks associated with the investment, and other details prescribed by the Presidential Decree in order to help the understanding of non-professional investors. If not, the financial investment firm shall be liable to non-professional investors for damages caused by such violation. The damages shall be presumed to be the amount calculated by deducting the total amount of money, etc. recovered or to be recovered by non-professional investors through the disposition of a financial investment product or any other method from the total amount of money, etc. paid or to be paid by the non-professional investors for acquiring the financial investment products.

VI. Conclusion

The CMFISA may have the following benefits. First, it is expected that the new Act will eliminate room for regulatory inequality without reasonable grounds. Second, the Act may address the insufficient regulatory definition of financial products with a comprehensive definition. It could significantly reduce concern about the tradability of a new financial product on the part of financial institutions, and provide adequate protection to those investing in new types of financial production. Third, it is also expected to eliminate room for regulatory inequality without reasonable grounds.